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Occupational Pension Schemes In Ireland:
Costs, Governance and Regulation


Thesis submitted in fulfilment of the requirements of a PhD Qualification.
The University of Dublin
Trinity College
March 2011.
DECLARATION:

I declare;

(a) This thesis has not previously been submitted as an exercise for a degree at Trinity College Dublin or any other University.

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SUMMARY

This thesis examines some of the key determinants other than investment strategy in the reported performance of Irish occupational pension schemes and the role that these determinants might play in any comprehensive set of proposals for reform of pension provision and coverage in Ireland. Specifically this thesis looks at the levels and transparency of fees and costs incurred by pension schemes, the subjectivity of actuarial assumptions upon which scheme liabilities are based and the expertise and training of and contribution by scheme trustees in the management of pension schemes. The thesis also examines Ireland's progress to date towards achieving secure, adequate and sustainable retirement income for all its pensioners and draws a comparison with reform measures being taken in the UK, where similar challenges in the area of retirement income provision are being experienced.

My research was based on legislation and regulatory pronouncements (both Irish and EU) applicable to the Irish pensions industry, on case law and on financial data from Irish pension schemes spanning the years 2002-2007. The schemes which provided data for the purposes of my research had an asset value of approximately €21.13bn or 24.4 per cent of total Irish pension fund assets at the end of 2007.

A summary of my research findings are as follows;

1. There is a lack of transparency, in total costs incurred by pension schemes, both on an annual basis and cumulatively over the lifetime of a scheme. Part of this gap is reflected in differing amounts of disclosed information within scheme financial statements which nonetheless comply with regulatory standards. Requirements for full and separate disclosure of costs in scheme financial statements would add to the informative value of the financial statements, which in turn could improve decision making by stakeholders and establish greater cost competitiveness within the fund management industry. By examining the "reduction in yield" (RIY) impact over the lifetime of a scheme, of pension fund costs, this research highlights the need for greater focus to be placed on cost efficiencies and competitiveness in future pension provision policy decisions. Even a small percentage reduction in costs per annum can have a significant impact over the lifetime of a fund.
2. There are advantages from a regulatory perspective and as a benchmark comparison, to a standardised valuation process such as the MFS (Minimum Funding Standard) valuation, which limits the subjectivity of the valuation result. The findings of this thesis also support the view of the Society of Actuaries that the MFS should be strengthened. Changes in actuarial assumptions can impact on the reported financial performance of a pension scheme and the subjectivity of certain actuarial assumptions facilitates "management" of the valuation result. Scheme trustees (if they are to carry out their role as trustees effectively), and regulators (to ensure good governance), have a responsibility to ensure that there is greater transparency in, understanding of and communication of, the actuarial assumptions used to value pension fund assets and liabilities.

3. Self regulation in the pensions industry and inadequate expertise on the part of trustees result in an inadequate level of appropriate governance of schemes. The inadequate training and expertise of trustees, which necessarily requires them to delegate significant areas of their trustee responsibilities to third party advisors, may lead to conflicts of interest resulting from information asymmetries, and ultimately leave trustees exposed to legal challenge by scheme members/beneficiaries if pension schemes fail to deliver on pension promises/expectations.

4. Ireland can learn from the UK experience both in terms of the positive aspects of UK reform (emphasis on reduced costs, greater coverage and more transparent governance) but also from the shortcomings and criticisms of the UK system (overlapping reforms resulting in multiple sources of retirement income, potentially cumbersome and inefficient systems and the potential for mis-selling in individualised pension arrangements). There is a window of opportunity to revisit proposals for Irish pension reform as set out in the National Pensions Framework and address the issues at present not addressed fully, so that when the proposals do come to be implemented, they will represent a more complete response to the fundamental concerns of adequate and sustainable pension provision in a cost efficient, transparent and properly regulated environment.
I would like to thank my supervisor Dr. Jim Stewart for his invaluable contributions and comments. Thanks also to my colleagues at NUI Maynooth, particularly my Department Head, Professor Rowena Pecchenino and Dr Tom O Connor. Finally I would like to thank my family, - my Mum, Tom, Jack Ben Mike and Alison.
# Table of Contents:

Pension Fund Performance (The Key Determinants) ............................................................... 13
1.1 Introduction ................................................................................................................. 13
1.2 Purpose of the Research ............................................................................................ 16
1.3 The role of “Costs” in efficient pension structures .................................................. 16
1.4 Complex regulatory and market structures – Necessary or ineffective and costly? .............................................................................................................. 19
1.4.1 Agency Issues .................................................................................................. 20
1.5 The role of actuarial assumptions in performance measurement ............................ 22
1.6 Pension Coverage in Ireland and other background Issues ................................. 24
1.7 Recent Irish Government initiatives towards pension reform in Ireland .................. 25
1.8 A UK Comparison ................................................................................................. 27
1.9 Structure of this thesis ............................................................................................ 29

CHAPTER 2 .................................................................................................................. 31
Research Methodology ........................................................................................................ 31
2.1 Data ......................................................................................................................... 31
2.2 Methodology .......................................................................................................... 35

CHAPTER 3 .................................................................................................................. 39
Literature Review ................................................................................................................. 39
3.1 The Role of Costs in Pension Fund Performance ................................................... 39
3.1.1 Policy Literature – costs................................................................................... 43
3.2 Understanding Actuarial Values ............................................................................. 44
3.3 The importance of education, professional qualifications and training, for trustees, in the governance of pension funds ........................................................................... 49
3.3.1 Agency Issues .................................................................................................. 50
3.4 Pension Reform in Europe ..................................................................................... 51
3.4.1 Replacement rates: ............................................................................................ 54

CHAPTER 4 .................................................................................................................. 56
The Role of Costs in Pension Fund Performance ............................................................... 56
4.1 The Visibility and Impact of Costs ......................................................................... 56
4.2 Regulations Relating to Fee Disclosure ................................................................... 75
4.3 Costs – An issue or not in dealing with pension provision into the future? .......... 81
4.4 The Active Vs Passive/Market Size Arguments .................................................... 84
4.5 Can the Irish market sustain a low cost fund management option? ....................... 85
4.6 Conclusion ............................................................................................................. 86

CHAPTER 5 .................................................................................................................. 88
The Actuarial Process: A Critique ...................................................................................... 88
5.1 Introduction ............................................................................................................. 88
5.2 The Role of the Actuary ......................................................................................... 88
5.3 The Actuarial Valuation Exercise .......................................................................... 90
5.4 Minimum Funding Standard requirement- “Discontinuance” or “Winding Up” valuation ........................................................................................................ 91
5.5 Valuation for the purposes of the Trustees Annual Report- “Ongoing Valuation” ........................................................................................................ 95
5.6 “The Accounting Approach” ............................................................................... 96
5.7 One question, three correct answers, or perhaps more? ..................................... 99
5.8 Conclusions ........................................................................................................ 113

CHAPTER 6 .................................................................................................................. 115
Trustees – Their Role in Pension Scheme Management ..................................................... 115
List of Figures

Figure 1.1: Long Term Interest rate History. 23

Figure 4.1: Disclosed fees as a per cent of fund value vs assumed actual fees of 2.2per cent of fund value. 61

Figure 4.2: Services Industry. Disclosed fees as a per cent of fund value vs assumed actual fees of 2.2per cent of fund value. 63

Figure 4.3: Retail Industry. Disclosed fees as a per cent of fund value vs assumed actual fees of 2.2per cent of fund value. 64

Figure 4.4: Manufacturing Industry. Disclosed fees as a per cent of fund value vs assumed actual fees of 2.2per cent of fund value. 65

Figure 4.5: Financial Services Industry. Disclosed fees as a per cent of fund value vs assumed actual fees of 2.2per cent of fund value. 66

Figure 4.6: Fees as a per cent of Fund Size; Parent (Financial Services) vs Parent (Non-Financial Services). 67

Figure 4.7: Scatter of Size of Fund (Ln) and Fees as a per cent of Fund Size 68

Figure 4.8: Fees as a per cent of Fund Size; Professional vs Non Professional Trustee. 69

Figure 4.9: Fees as a per cent of Fund Size; Defined Benefit vs Defined Contribution. 70

Figure 4.10: Income and Expenditure Account of Scheme A for the year ended 31 December 2002. 78

Figure 4.11:RIY Impact of annual costs of 2.2% on gross yield of 4.5%. 80
Figure 4.12: Income and Expenditure Account of Scheme A for the year ended 31 December 2002.

Figure 4.13: RIY impact on fund values - 2.2% vs. 0.3% annual costs, starting fund €20m.

Figure 4.14: Increase in Fund Value at starting value of €20m if costs are reduced from 2.2% to 0.3% of fund value

Figure 5.1: Impact of changes in assumed rate of pension increase on pension scheme liabilities.

Figure 5.2: Impact of changes in assumed rate of salary increase on pension scheme liabilities.

Figure 5.3: Impact of changes in assumed rate of inflation on pension scheme liabilities.

Figure 6.1: Number of trustees per scheme.

Figure 6.2: Does the Scheme use the services of a professional trustee?
List of Tables.

Table 1.1: Pension coverage in the State for employed persons aged 20 to 69 years, 2002-2008. 13

Table 1.2: Occupational Pension Scheme Membership. 15

Table 2.1: Profile of Survey Respondents: 32

Table 2.2:
Total Population of Pension Schemes at end 2007, as reported by the Pension Board Annual report 2007 32

Table 2.3:
Availability of the required information from financial statements of respondents. 34

Table 4.1:
Fees Disclosed as a percentage of fund size -Summary Statistics. 72

Table 4.2: Regression Estimates. 74

Table 4.3: Comparison of Fund Performance;
Active vs. Passive management – Scheme B. 85

Table 5.1: Comparison of the three valuation approaches to measuring pension fund performance. 100

Table 5.2: Comparative results under three valuation bases. 103
Table 5.3: Impact of assumption changes on the calculation of pension scheme liabilities.

Table 5.4: Scheme D – Impact of changes in assumed investment return of required funding contribution rate.

Table 5.5: Impact of Assumption changes on valuation result.

Table 6.1: Schedule of Complaints received by the Pensions Ombudsman.
**LIST OF ACRONYMS.**

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>A.F.C.</td>
<td>Actuarial Funding Certificate.</td>
</tr>
<tr>
<td>A.S.P.</td>
<td>Actuarial Statement of Practice.</td>
</tr>
<tr>
<td>D.B</td>
<td>Defined Benefit.</td>
</tr>
<tr>
<td>D.C.</td>
<td>Defined Contribution.</td>
</tr>
<tr>
<td>I.A.S</td>
<td>International Accounting Standard</td>
</tr>
<tr>
<td>IORP</td>
<td>Institution for Occupational Retirement Provision</td>
</tr>
<tr>
<td>M.F. S.</td>
<td>Minimum Funding Standard.</td>
</tr>
<tr>
<td>M.P.I</td>
<td>Managed Portfolio Internal Rate of Return.</td>
</tr>
<tr>
<td>R.I.Y</td>
<td>Reduction in Yield.</td>
</tr>
<tr>
<td>SORP</td>
<td>Statement of Recommended Practice.</td>
</tr>
<tr>
<td>T.E.R</td>
<td>Total Expenses Ratio.</td>
</tr>
<tr>
<td>V.I.F.</td>
<td>Variance Inflation Factor.</td>
</tr>
</tbody>
</table>
CHAPTER 1

Pension Fund Performance: (The Key Determinants).

1.1 Introduction

The pensions system in Ireland (in common with many other countries) has two main elements, - a State - run Social Welfare system and a system of private, voluntary, supplementary, pensions provided through a variety of arrangements and regulated by a State approved body. The majority of voluntary pension arrangements take the form of occupational pension schemes although there is a sizable minority of other individual private pension arrangements. Occupational pension schemes are privately managed pension schemes offered by employers to some or all employees as part of an overall remuneration package. These schemes are funded by contributions from the employer and also in many cases the employees. The main objective of the schemes is that the contributions, together with the return from the investment of the contributions, will provide a targeted level of replacement income on retirement to complement the employee’s social security pension. Other individual private pension arrangements consist essentially of Retirement Annuity Contracts (RACs) used by the self employed and Personal Retirement Savings Accounts (PRSAs) designed to suit the needs of employees in sectors where occupational pension schemes are not generally offered.

Currently over 50 per cent of Ireland’s working population have voluntary pension arrangements in place (Table 1.1.)

Table 1.1 – Supplementary Voluntary Pension coverage in the State for employed persons aged 20 to 69 years,

<table>
<thead>
<tr>
<th></th>
<th>Q1 2002</th>
<th>Q1 2004</th>
<th>Q1 2005</th>
<th>Q4 2005</th>
<th>Q1 2007</th>
<th>Q1 2008</th>
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<tr>
<td>State</td>
<td>52</td>
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<tr>
<td>Male</td>
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<td>55</td>
<td>58</td>
<td>55</td>
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</tr>
<tr>
<td>Female</td>
<td>45</td>
<td>47</td>
<td>48</td>
<td>51</td>
<td>50</td>
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Note; The statistics refer to all working persons, employed and self employed. The latest available data was up to Q1 2008.
For individuals who are employees, the vast majority of voluntary pension arrangements are either defined benefit (DB) or defined contribution (DC) schemes. A DB scheme is one where the pension on retirement is fixed in advance usually as a proportion of the member’s salary in their last year of service or based on an average of their annual earnings for the last three years of service. The contribution rate by the employer/employee is set at a level which is actuarially calculated to produce the targeted pension on retirement. In the event of a shortfall, the employer guarantees to make up the deficit so that the promised level of pension is met. A risk for the employee in a DB scheme is that the employer is financially unable or unwilling to honour this guarantee. Incidences of employers revoking pension promises under DB schemes have been rare in the past. However, the recent developments in the case of the Waterford Wedgeford Plc. and S.R. Technix Ltd, pension schemes\(^1\) may become more commonplace as the current global recession results in schemes with funding deficits of such magnitude that recovery can only be achieved in the medium to long-term. The solution to funding deficits may also require significant adjustments either in terms of the levels of benefit granted, the levels of contribution made or both.

DC schemes have been the traditional alternative to a DB scheme as described above. A DC scheme “defines” the contribution to be made by the employee and the employer rather than the benefit promised on retirement. The rate of contribution may be set depending on a number of possible factors – affordability, the maximum amount the employer is willing to commit, a level actuarially estimated to produce a targeted fund on retirement. These contributions are invested on behalf of each scheme member and the “accumulated fund”\(^2\) on the date of the member’s retirement is used to purchase an annuity. The retirement benefits for each member depend on the value of the annuity that the member’s “accumulated fund” at his/her retirement date can purchase and so it is not possible to know in advance what pension benefits the member will receive. In the case of a DC scheme, the commitment of the employer is limited to the annual employer contribution to the scheme. The “investment risk” (the risk that the contributions once invested will not grow to produce an adequate fund on retirement or will not grow as expected), is carried entirely by the employee. As can be seen from Table 1.2, the number of new schemes being established as DC schemes rather than DB

\(^1\)Waterford Wedgeford employees are currently in negotiations with the receiver of that company as to their entitlements under the Waterford Wedgeford pension scheme, which is reportedly in excess of €100m in deficit. The pension benefits of S. R Technix employees have also been significantly curtailed since that company closed down its operations in Ireland and refused to make good the pension scheme deficit.

\(^2\) The contributions increased by positive investment returns but reduced by investment losses and fees/expenses.
schemes rose between 1996 and 2008 as employers sought to limit their obligations under pension arrangements.

Table 1.2 Occupational Pension Scheme Membership.

<table>
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<tbody>
<tr>
<td>31/12/1996</td>
<td>2,290 schemes</td>
<td>412,641 members</td>
<td>48,261 schemes</td>
<td>88,759 members</td>
</tr>
<tr>
<td>31/12/2001</td>
<td>1,956 schemes</td>
<td>455,627 members</td>
<td>95,975 schemes</td>
<td>214,871 members</td>
</tr>
<tr>
<td>31/12/2005</td>
<td>1,478 schemes</td>
<td>499,885 members</td>
<td>88,841 schemes</td>
<td>234,814 members</td>
</tr>
<tr>
<td>31/12/2006</td>
<td>1,411 schemes</td>
<td>522,645 members</td>
<td>92,075 schemes</td>
<td>255,008 members</td>
</tr>
<tr>
<td>31/12/2007</td>
<td>1,319 schemes</td>
<td>530,933 members</td>
<td>98,483 schemes</td>
<td>269,465 members</td>
</tr>
<tr>
<td>31/12/2008</td>
<td>1,271 schemes</td>
<td>579,922 members</td>
<td>90,424 schemes</td>
<td>272,197 members</td>
</tr>
</tbody>
</table>


Ultimately, the objective of any pension arrangement is that it meets its targeted pension liabilities as they fall due. At any particular point in the life of a pension scheme, its ability to meet its targeted pension liabilities can, (and is required by regulation to) be assessed, although this can only be a best estimate given uncertainty about the future. This “valuation” process is discussed in more detail in chapter 5. Although the assets in which the scheme’s contributions have been invested, the investment strategy of the scheme, is an important factor in the valuation process and attracts most comment in any discussion on pension fund performance, it is not the only determinant of the reported performance of occupational pension schemes. The focus of this thesis is on the key determinants other than investment strategy in the reported performance of Irish occupational pension schemes and the role that these determinants should play in any comprehensive set of proposals for reform of pension provision and coverage in Ireland. In particular this thesis focuses on the levels of costs incurred by funded pension schemes and on the regulatory framework and Governance structures within which pension schemes operate. It is a stated objective of the Government and the Pensions Regulatory body (The Pensions Board) that at least 70 per cent of the working-population over 30 should have a supplementary pension. This thesis seeks to demonstrate that in the absence of full mandatory pension provision requirements, reform in both the areas of costs and regulation is necessary, as a precondition to achieve this level of coverage.
1.2 Purpose of the Research.

This research was undertaken for the following reasons:

1. To demonstrate the impact of costs on pension fund performance, the positive impact that efficiencies in costs can have on pension fund values and adequacy of cover, and how improved information on charging structures could establish greater cost competitiveness within the fund management industry.

2. To demonstrate the importance of actuarial assumptions in the valuation of pension fund liabilities and how changes in actuarial assumptions can impact on the reported financial health of a pension scheme. The importance to scheme trustees (if they are to carry out their role as trustees effectively), and regulators (for good governance), of greater transparency in and understanding of, the actuarial assumptions used to value pension fund assets and liabilities, becomes evident.

3. To examine the role of trustees in pension scheme management. In particular this research seeks to demonstrate that given the degree of responsibility which falls on scheme trustees (either as a result of specific legislation or directed by case law), inadequate training and expertise of trustees, and over delegation by them of their trustee duties results in an inadequate level of real governance of schemes. This in turn potentially leaves trustees exposed to legal action where pension schemes fail to deliver on pension promises or expectations.

1.3. The role of “Costs” in efficient pension structures.

Between November 2005 and January 2006, both the Irish and UK Governments produced key reports on pension provision (UK Pensions Commission (2004) and (2005) and The Pensions Board (2006a, 2006b and 2006c). These reports analysed the existing pension system in each jurisdiction and set out various strategic objectives and how they might be achieved. The reports were followed up in the UK by the UK Pensions Act, 2008, which gave effect to many of the recommendations of the UK Pensions Commission while in Ireland there was more piecemeal legislation introduced, dealing with discreet aspects of the Irish pension system. There is a wealth of detail and information in both the Irish and UK reports. A review
however of the main recommendations of each report and provisions of subsequent legislation, whilst highlighting the common features between the two jurisdictions, suggests some fundamental differences in emphasis in the Irish and UK approaches. These differences are of concern in the Irish context. For example, there are no proposals in the Irish reports referred to or Irish legislation enacted, designed to improve and promote efficiency and effectiveness of the structures charged with managing Irish pension plans (through for example cost reductions and increased disclosure requirements). Instead, the Irish focus is on increasing coverage, through soft mandatory provisions, increasing tax relief on pension contributions for certain categories of tax payer and the lessening of the administrative burden at the initial point of sale.

The Irish Government (2007a) in its Green Paper on Pensions (thereafter referred to as the Green Paper (2007a)) raises some concerns around cost structures relating to private pension arrangements and the difficulties posed by the lack of transparency surrounding them. It states;

“Previous reviews and reports on pension coverage undertaken by the Pensions Board have concentrated on macro issues related to increasing pension coverage and none specifically attempted to quantify the level and impact of charges levied on different types of funded supplementary pension arrangements” (Green Paper (2007a), para. 12.77)

In relation to individual private pension arrangements such as PRSAs, and retirement annuities, there is a statutory requirement to disclose to the relevant individual at the point of sale, the contract charges and any associated sales commission. PRSAs are also subject to statutory control in terms of the type and quantum of explicit charges which can be made to a PRSA contract. However overall charges made to other forms of funded supplementary pension arrangements, (which are in the majority), are not currently subject to any form of statutory control.

This means that;

“ Apart from PRSAs, there is no readily available central source of information on the level of explicit third party charges made to funded supplementary pension arrangements for various services” (Green Paper (2007a), para. 12.76)
The Green Paper (2007a) distinguishes between “explicit” charges (which should be disclosed and entirely visible) and “implicit” costs (which may not be directly visible and reduce the investment return provided to a scheme or increase the wholesale cost of a product or service, before other explicit charges are added) but notes that there is a further layer of ambiguity around charges made for “bundled” services and products such as life assurance products.

Even where such charges are explicit there is no clarity around how much is being charged for each of the bundled services being provided, e.g. how much of the charge relates to: set up costs, ongoing administration, compliance costs, investment management costs etc. (Green Paper (2007a), para. 12.96)

The absence of such information means that, as the Green Paper (2007a) states (para.12.120), it is impossible to know: whether charges represent value for money; if charges have been increasing or decreasing through time; which particular charges are material and which are not; and what initiatives, if any, could be undertaken to significantly reduce such charges.

When considered in the context of the responsibilities of trustees to the pension scheme (as discussed in Chapter 6), the absence of such information means;

1. It is not possible to accurately estimate levels of pension contribution required to achieve a target pension level if a reliable estimate cannot be made of the impact of both implicit and explicit costs on total costs including the effect of administrative charges on contributions invested and on returns;

2. It is not possible to make a rational choice between different pension products and different methods of pension provision, for example individual versus collective, pay as you go versus funding, State provision versus private sector provision.

3. In effect, it is not possible for trustees to comprehensively perform their statutory duty in the absence of such information. (This issue is analysed further in chapter 6);

Research on the investment performance and strategies of Irish pension schemes, identified some other factors that influence pension adequacy on a national level (Mc Nally, 2003).

Some of these factors such as costs, cost structures and value for money, are either ignored or unexplored in the Irish debate on pension policy and retirement income provision in the future (see section 1.7 below). Any comprehensive set of proposals on pension provision into the future should involve a critical analysis of the variables affecting the efficiency and effectiveness of current pension arrangements, in terms of the governance objectives for pension schemes, coverage, regulators’ aspirations and the role of trustees. It is not appropriate that any such set of proposals while aimed at increasing pension contributions and
coverage, should ignore almost entirely what happens to the contributions once they are paid into the scheme by the member or sponsoring employer – what charges and fees have been made against the contributions and whether such charges and fees represent value for money in terms of the service provided. In the absence of full mandatory provisions forcing individuals to contribute to a pension arrangement, it is inconceivable (particularly in times of recession) that the Pensions Board could achieve it’s targeted 70 per cent coverage rate for the over 30 working population, notwithstanding considerable tax incentives, while the perceived problems of poor value for money and pension security remain unaddressed (employees will choose to opt out of or not join a non – mandatory scheme if it is unaffordable and/or does not represent value for money). Tax incentives, no matter how valuable have reduced effect if they are eroded by increasing costs. A critical analysis of the existing system including pension structures, (for example, who carries what risk and what responsibilities and to whom and how are they accountable), and value for money issues such as cost structures and inefficient market structures, is necessary as a first step to introducing reform measures to address public concern in these areas. Increasing the transparency of the full range of pension scheme costs is a necessary part of any such critical analysis (This is discussed further in chapter 4).

1.4. Complex regulatory and market structures – Necessary or ineffective and costly?

Occupational pension schemes in Ireland are organised in the legal form of a trust. Accordingly, they are primarily governed by Trust law. However this is supplemented in particular by the Pensions Act 1990, and supplementary legislation including, the Pensions Amendment Act, 1996. In addition, occupational pension schemes are subject to employment law, tax law, insurance law, social welfare law and more recently family law (See Appendix 1). The priority of pension legislation is to ensure that trustees run pension schemes in the best interest of the scheme members. As discussed in Chapter 6, while the legislation in this area is consistent with ensuring that members’ interests are not damaged by gross incompetence or mismanagement by the trust, this does not necessarily mean the trust is run as efficiently as it could or should be. For example, there is no specific legal requirement for trustees to have any particular level of expertise in investment matters, only that they obtain “proper advice”. As a result, trustees may consider that they can discharge their responsibilities by outsourcing fully key areas of their responsibilities such as the investment decision – making aspects, notwithstanding case law rulings to the effect that trustees cannot fully delegate their trustee responsibilities. This can lead to inefficiencies and as discussed in
Chapter 6, may ultimately leave trustees exposed to legal challenge by scheme beneficiaries and or the regulator if schemes fail to deliver on pension promises or expectations. As Kennedy (2010) points out

“Scheme trustees are obliged under law to invest scheme assets in a manner appropriate having regard to the nature and duration of the expected liabilities of the scheme. There is also a well established obligation under trust law to invest reasonably and prudently. The data available to the Board raises considerable doubts as to whether the current investment strategy for many schemes fulfils these requirements. The great majority of trustees of defined benefit schemes rely on professional advice; It has to be asked whether the advice takes sufficient account of the nature of the liabilities of schemes and the consequences of the risks taken.”

Pension provision in Ireland forms a major source of income for many firms in the financial services sector, including firms in the fund management sector, the insurance sector and the actuarial, accounting and legal professions. This income can take many forms including – fee income, consultancy fees, management charges, commissions and transaction charges. The wide variety of charging structures is partly due to the investing structures through which pension schemes operate (see Appendix 1) and partly due also to trustees lack of expertise particularly in investment matters, which results in them using the services of a variety of investment/pension consultants. The difficulty with having a variety of institutional arrangements and advisors is that in such situations, no one may have a clear mandate for taking decisive action or changing direction. This may result in conflicts of interest and agency issues (see below) with the result that there may be a less than sensible or effective overall approach to key decision-making. The use of one external professional specialist can result in conflicts of interest - the use of several compounds this issue. Increased costs must also be a concern.

1.4.1 Agency Issues

Scheme members rely on trustees for assurance that their pension interests are being protected. Trustees use the services of advisors (scheme actuaries, fund advisors, fund administrators, investment managers etc) to discharge their responsibilities to the pension scheme. These advisors are often employed by firms who may provide more than one service to scheme trustees and/or may also provide services to the sponsoring employer. For example,
an investment services firm may provide investment advice, custodian services and professional trustee services to the scheme and may provide separate investment services to the sponsoring employer. The scheme actuary in addition to providing actuarial services to the scheme trustees may also provide services in relation to contribution levels, and the scheme valuation, to the sponsoring employer. This gives rise to potential conflicts of interest as discussed further in Chapter 5. There is an ongoing risk for many schemes that stakeholders (scheme members, employers, trustees) place undue reliance on others to deliver on pension promises. Where there are information asymmetries, for example where stakeholders are not adequately informed of the variables affecting delivery of pension promises and/or do not have the appropriate knowledge or understanding to ask the necessary questions, a variety of agency issues can arise. Agency issues arise when the interests of one party (e.g. the principal) do not coincide with the interests of the other party (the agent). This is discussed in more detail in Chapter 3. In the pensions industry agency issues arise not only in the context of the principal/agent relationship existing between the scheme trustees and the investment advisor/fund manager/professional trustee, but also in the context of the relationships which exist between the scheme actuary and the scheme trustees and the scheme actuary and the sponsoring employer. These agency issues include:

1. Self interested behaviour by pension providers, which may not be transparent to pension beneficiaries, for example, recommending a high equity strategy for a mature fund which would give rise to larger fees than a less risky portfolio consisting of Government bonds and cash. The Society of Actuaries in its submission to the consultative process on the Green Paper (2007a) notes that the current regulatory system in Ireland\(^3\) creates incentives to rely on (hoped for) out-performance of equities to repair funding deficits, in situations where a high equity strategy might not be appropriate from a risk perspective. (Society of Actuaries in Ireland (2008d p.4-3).

2. Conflicts of interest may arise between pension experts acting for pension providers and also providing information to scheme members. For example, the scheme actuary will have obligations towards both the sponsoring employer and the scheme members in terms of giving an opinion on the adequacy or otherwise of employer contributions. Another important example is that of the professional investment consulting firm which may provide investment advice, and actuarial services to a scheme and also act as a trustee to the scheme. While different divisions within the firm may provide

\(^3\) The Irish Pensions Industry is largely self-regulated. The Pensions Board, which is the pensions regulatory authority, while under the auspices of the Department of Social Protections, is part financed by subscription fees from pension scheme members and staffed by experts from within the pensions industry.
these differing services, there are nonetheless significant conflicts of interests to be managed.

3. Considerable information asymmetries may arise between pension providers and pension scheme members, for example in relation to the reporting of total costs as discussed in Chapter 4.

Agency issues in the pensions industry are compounded where there is poor regulation and where trustees (who are ultimately responsible for the management of the pension scheme) have inadequate expertise or lack the independence and authority to recognise and deal within an appropriate framework, with the agency issues that arise. The consequences can range from minor inefficiencies to more serious mis-management and financial loss for both scheme contributors and beneficiaries.

1.5. The role of actuarial assumptions in performance measurement.

Most observers of pension fund performance focus on how assets have performed and in what direction markets are moving. However while markets and investment returns affect the asset side of pension fund balance sheets, the overall performance of a pension fund for a specific time period is a function of both its assets and its liabilities. The liabilities of a pension fund are monetary amounts to be paid at various times in the future. These are estimated by actuaries in present day terms using discount rates based on long term government bonds (Pension Board requirement) or corporate debt (a financial reporting requirement – International Accounting Standard (IAS) 19). This is discussed further in chapter 5. Accordingly, as these rates change, the value today (present value) of future pension payments also changes. If rates fall, the present value of future benefit payments rises and vice versa.

Part of the difficulty encountered by pension funds in recent years is due to the fact that long term interest rates have fallen to historically low levels in nominal terms (Figure 1.1).
Thus, while the value of global stock markets has also fallen reducing the value of pension fund assets, there has been no corresponding reduction in the value of long-term liabilities because of the low levels of long-term interest rates. Indeed in general long-term liabilities have increased because of a combination of low long-term interest rates and increasing longevity (Stewart 2005). In addition, the cost to pension funds of purchasing life annuities for retiring members has also risen due to falling long-term interest rates. The assessment of pension fund liabilities is a complex exercise and little understood outside the actuarial profession. The actuarial exercise can involve several subjective assumptions and the valuation of pension liabilities can be significantly affected by marginal changes in some of these assumptions for example in relation to longevity, and future stock market performance. This raises the need for far greater transparency in relation to the key actuarial assumptions used in the valuation exercise, and the sensitivity of the overall scheme valuation to changes in these assumptions. There is necessarily a degree of subjectivity in preparing actuarial reports. The difficulty is that if trustees in particular do not have a certain level of knowledge of the variables that can change a valuation, they cannot satisfy themselves as to the reliability of the valuation outside of the fact that it was signed off by a professional actuary. Furthermore they cannot be prepared for, or be in a position to explain to scheme members, changes either positive or negative to valuation estimates and the overall scheme surplus or (more likely in recent years) actuarial deficit. Since actuarial valuations are required by regulation to take place only every three years, between valuation dates (i.e. during the intervening three year period), trustees may focus on investment performance as perhaps the
sole indicator of the performance of the scheme. The sensitivity of the actuarial valuation to changes in other key variables in the valuation process needs to be communicated to trustees (who in turn must communicate effectively to scheme members), and sponsoring employers. Increased transparency in this area might in turn result in calls for less subjectivity and more rigour in the actuarial approach. This issue is considered in detail in chapter 5.

1.6. Pension Coverage in Ireland and other background Issues.

Pension coverage rates have remained relatively static over the last five to seven years varying between 52 per cent and 55 per cent for the entire population of employed persons between 20 and 69 years old (See Table 1.1). Overall coverage rates increased by just 2 per cent in the period from the first quarter of 2002 to the first quarter of 2008 and showed a 1 per cent decline in male coverage and a 5 per cent increase in female coverage.

It is estimated that at the end of 2005, 2006, 2007 and 2008, total assets of Irish pension funds amounted to €77.9bn, €87.7bn, €86.6bn and €63.5bn respectively (Green Paper (2007a), para. 12.9 and Irish Association of Pension Funds (IAPF) 2002-2008). The proportion of these assets managed on behalf of DC schemes increased from 14 per cent at end 2006 to 20 per cent at end 2007 and 34 per cent at end 2008. Approximately 4 per cent were managed on behalf of Additional Voluntary Contribution arrangements and this remained relatively static over the four year period (IAPF 2002-2008). The remaining proportion (approximately 80 per cent at end 2006 falling to approximately 60 per cent by end 2008) was managed on behalf of DB schemes. This represents a growing increase in DC scheme assets under management.

As at December 2007 (the final year included in this study), there were 99,802 pension schemes registered with the Irish Pension Board with a total membership of 800,398. Of this, 269,465 individuals were members of defined contribution schemes while there were 530,933 members of defined benefit schemes. As mentioned above, the trend however is towards defined contribution schemes, with a significant number of one-member schemes being registered (Table 1.2).

The Government encourages and promotes membership of occupational and personal pension schemes through favourable tax treatment (see Appendix 2). Contributions by both employees and sponsoring employers are tax deductible subject to certain limits and conditions. Investment returns on contributions are also exempt from taxation when earned by the scheme and while retirement income drawn down from such schemes is taxed under normal tax rules
there are provisions for substantial lump sums to be drawn down tax free at the point of retirement. This deferral of taxation and the promise of a tax-free lump sum on retirement provide a considerable tax incentive for pension provision, depending on personal circumstances.

1.7. Recent Irish Government initiatives towards pension reform in Ireland.

The Green Paper (2007a) was published as part of a commitment in the social partnership agreement "Towards 2016" and is reflected in the commitments of the Government in relation to pensions as set down in the Programme for Government (2007-2012)⁴ (Irish Government 2007b). The Green Paper builds on earlier reports from the Pensions Board (2006a, 2006b and 2006c). It is useful to consider the recommendations and analysis in these earlier reports. The Pensions Board (2006a) was commissioned by the Minister for Social and Family Affairs under the terms of the Pensions Act 1990 and published in January 2006. The review was undertaken by the Pensions Board⁵ and the directive of the Minister was to undertake a full review of pension coverage and associated issues without delay.

The Pensions Board (2006a), recognised the pension challenges facing the State, in terms of pension coverage and adequacy of cover;

"The Board is very conscious of the importance of retirement provision for the welfare and quality of life of the people of Ireland. It must always be remembered that adequate retirement provision has an enormous personal impact on individuals. Ireland is currently faced with the prospect of almost half of the workforce retiring with no provision to replace their income with anything other than Social Welfare pensions. In many cases this would have serious consequences in terms of the quality of life of those individuals. Retirement provision will also have a major impact on the future progress of the Irish economy and the scale of the issue has the potential to result in very serious consequences for the country at a macro-economic level."

(Pension Board, (2006a), p.iv)

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⁴ The Programme for Government (2007-2012) makes a number of commitments in relation to pensions and providing better support for old people. These include; increasing the basic State pension by around 50 per cent by 2012, developing an SSIA type scheme to make supplementary pension provision more attractive to those on low income and increasing replacement rates.

⁵ State Board responsible for regulation of pension schemes.
However the Pensions Board recommendations suggest it could see no shortcomings in the current pension system, which could be firmly laid at the door of the pensions industry itself. The improvements recommended by the Pensions Board are ones for the State to implement through increased tax breaks and reduced regulation so as to reduce bureaucracy.

The main recommendations of the Pensions Board (2006a) are as follows:

- The State incentive for personal contributions to Personal Retirement Savings Accounts (PRSA’s) be granted by means of a matching contribution of €1 for each €1 invested, rather than through tax relief, subject to a maximum amount. These contributors should be allowed limited access to their funds before the age of 45.
- Tax relief for other forms of supplementary pension provision be allowed at the higher rate for all personal contributions.
- The point of sale regulation of standard PRSA’s be reduced by eliminating the requirement to prepare a fact-finding questionnaire.
- Incentives should be introduced to encourage the proceeds of special savings investment accounts (SSIA’S) to be saved for retirement, targeted at those who would not otherwise qualify for tax relief, or who have not recently fully availed of their tax relief entitlement.


Effectively the focus of the Pensions Board recommendations was on increasing coverage through tax relief and the lessening of the administrative burden at the initial point of sale (for example by eliminating the requirement to complete a fact-finding questionnaire). There are no references to any “value for money” issues that might potentially increase the future value of pensions in payment. The recommendations do not appear to recognise any need to do anything to promote confidence in the efficiency and effectiveness of the pension system notwithstanding the accepted inadequacies in terms of pension coverage and adequacy of cover.

The pensions Board (2006b), states that a combination of an increase in the State pension with a “mandatory” supplementary system for those who are not already making supplementary provisions, would be the most appropriate and practical approach to improving the position of pensioners in Ireland by means of a mandatory system. While the report does not recommend such an approach, it is a comprehensive discussion of the main social, economic budgetary and practical implications of introducing such a system. It contains only a brief discussion of
costs. In the context of the overall pensions debate, the report is a further indicator of the persistent focus on coverage in reports from the Pensions Board.

In 2009 the Irish Government introduced provisions which attempted to alleviate somewhat the plight of pension schemes in the process of being wound up or currently failing to meet the statutory funding requirements. This was followed up in 2010 by the “National Pensions Framework”, the most recent Government pension policy report which draws on the findings of a number of expert reports including the Mc Carthy Report (2009) and the Commission on Taxation Report (2009). These are discussed in detail in Chapter 7. These developments do not represent an all-encompassing address of the issues at stake for pension provision in Ireland and the difficulties currently being faced by circa 75 per cent\(^6\) of occupational pension schemes who currently do not satisfy the funding requirements of the regulatory authority, the Pensions Board. Neither do they address the serious concerns raised by the Pensions Ombudsman\(^7\) on “poor administration” and (more recently) mis-selling/mis-buying of pension products to/by individuals for whom the particular products were not suitable. In terms of a possible role for the State in the provision of sustainable, affordable occupational pension cover for all employees, the developments represent tentative first steps.

1.8 A UK Comparison

As discussed in chapter 7, the UK and Irish systems are somewhat similar: both countries have an almost universal social welfare system which is supplemented by voluntary private pension provision.

Irish policy makers have been closely monitoring the development by the UK Government of a national pensions strategy. The UK Pensions Commission was established in December 2002 following the UK Government’s pensions Green Paper. It issued its first report in October 2004. This report concluded, that faced with the increasing proportions of the population aged over 65, society and individuals must choose some mix of four options. Either pensioners become poorer relative to the rest of society, or some combination of higher taxes/national insurance contributions, higher savings and/or later retirement age will be required. The Commission’s second report published in November 2005 brought forward recommendations to deal with these pension challenges and choices.

\(^{6}\) Pensions Board estimate - July 2010
\(^{7}\) The Pension Ombudsman has reported growing numbers of complaints since he was appointed – for example there was a 56per cent increase in the number of complaints received in the first half of 2009 when compared with the same period in 2008 – www.Pension Ombudsman.ie.
“It is wrong to talk about a crisis of pensioner income today, but the problems in the UK’s pension system will grow increasingly worse unless a new pensions settlement for the 21st century is now debated, agreed and put in place.”
(UK Pensions Commission (2005), Second report, press release.)

The Pensions Commission recommended two key elements of reform in the UK as follows:

- The creation of a low cost national funded pension savings scheme into which individuals would be automatically enrolled but with a right to opt-out, with a modest level of compulsory matching employer contributions and delivering the opportunity to save for a pension at a low annual management charge of 0.3 per cent per year or less. This would require contributions to be collected in a cost effective fashion such as under the PAYE system and provide members with the option of investment in very low cost funds, bulk bought from the fund management industry.

- Reforms to make the State system less means-tested and closer to a universal system than it would be if current indexation arrangements were continued indefinitely. In order to achieve these aims, while maintaining the standard of living of the poorest pensioners, the State needs to be more generous. In the long term this implies some mix consisting of an increase in taxes devoted to pensions expenditure, an increase in State pension age, raising labour force participation rates, reducing unemployment and increasing immigration. (UK Pensions Commission (2005) p.6)

The Commission identified “costs” as a common area of concern across many countries. The report refers to the capability of reducing costs through nationally administered schemes as being a key area of relevance arising from its review of pension developments in other countries.

In its final report issued in 2006, intended as a summary of its recommendations for reforming UK Pensions, the Commission reiterated its opinion that a single national system purchasing operational services from competitors is likely in the long run to deliver the most favourable combination of low cost and member benefits, and that a benchmark of 30 b.p. (0.3 per cent) for total costs remains a reasonable target at which to aim. The UK Government moved relatively quickly to implement the recommendations of the Commission with the enactment of the Pensions Act 2008. One of the principal provisions of the Pensions Act 2008
was the creation of a new low cost savings vehicle, effective from 2012. This is discussed in detail in chapter 7.

1.9. Structure of this thesis.

The rest of this thesis is divided into seven chapters as follows;

Chapter two sets out the data source for this study and the methodology and research methods used.

Chapter three reviews the relevant literature on the aspects of pension fund performance which are the focus of this thesis; the role of costs in pension fund performance, regulation and the role of trustees in scheme governance and the subjectivity and transparency of actuarial assumptions.

Chapter four shows the results of quantitative analysis carried out on the data source described in chapter 2, which demonstrate the impact of cost factors on the valuation of a scheme over its lifetime and the current poor disclosure in annual reports to scheme members.

Chapter 5 demonstrates using a model set of actuarial assumptions, how changes in certain of those assumptions can impact significantly on the reported performance (surplus or deficit) of a pension scheme. This is calculated using percentage rate changes in assumptions regarded as being within an acceptable range (as set down by regulation and standards).

Chapter 6 reflects the study results on the qualifications of pension scheme trustees, the levels of expenditure incurred on trustee training and the frequency of trustee board meetings, in the context of the responsibilities of trustees as established by legislation and case law. It advances arguments for an enhanced role for trustees in achieving increased transparency and efficiencies in the governance of pension schemes.

Chapter 7 considers the most recent developments in Irish pension reform within the context of the stated objectives of the Pensions Board and the issues regarding cost levels, efficiency, transparency and regulation set out in earlier chapters of this thesis. It also considers the impact of EU legislation and developments in pension reform in the U.K., where the pension system is broadly similar. It concludes that Irish proposals to date lag behind those of its nearest neighbour and fall far short of an all embracing effective response to the challenge of
providing secure, sufficient, sustainable and affordable retirement income levels for all Irish pensioners into the future.

Chapter 8 sets out my overall conclusions.
CHAPTER 2

Research Methodology

2.1. Data

The UK Pensions Commission concluded that present data sources in the UK are significantly
deficient as a basis for some aspects of evidence-based policy making (UK Pensions
Commission (2004) p 289). It is fair to say that Irish data sources are significantly more
deficient than those in the UK. Data is available to individual scheme members because Irish
pension legislation requires pension fund trustees to provide scheme members with annual
financial statements showing a "true and fair" view of the schemes' financial affairs for the
accounting year in question. However pension fund financial statements are generally only
available to sponsoring employers, trustees and scheme members and are not available to the
general public. Because pension schemes are legally constituted as trusts rather than as
companies, the Irish company law requirement to file annual financial statements with the
Companies Registration Office (which can then be accessed by the general public) does not
apply. In undertaking research in this area a major challenge therefore, is the collection of
data relating to individual schemes, and especially to collect data for the same schemes, over
a time period.

The Irish Association of Pension Funds (IAPF) is a non-profit, non-commercial organisation
which represents the interests of Irish pension funds. It is the principal such organisation in
Ireland. For the purposes of this research, all pension schemes registered with the IAPF for
2003 (there were 352 schemes included on the IAPF 2003 register), were circulated, with a
request for copies of the schemes' financial statements for the financial years ending 2002 to
2007 inclusive. A copy of the request letter is included in Appendix 10. As a result of this
circulation process and other personal enquiries through friends, acquaintances and work
contacts (not all pensions schemes are registered with the IAPF) financial data was obtained
from 58 Irish pension schemes although as discussed below, there was varying amounts of
data for each scheme.
A profile of the respondents across scheme type, number of members and total scheme assets is set out in Table 2.1 and the potential total population as reported by the Pensions Board is described in Table 2.2. All of the schemes included in this study had in excess of 100 members. The number of schemes included in the study (58) accordingly represents approximately 10 per cent of all pension schemes with in excess of 100 members (Table 2.2 below).

Table 2.1
Profile of Respondents in Study:

<table>
<thead>
<tr>
<th></th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of schemes</td>
<td>43</td>
<td>15</td>
<td>58</td>
</tr>
<tr>
<td>No. of members at end 2007 (active and deferred)</td>
<td>371,653</td>
<td>3,138</td>
<td>374,791</td>
</tr>
<tr>
<td>Assets under management at end 2007</td>
<td>€21.09bn.</td>
<td>€0.04bn</td>
<td>€21.13bn</td>
</tr>
</tbody>
</table>

Table 2.2
Total Population of Pension Schemes at end 2007, as reported by the Pension Board Annual Report 2007.

<table>
<thead>
<tr>
<th></th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of schemes</td>
<td>1,319 of which 972 have less than 100 members</td>
<td>98,483 of which 98,256 have less than 100 members</td>
<td>99,802 of which 574 have in excess of 100 members</td>
</tr>
<tr>
<td>No. of members at end 2007</td>
<td>530,933</td>
<td>269,465</td>
<td>800,398</td>
</tr>
<tr>
<td>Assets under management at end 2007</td>
<td>Approx. €65.9bn.</td>
<td>Approx. €20.7bn</td>
<td>€86.6bn.</td>
</tr>
</tbody>
</table>

Pensions Board (2008)

The schemes which provided data for the purpose of this study had an asset value of approximately €21.13bn or 24.4 per cent of total Irish pension fund assets at the end of 2007. The schemes account for approximately 375,000 members in total, some of which are described as active and some of which are described as deferred (Table 2.1). It is not possible to confidently state what this number represents in percentage terms of total pension scheme membership reported by the Pensions Board. The Pensions Board annual report for 2007 discloses the total number of active pension scheme members as 800,398 which would suggest that the number of scheme members included for the purposes of this research was approximately 47 per cent of the qualifying population. However it is unclear how the accumulated statistics deal with a number of situations particularly in relation to "deferred" members. These issues include:
1. Employees who have built up pension entitlements (which may be significant) in a previous employment but are now working and do not have pension cover in their current employment. These individuals would be recorded as deferred members in the data compiled for the purposes of this research. They should be included in the coverage statistics reported by the Pensions Board but it is unclear as to whether this is the case. Potentially, the Pensions Board coverage statistics could be understated if some or all deferred members were excluded from the reported coverage statistics.

2. There could be employees included under the deferred category in respect of a previous employment and the active category in respect of a current employment. This type of double counting could not be determined from the data compiled for this research and it is likewise unclear as to how this type of situation is dealt with in the production of the Pensions Board Statistics. This could give rise to overall coverage statistics overstating coverage levels.

3. It is unclear as to how employees who are members of pension schemes but who are not currently making contributions (because of, for example career breaks) are treated in the production of the Pensions Board statistics. These individuals would be expected to be included as deferred members in the data compiled for the purposes of this research but they are either included as active or not included at all in the Pensions Board statistics. Potentially, coverage levels could be understated if this category of employee was excluded from the statistics.

The Pensions Board has made some corrections to its coverage statistics in its annual report 2008 citing mistakes in earlier years in reporting and late reporting by its members. For all of the above reasons the profile of respondents set out in Table 2.1 may not be directly comparable with the total population as reported by the Pensions Board as set out in Table 2.2. Accordingly it could be slightly misleading to categorically express the number of members included in the data base used in this research as a percentage of the total number of pension scheme members as expressed by the Pensions Board.

A data base was compiled for the years 2002 to 2007 of the information provided on the key income and expenditure amounts disclosed by each of the schemes and the total assets of each scheme at the beginning and end of each period. The data is both cross sectional and time
Each pension scheme annual report is treated as one observation. However there are variable amounts of data for each pension scheme. There are minimum requirements set down by regulation/legislation (Accounting Standards, Pensions Act 1990) and while some schemes only provide details sufficient to satisfy the minimum requirement (and some schemes do not appear to do this stating that more detailed information is available upon request from the trustees), others provide more than the minimum and some provide comprehensive information. In particular the scheme "Income and Expenditure" Account or "Fund “ Account showing details of income for the year (including contributions received, investment income and gains from the sale of investment assets) and expenditure (typically comprising pension payments, transfers, and management expenses including investment fees and charges), varied considerably across the schemes studied in terms of the level of detail disclosed. While all schemes showed the net increase or decrease in the fund size over the year in question and net inflows and outflows for the year, there was no uniformity across schemes in the levels of further detail given. Some schemes provided only summary information to members and included a statement that details could be obtained directly from the scheme trustees. Table 2.3 summarises the success rate in terms of accessibility of the required information from the financial statements of the respondents.

Table 2.3

<table>
<thead>
<tr>
<th>Availability of the required information from financial statements of respondents</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scheme membership details</td>
<td>100 per cent</td>
<td>100 per cent</td>
</tr>
<tr>
<td>Costs disclosed in full or part</td>
<td>56 per cent</td>
<td>7 per cent</td>
</tr>
<tr>
<td>Trustee details in full or part</td>
<td>77 per cent</td>
<td>66 per cent</td>
</tr>
</tbody>
</table>

Apart from the Fund Account, Balance Sheet, Auditor’s report and Actuarial certificate, there were also significant differences in the level of additional information provided by each schemes’ financial statements. The data base compiled for this study reflects information provided by each scheme on scheme trustees, expenditure levels incurred on trustee training, details of trustee meetings and other information with regard to the trustees’ role within the pension scheme. Again, the level of detail varied significantly with many scheme statements providing no details apart from the names of the trustees. While not a specific focus of this thesis, the varying level of disclosure in relation to investment strategy, asset profiles and any correlation in terms of maturity between scheme assets and scheme liabilities was very apparent with some schemes disclosing no information on these matters at all and some giving quite detailed information on mix of assets, markets invested in etc.
The vast majority of pension scheme respondents prepared financial statements corresponding to each calendar year i.e. year ending 31 December 2007 etc. Where a scheme did not have a 31 December accounting year end, the scheme information was allocated to the closest calendar year end, e.g. financial statements data for the year ending 31 March 2006 was allocated to calendar year 31 December 2005.

2.2 Methodology

Using the data base compiled, the levels of disclosed costs in the financial statements of the respondents were compared with industry estimates of actual costs incurred by pension schemes, to illustrate the transparency or otherwise in pension scheme financial statements, of total costs incurred annually. Both mean and median calculations of disclosed costs were calculated on the basis that while the mean represented the average rate of disclosure across all schemes for a particular year, the median calculation was considered a better indication of central tendency given the presence of outlier values. It is demonstrated in Chapter 4 that based on industry estimates of actual rates, mandatory full cost disclosure by pension schemes would be likely to result in very significant increases in cost levels disclosed in scheme financial statements.

Time series graphs were prepared to check for changes (improvements or otherwise) in disclosure over the years under review given the growing attention in recent years by scheme members and outside commentators on pension scheme performance generally. The comparison was repeated, across scheme size, industry type (financial services, retail, services (other than financial services) and manufacturing), scheme type (DB or DC) and by reference to whether the scheme had a professional trustee. Again, mean and median calculations were prepared because of the skewed distributions. Regression analysis was carried out to determine the strength of the relationships between fund size and levels of costs disclosed, industry type and levels of costs disclosed, scheme type and the levels of costs disclosed and the impact of a professional trustee on costs disclosed. Co-efficient estimates were calculated from pooled ordinary least squares regressions, with t-statistics (absolute value) calculated using standard errors adjusted for clustering at the fund level. Disclosed fees as a percentage of fund size was the dependent variable while the dummy variables were (1) the existence or not of a professional trustee, (2) whether the scheme was a DB as opposed to a DC scheme, (3) if the parent company was in the financial services industry and (4) whether the parent company was a publicly quoted company. Industry variables used were (1) services, (2)
financial services, and (3) retail, while manufacturing was the excluded (and thus referenced) industry class. The coefficients were adjusted\(^8\) to account for the small sample size. Variance inflation factors (V.I.F.’s) were calculated to test for multicollinearity.

As discussed in chapter 4, there are some legitimate reasons for the poor levels of disclosure and lack of transparency, but in terms of the information being presented to scheme members, the net effect is that scheme members are presented with income levels which are in fact net of certain costs (the costs have already been deducted) and in many cases minimal cost details are disclosed as a result. Scheme members and those using pension scheme reports may assume that little or no costs have been incurred or that costs are not a factor in assessing the performance of the scheme. Using income and expenditure accounts of three of the respondents (two from the financial services industry and one from the manufacturing industry) and assuming industry estimated cost levels of 2.2 per cent of scheme assets annually, the income and expenditure amounts are restated to show scheme income gross (before) costs with costs stated/disclosed separately. The “bottom line” result remains unchanged but the impact of costs on gross income in arriving at that bottom line is more transparent. The three respondents (to be known as Schemes A, E and F) were chosen from the group of respondents because relatively they were quite large schemes and provided detailed income and expenditure accounts, both of which help to demonstrate the significance of full cost disclosure.

Future value calculations are used to reflect the impact of cost factors on the valuation of a scheme over its lifetime and how even proportionally small annual cost savings can have significant cumulative effects over the lifetime of a fund. This demonstrates that for Irish pension schemes, net returns and scheme values are in part a function of costs, particularly when the cumulative effect of costs over the lifetime of a scheme is acknowledged. Using a 0.3 per cent rate for fund management charges (in line with the UK proposals for a low cost pension scheme model), the income and expenditure accounts of three of the respondents were restated to demonstrate the impact over the lifetime of a scheme of a reduction in annual fund management charges to a level equivalent to the proposed UK low cost option. The difficulty for schemes where management fees are not performance related is highlighted by the experience of one of the respondent schemes who provided me with comparative returns for its actively and passively managed funds. Over a sustained time period, the actively managed funds generated poorer returns but incurred higher fees and charges.

\(^8\) Bootstrapping provides a way to account for the distortions caused by a specific sample which may not be representative of the population.
As mentioned in Chapter 1, at the core of the regulatory framework for Irish pension schemes is a requirement that all funded pension schemes are subject to an actuarial valuation process by law at least once every three years (Chapter 5). The objectives of this exercise is to determine for the benefit of the regulators, scheme members, sponsoring employers and trustees, if a particular scheme is solvent (capable of meeting its liabilities as they fall due) or insolvent and what if any, actions are required (for example in terms of increasing the level of contributions) by employers and or employees into the future. This thesis examines the assumptions underpinning the actuarial valuation exercise and shows that changes (which may be acceptable under the guidelines for calculating pension liabilities) in certain assumptions (for example, on mortality rates, investment returns, rate of salary increases) can have a significant impact on the reported valuation of pension scheme liabilities. There is a perceived lack of focus on this by scheme trustees and members alike. This is at least partially due to a lack of transparency in the actuarial exercise.

For the purposes of this research, a valuation model was constructed incorporating some of the core variables used in an actuarial valuation exercise. The subjectivity of the valuation exercise is due to the range of possible values, which might be attributed to a number of these core variables. The actuary’s role is to attribute the most appropriate value to each core variable based on past experience, future expectations or a combination of both, and taking into account regulatory requirements and other influences both internal and external to the scheme. The valuation model constructed for the purposes of this research is used to demonstrate the impact of changes in the value of a number of core variables on the valuation result of a scheme, i.e. the scheme surplus or deficit and on the reported funding requirement (i.e. contribution rate). The valuation model also demonstrates the interaction of certain variables in the valuation process – differences between the assumptions are often more important than the absolute value of the assumptions in isolation (e.g. the rate of expected salary increase vs. the expected discount rate or return on investments). Finally the valuation model demonstrates how certain changes in a prescribed set of core variables can impact significantly on the reported performance (i.e. surplus or deficit) of a scheme notwithstanding that the percentage rate change in the variable would not be regarded as a breech of regulatory requirements. These theoretical results are supplemented by data provided by two schemes on the precise impact for the valuations of those schemes of “more prudent” and “less prudent” actuarial assumptions.
As mentioned earlier, the data base extracted from the annual reports of those schemes included in the study, summarises the information provided in relation to the trustees of each particular scheme, in particular, the number and qualification of trustees, the number of trustee meetings annually, the levels of expenditure incurred by the scheme on trustee training, the level of usage of professional trustee firms and any information provided as to the role of the trustees in the decision making processes particularly the investment decision making process. Chapter 6 examines issues relating to the legal requirements of the management of pension funds by trustees and argues that in the light of the findings of this study, pension fund trustees are often ill equipped to perform their statutory role. This can leave trustees exposed to legal challenge in the event that schemes fail to deliver on pension promises/ expectations. While “professional” trustees (who are fully trained in the role and responsibilities of a trustee) appointed to the scheme by the sponsoring employer may be an exception to this generality, the study results suggest that only approximately one third of all schemes use the services of a professional trustee.

Chapters 4, 5, and 6 identify challenges facing the Irish pensions system in terms of its regulation and efficiency which the relevant academic literature suggests are reflected elsewhere in other jurisdictions and which might be expected to be reflected in the ongoing reform of pension systems world wide. There has been some pension reform in Ireland over the past ten years. Chapter 7 looks at the progress of that reform particularly in the area of costs, regulation and the role of trustees. In this context it considers the most recent (March 2010) Irish Government proposals in the area of pension reform. It also looks at recommendations for reform contained in reports commissioned by the Irish Government and recommendations put forward by the industry and other interested parties. Given that there are strong similarities between Ireland’s pension system and the pension system of our nearest neighbour, the UK (almost universal social welfare pension system although at a low rate, supplemented by private pension provision), this chapter examines reform measures being taken in the UK, again with specific reference to costs, regulation and the role of trustees. One might expect a convergence of policies because of the similarities in the underlying pension systems but also because of EU objectives for harmonisation across the EU in relation to the funding and regulation of occupational pension schemes. However despite common origins and common problems this chapter concludes that Ireland lags considerably behind the UK in attempting to address the difficulties of high cost and poor governance which are features of private pension provision in Ireland.

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9 Both pension systems have their origins in the early part of the 19th Century. The formative legislation was the UK Superannuation Acts 1834 – 1919 (Irish Government, 2000).
CHAPTER 3

Literature Review

This chapter reviews relevant literature on the aspects of pension provision which are the focus of this thesis; the role of costs in pension fund performance, the subjectivity and transparency of actuarial assumptions, the role of trustees in scheme governance and the pattern of pension reform in Europe.

3.1 The Role of Costs in Pension Fund Performance

One of the more rigorous studies in this area was by Whitehouse (2000). He uses two techniques for measuring the effect of pension fund charges on fund performance, a “reduction in yield” (RIY) measure and a “reduction in premium” measure. The “reduction in yield” measure is the difference between the gross return that the fund earns and the net return after charges, or the percentage rate of return of the product assumed for projection purposes and the percentage return to the investor after expenses. It is expressed as the percentage point amount that fees and charges subtract from the gross return to a fund, for example if the gross return is 3.5 per cent, RIY 1.5 per cent, the net return is 2.0 per cent. The “reduction in premium” measure also known as the “charge ratio” reflects the proportion of contributions paid in fees and shows the difference between the total accumulation in the pension fund with and without charges. It compares maturity values rather than rates of return. Other techniques used by industry researchers and professionals in this area include “total expenses ratio” (TER) and “Managed Portfolio Internal Rate of Return” MPI, (the price of a managed portfolio that yields the market rate of return on €1). The former looks at net operating expenses as a percentage of funds under management while the latter looks at the ratio of internal rate of return to gross yield.

Whitehouse (2000), showed in his study of DC schemes across thirteen countries, very different approaches and policies on charge levels and structures. In countries with systems based on individual accounts and individual choice among competing pension providers, average charge ratios (i.e. proportion of scheme contributions paid in fees) varied from under
15 per cent to above 30 per cent although the author accepted that his results were somewhat sensitive to changes in assumptions. The report observes:

“Measuring the price of financial services is more difficult than other goods and services. Fees can take many forms. Different kinds of charge interact and accumulate in different ways, particularly with long-term products such as pensions and life-assurance. This often means that the price of financial services is not transparent.”

(Whitehouse 2000, p.6)

Measures of cost are in themselves complex. In many cases, the key issue is not so much which measure to use but rather what costs and charges (i.e. explicit, implicit or both) should be included in the calculation. For example, custodians and trustees fees are currently included in unit trust RIY calculations but not in those for life assurance products. Commission payments to agents are included in RIY calculations and this means that to provide a full comparison, separate calculations are needed for the same product when sold through different channels. Different tax treatments across life funds and unit trusts may need to be recognised for a full comparison. This may not be such an issue for pension funds because of their tax exempt status, but could be important in evaluating returns from jurisdictions where the tax exempt status of pension schemes is not recognised or in evaluating returns to individuals in receipt of pension income. RIY will vary depending on how long the investment is held because of the combined effect of explicit and annual charges. For this reason there is an argument for a separate indicator of “short term” price.

Bikker and De Dreu (2009), used data from Dutch pension funds for the period 1992 – 2004 to support the findings of Bateman and Mitchell, (2004) that administrative and investment costs can substantially increase the cost of retirement security. They illustrate how under certain conditions, an annual increase in pension fund operating costs (administrative and investment costs) of 1 per cent of pension fund assets implies a cumulative reduction of 27 per cent of eventual pension benefits, an increase of 37 per cent or more in pension costs. The authors found that in the Netherlands, annual administrative costs alone typically fall between 0.1 per cent and 1.2 per cent of pension fund assets but that pension funds had generally focussed on other measures such as lower inflation or wage indexation and a move from final to average salary schemes, to reduce the overall costs of retirement security. They found that there was a strong dispersal in administrative costs and investment costs across Dutch pension schemes, explained mainly by their size and that industry funds or collective pension arrangements were significantly more efficient than single company funds and other types of arrangements. They also found that industry funds DC schemes were somewhat cheaper than
DB schemes. The authors argued that given the significant cost differences across pension funds and the huge cumulative impact of additional costs, cost reduction should receive more attention. The authors had access to a detailed data set from the Dutch pension regulator, a facility which is not replicated by the Irish pensions’ regulator in the case of Irish pension arrangements or pension regulators in many other countries. For the purposes of their study, the authors define administrative costs as including all costs incurred to operate the pension fund except investment costs, while investment costs include wages of portfolio managers and analysts, brokerage fees and the cost of electronic trading facilities.

Bateman and Mitchell (2004) explored the links between retirement plan offerings and pension expenses for a wide variety of private and public sector pension plan types, using data from the Australian pensions’ regulator on 2000 Australian pension schemes. They concluded:

- Larger pension plans in Australia are more costly to manage than smaller ones, but expenses rise less than proportionately. Some schemes are simply “too small” to be cost effective under a mandatory pension system.
- The least costly Australian design is an employer sponsored DC plan. DB and retail pensions to the general public are 30 per cent – 70 per cent more costly.
- Pension expenses, when incurred over a worker’s lifetime in the labour market, can substantially erode retirement assets. The impact is most striking for workers covered by small plans and retail plans.

Ghilarducci and Sun (2006) investigated the DB vs. DC choice made by 700 firms in the US between 1981 and 1998. During this period, DC schemes expanded and overtook DB schemes as the scheme of choice. The authors found that during the period a 10 per cent increase in the use of DC schemes (including 401(k) plans) reduced employer costs per worker by 1.7 per cent to 3.5 per cent and suggest that these lower administration costs may explain the popularity of DC schemes.

Dobronogov and Murthi (2005) discussed fees and costs of pension schemes in the transition economies of Croatia, Hungary, Kazakhstan and Poland. The authors found the cost structures to be complex and generally poorly understood by consumers. There were large once off costs incurred in setting up schemes and as a result, collective or industry schemes showed strong economies of scale. The authors found that cost structures were not fully transparent, that in Hungary there was no requirement for transparency enshrined in law, and in Kazakhstan,
Poland and Croatia where pension schemes are obliged to reveal charges explicitly, the impact of charges may not be fully apparent to members. Price controls apply in Poland, Croatia and Kazakhstan. However the authors conclude that the use of price controls is likely to be successful where there is a strong regulatory capacity, with the necessary technical staff to analyse costs and fees and a governance structure that is free from undue influence. Where this is lacking, price controls may be less effective. In the countries surveyed, the authors found that the operation of price controls had mixed results.

James (2000) refers to the apparent enigma whereby investors continue to invest in high priced funds even after consulting with a financial advisor who is obliged by regulation to give “best advice”. He concludes that in practice the “best advice” requirement places few constraints upon what funds an advisor can recommend, citing from an earlier UK Government discussion paper from the Personal Investment Authority (P.I.A.);

“there is a large element of opinion in what does or does not amount to best advice in any particular case, and there is no external yardstick (against which to judge advice given)”.


The absence of a standardised reporting format for costs which results in a lack of transparency in relation to costs and cost levels might be part of the explanation for the enigma referred to by James (2000). In the financial statements of pension schemes for example, costs may be disclosed separately i.e. gross income less costs resulting in net income, or a net income figure may be shown without any mention of costs or a combination of the two approaches may be used. Where the net income approach is used, there could in essence be no specific figure for costs disclosed anywhere in the financial statements. This is discussed further in Chapter 4.

Myners (2001) refers to the absence of evidence showing that investment advisors are chosen on the basis of cost competitiveness. This is not surprising given that the information to make such assessments is so difficult to obtain. The author makes specific reference to “commissions” and says that the sum which pension funds pay in commissions to investment houses and stockbrokers for providing dealing and research may well be similar in size to the fees which they pay for active fund management. Yet the treatment of these costs is different to that of a fund management fee in two respects. Firstly, commissions charged are disclosed on a transactions by transaction basis and form part of the note confirming the transaction (which the trustees would not necessarily see) and are usually not disclosed in aggregate on
an annual basis, which would be much more meaningful for trustees. Secondly, the firms which provide the services for which commission is charged are selected by the fund manager, acting as agent for the pension scheme. The pension scheme has no direct involvement in the decision, and the process by which the fees are negotiated is not transparent to the scheme trustees.

The author concludes that clients’ (e.g. pension schemes) interests would be better served if fund managers were to absorb the cost of any commissions paid and pass it on to the client by way of a single all inclusive fee which could be negotiated with clients in terms of all its' constituent elements. Clients would see more clearly what they were actually paying for investment services. The objective of purchasing only those services which contributed to superior investment returns, and to do so, in a way which is most efficient would be easier to achieve.

At EU level, the Social Protection Committee (2008), draws a distinction between DB and DC schemes in assessing the role costs and charges play in any particular pension scheme and whether it has any behavioural impacts. The Committee’s view is that in a DC scheme costs can have a more directly visible impact on benefits while in a DB scheme, because benefits are predefined to a certain degree, costs play a less transparent role and are not as visible or as readily comparable. The Commission suggests that transparency of costs puts pressure on trustees, making them accountable to members and stimulating them to search for efficiency gains.

3.1.1 Policy Literature – costs

The Pensions Board (2006a) makes little reference to costs in the main body of the report. However in Appendix 6 to the report, “Life Strategies/ ESRI report on alternative systems” certain assumptions on pension cost levels are made. These assumptions were used in assessing certain potential alternative systems of pension provision, put forward by the Pensions Board for detailed analysis, as part of the National Pensions Review (see also Stewart (2005, pp. 115). Different categories of costs were identified – (1) trading costs, (2) the empirical costs of selling, processing and administering pension products and the explicit charges paid to fund managers and (3) administration charges. In relation to trading costs, the report bases its assumptions on the UK experience as set out by James (2000), and assumes 0.65 per cent implicit costs for equity investment on average, 0.25 per cent for corporate bonds and 0.10 per cent for Government bonds. In addition to these direct trading costs which
are typically netted off against gross investment return, the explicit costs in (2) and (3) above are assumed to have an RIY impact of 1.5 per cent, based on a survey of administrative costs in the UK by the Government actuary’s department and other data sources. One off expenses of 3 per cent of the fund prior to annuitisation are also assumed reflecting typical annuity commission rates of 2 per cent plus an assumed profit margin of 1 per cent. It may not be entirely appropriate to assume that UK cost levels would similarly apply in Ireland given economies of scale in the UK market and the very different scale involved.

The Green Paper (2007a) uses an RIY level of 1.5 per cent per annum to illustrate the impact on accumulated retirement funds of a reduction of 0.5 per cent per annum and 1 per cent per annum. It concludes that a regular contributor over 25 years would have a 9 per cent greater retirement fund if the charge level was reduced from 1.5 per cent per annum to 1.0 per cent per annum and have a 20 per cent greater retirement fund if the charge level was reduced to 0.5 per cent per annum. However the Green Paper (2007a) suggests that annual charges higher than 1.5 per cent per annum exist and refers to some unit linked investment funds which may have bid/offer spreads of between 3 per cent and 5 per cent not including actual trading costs.

More recently, the Irish Government, (2010a), whilst recognising that there may be economies of scale arising from a national auto-enrolment scheme makes no further commitment to ensuring that potential cost savings are realised. Outside of the limited 2009 provisions in relation to the State provision of annuities (discussed in Chapter 7), Government policy reflects little that might address any of the high cost issues experienced currently by existing schemes.

3.2 Understanding Actuarial Values.

Actuarial values are a function of the assumptions used in the valuation process. The Society of Actuaries (2008a) and (2008c) in their Actuarial Statements of Practice on Pensions numbers 1 and 3 (ASP Pen 1 and ASP Pen 3), provide guidance to Actuaries on preparing an actuarial valuation report for a defined benefits pension scheme. As discussed earlier, a defined benefits pension scheme is one where members are promised a defined pension on retirement based on their length of service, and level of salary on retirement. The level at which the employer and/or the employees must contribute to the scheme in order to meet these commitments is determined primarily by the scheme actuary based on a wide variety of assumptions including projected rates of return on contributions invested, numbers and ages of members entering and leaving the scheme, mortality rates of members, early retirement
rates and salaries of members on retirement. These assumptions can only be best estimates based on previous experience and expectations for the future. ASP Pen 1 states that it is not intended to restrict the actuary's freedom of judgement in choosing the method of valuation and the underlying assumptions employed in deriving the level of contribution required but it is intended to ensure that the methods and assumptions used are properly explained and that variations between the assumptions chosen and actual experience are analysed in the report.

The difficulty is that advice produced by the actuarial profession may lack clarity, brevity and simplicity in its explanations, with the result that scheme members and trustees remain largely ignorant of the actuarial exercise and by default or otherwise rely on their own assumption that the "expert" i.e. the actuary is always right.

The effect of differing assumptions on actuarial values is briefly discussed in Stewart 2005 (p 82). The net conclusions from an actuarial valuation carried out in accordance with ASP Pen 1 may be (1) whether the pension scheme is in surplus or deficit i.e. the difference in value between the discounted value of its actuarially expected liabilities and the value of its assets and (2) what level of contribution is required to meet targeted pension provision. A valuation carried out for the purposes of determining whether a pension scheme meets its funding requirements as set down by the regulatory authority, the Pensions Board, must comply with the provisions of ASP Pen 3. This is discussed further in Chapter 5. As discussed in Chapter 5, for actuarial reporting purposes, scheme assets are required to be valued on the basis of current market values (Society of Actuaries (2008a), Para.2.2.9) or net realisable value, (Society of Actuaries (2008c), Para.2.12) depending on the purpose of the valuation. However depending on the class of asset, there can be debate about what is current market value or net realisable value. International Accounting Standards No. 19 (IAS 19) requires that in determining whether a pensions scheme is in surplus or deficit for the purposes of the sponsoring employer's financial statements, pension fund assets should be valued at "fair value" (discussed in Chapter 5), which, in most but not all cases is equivalent to current market value. Where market value is not readily available, historically, actuaries have used a moving average basis of valuation.

In the case of a DB scheme, the schemes liabilities are the amounts required to produce a given stream of pension income in retirement for those scheme members who have not yet retired and to continue with pensions in payment for existing scheme pensioners. These amounts are discounted back to a single capital value using different discount rates depending on the nature of the liability. The forecast pension payment of an individual DB scheme member requires forecasts of future salary and the relationship of future salary and future
pension, as laid down by the scheme rules. These individual estimates of future fund requirements are required by ASP Pen 1/ASP Pen 3/IAS 19 to be discounted as appropriate, to the present day by reference to the yield on long dated Government debt (usually used in the case of pensions in payment) or by the yield on long term corporate bonds (usually used in the case of members who have not yet retired) or an estimated or prescribed estimated return on scheme investments. The discount rate to be used will depend on the purpose for which the valuation is required. (This is discussed further in Chapter 5). The aggregate scheme liabilities is the sum of the individual liabilities for each pension scheme member although in some cases calculations can be made on a class basis.

A pension scheme valuation result is thus equal to the total value of scheme assets minus total estimated scheme liabilities (calculated as appropriate) as described above.

There is considerable discretion in the choice of assumptions used to estimate pension liabilities. There is also choice although to a lesser extent in the method used to estimate the value of pension assets. These divergences in estimating pension fund solvency are reflected in a debate within the actuarial profession on alternative valuation approaches to pension scheme assets and liabilities. Pemberton (1998) argues that the traditional actuarial discounted cash flow approach to valuing pension fund assets and liabilities, which is largely based on discounted cash flows, can differ significantly to the value of pension fund assets using current market prices. He also however questions the pricing approach which uses current market prices on the basis that this approach has serious limitations in both a theoretical and practical sense. He gives the example of trustees responsible for liabilities which are exactly matched by some long dated index-linked government debt and the amount of this debt is exactly sufficient to meet the liability cash-flows as they fall due. If however the trustees were to sell the debt for cash, there would be two effects. The expected amount of future asset cash-flows would be lower (assuming the expected return on cash is lower than on government debt) and there would be a mismatch of risk. If the trustees were to continue to hold cash over the long term in preference to index linked government debt, then the scheme would be worse off. The pricing approach to value would not however recognise any change in the position of the scheme as it fails to capture the effect of the asset/liability interactions on a scheme surplus or deficit.

Mac Donald (1993) in his discussion of the actuarial valuation exercise for the purposes of determining the solvency or otherwise of a life insurance business, recognizes that a valuation basis is an extremely simple model of the future, usually modelling interest and inflation as
constants, but that actual experience is unlikely to resemble the model used, either quantitatively or qualitatively. Models are based on assumptions and necessarily include some variables that are deemed to be key and exclude other variables. In a changing economic environment, variables that were assumed to be key may become less important and vice versa (e.g. demographics, immigration, new entrants.)

"Whatever method may be preferred, and whoever chooses the basis, every conventional valuation basis is a model of the future. That the interest, mortality and expense assumptions are all models tends to be disguised by their simple nature; we do not usually dignify a fixed interest rate with the name "model". They are models nevertheless, and it is legitimate to ask how well they perform their tasks, and whether other models might be better." (MacDonald, 1993, p725).

Connell (2007), refers to the plethora of assumptions which must be examined in assessing different proposals/models for future pension provision,

"Underpinning the model are assumptions about demographic change. At the simplest level we need to know how many pensioners there are likely to be at different points in the future. Another important issue is what is the size of the labour force? At the next level there are assumptions about economic growth and labour force participation rates. Assumptions regarding the former are quite speculative and yet have a huge impact on the projected size of the economy as projections extend forward to 40 and 50 years" (Connell, 2007, p51)

The author also identifies assumptions regarding growth in real wages, performance of investments, levels of administrative costs as additional assumptions which should be factored into any such assessment model.

De Jong (2008) looks at the complexities which wage – indexed liabilities (ie where future pension benefits are based on estimated salaries at date of retirement) brings to the valuation process. The author concludes that there are two main issues to be addressed. The first is that expected wage growth has to be taken into account and the second is that while assets may be chosen strategically to include assets that show correlation with wage growth, the pension fund cannot replicate a wage exactly with its asset mix, so that there will always be a non – hedgeable residual wage risk.
Whyms (2009) in a useful but rare Irish study of the valuation of scheme surpluses/deficits for financial reporting purposes, considers the impact of the discount rate (which is based on long term corporate bond rates) used in the actuarial valuation calculation of the deficits of pension schemes of companies quoted on the Irish stock Exchange. The author argues that the deficits on such schemes estimated at the time of the report to be €3.5bn or between 12 per cent and 14 per cent of the market capitalisation of the sponsoring companies, would have represented 40 per cent of the market values of the companies if bond yields had not risen in 2008.

Lane Clarke & Peacock (2008) estimated that under the accounting standard IAS 19, the aggregate FTSE 100 UK pension deficits and surpluses stood at an overall deficit of €41 billion as at mid – July 2008 in contrast to an aggregate €12billion surplus in July 2007. However while equity market falls and rising inflation had a combined negative effect on scheme valuations of €93 billion, this was counteracted to the tune of €40 billion by the fact that corporate bond yields rose thereby increasing the rate at which pension liabilities were to be discounted in accordance with IAS 19. The authors reported a far greater range of discount rates used by companies reporting under IAS 19 in the year to 31 March 2008 than had been used in the twelve months previously.

Given that there is robust debate on optimal valuation approaches within the actuarial valuation itself, and there are external factors, such as discount rates significantly impacting on pension schemes’ reported results, the importance of regulation to monitor and control the subjectivity of and increase the transparency of the actuarial valuation process is paramount. Moloney and Whelan (2009), argue that the State does not get value-for- money for its subsidy to private pension arrangements due in no small measure to the weakness of the regulatory regime for private pension arrangements. The authors estimate the value of the Irish States’ subsidy (mainly tax based) to private pension provision in Ireland to be approximately 4 per cent of GNP, equivalent to the total annual payments under the State flat-rate contributory and non- contributory pension schemes.

“The defined benefit scheme in the private sector, generally believed to be the ideal model and comparable with similar schemes in the public sector, is shown not to be so: their pension promises rely too much on the employer’s goodwill and its continuance. In essence pension regulation requires only partial asset backing for benefit promises, has little enforcing powers for even that minimum standard, and allows no support from the sponsoring employer’s balance sheet. The weak regulatory system is helping conceal the true cost of superannuation undertakings, with the risk ultimately borne by the members.” Moloney and Whelan (2009) p.3.
3.3 The importance of education, professional qualifications and training, for trustees, in the governance of pension funds.

Research in this area suggests that there are arguments to support the selection of scheme trustees by reference to their educational and professional qualifications. Clarke, Smith and Marshall (2006), while treating their results with caution, given the small sample of trustees and funds studied, advise that given the range of task-specific skills required of trustees, trustees should be assessed for their fit with different types of roles and responsibilities. The authors also suggest that the average trustee may not have the education and professional qualifications to play the role of informed consumer of financial advice and decision making and that training and experience may not make up the difference if trustees come to investment responsibilities without sufficient qualifications. Given the limits of trustee competence, the authors are of the view that pension funds could consider complementing their decision-making bodies with independent experts capable of contributing to challenges which require sophisticated statistical knowledge and experience.

The authors' conclusions support earlier conclusions by Tversky and Kahneman (1974) that norms, habits and personal characteristics of trustees matter when calibrating the degree of trustee consistency and Simon (1982) that the context in which decisions take place matters when assessing the nature and extent of decision-making consistency.

Myners (2001) proposes that there should be a legal requirement that, where trustees are taking a decision, they should be able to take it with the skill and prudence of someone familiar with the issues concerned, as in the US. If trustees do not feel that they possess such a level of skill and care, then they should either take steps to acquire it, or delegate the decision to a person or organisation who they believe does.

Myners (2001) details the findings of UK based research conducted among trustees and scheme administrators of which 226 respondents were trustees. Some interesting facts emerge.

- The majority of trustees had no professional qualification in finance/investment.
- In the first twelve months of trusteeship, 26 per cent of trustees received less than one day's training and 43 per cent of trustees received one or two days training.
- The majority of trustees held other full time jobs.
54 per cent of trustees spoke to investment managers less than once every three months.

61 per cent of trustees spent time with investment managers less often than every three months.

49 per cent of trustees spent three hours or less preparing for pension investment matters.

3.3.1 Agency Issues

Within the pensions industry, agency difficulties can be prevalent in a number of the key relationships – that of the scheme members and the scheme trustees, between the scheme trustees and the scheme fund managers, between the scheme actuary and the scheme trustees and also between the scheme actuary and the sponsoring employer. These agency issues are compounded by a light touch regulatory environment (currently favoured by regulators) and if trustees have not the expertise, training or operating framework in place, to recognise and deal with them with appropriate guidelines and monitoring. The result can be conducive to an inefficient pension system, with high costs and a lack of transparency to scheme members, notwithstanding the accountability of pension fund trustees to scheme members.

The agency problem arises because the principal and agent have different goals and the principal may not be able to determine if the agent has behaved appropriately. The essence of the problem is that the principal does not have the expertise that the agent has. That is why the principal needs the agent (Allen 2001). Eisenhardt (1989) describes “moral hazard” as the lack of agreed upon effort on the part of the agent. “Adverse selection” refers to the misrepresentation of attributes by the agent and it arises because the principal cannot completely verify these skills or abilities when he or she is hired (Eisenhardt (1989). The principal –agent relationship which exists between pension scheme trustees (as principal) and the schemes fund manager(s) (as agent) is potentially fraught with difficulties unless there are clear guidelines as to objectives/benchmarks and appropriate constraints and incentives in the underlying contract. Allen (2001, p.3) suggests that the way in which investment managers are remunerated can exacerbate the problem. Awards and penalties are not symmetric.

“If the people making the investment decisions obtain a high reward when things go well and a limited penalty if they go badly, they will be willing to pay more than the discounted cash flow for an asset….. Risky assets become attractive, their prices are bid up and a bubble can occur”
Monitoring may be difficult;

“For any specific situation, there will be an optimal amount of monitoring that balances the possibility of lost resources due to improper agent action against resources spent monitoring the agents behaviour” (Emery & Finnerty, 1991, p.222).

Solutions may be costly -the principal may invest in information systems such as reporting procedures to discover the agents’ behaviour. Another alternative is an outcome - based contract which would motivate the agent to align his preferences with those of the principal (Eisenhardt 1989). Regulators have introduced a range of policy measures to mitigate or reduce agency issues. However, market based solutions through competition amongst providers may not reduce agency issues because of informational asymmetries.

3.4 Pension Reform in Europe

This thesis argues that concerns raised in it on costs levels, regulation and governance should be reflected in any comprehensive programme for pension provision in Ireland. As the literature suggests these concerns are similarly relevant elsewhere throughout the EU and the rest of the world although to a greater or lesser extent depending on individual country circumstances. It is useful therefore to consider literature charting developments in pension reform throughout the EU in particular as a context for the Irish experience.

The forecast increase in the cost of old age pension provision and possible future difficulties in funding pensions in many countries, is at this stage well documented. “Rapid demographic transitions caused by rising life expectancy and declining fertility mean that the proportion of old people in the general population is growing rapidly” (World Bank,(1994), Foreword). Changing labour markets, in particular reduced participation in the labour force by males over 50 (Disney, 1996 p. 193, and p. 225) due to early retirement and/or disability also contributes to the dependency ratio. In most developing countries, an informal system whereby children care for their aged parents and income transfers flow between generations in both directions is still the mainstay of provision in old age. But in many countries, economic development has resulted in the informal arrangements giving way to formal market arrangements and to varying degrees, mandatory government programmes (World Bank, 1994, Ch.2).
In very many countries, Governments have developed formal pension arrangements to some degree. Key to the type and nature of each system is Government policy on a number of policy issues viz:

- Whether primary reliance should be on voluntary or mandatory mechanisms;
- The replacement rates built into the design of social security and private pension benefits;
- The balance to be attained between poverty alleviation and redistribution, saving and income smoothing.
- What elements of insurance should be provided.
- How the system should be financed – funded or on a pay as you go basis.
- Should the system be managed publicly or privately.

The widely cited World Bank Report (1994) identifies in its overview, three functions of old age security systems – redistribution, saving and insurance. The study suggests that financial security for the old and economic growth would be better served if Governments developed three systems or “pillars” of old age security; a publicly managed system with mandatory participation and a limited goal of reducing poverty among the old (social security pension), a privately managed mandatory D.C. system (a pension plan either a personal savings or occupational plan), and voluntary savings (a personal savings or occupational pension plan).

The World Bank (2006) provides an evaluation of the banks efforts at pension reform. While its evaluation understandably focuses on countries that sought the banks guidance on pension reform, it illuminates the many challenges and difficulties involved in designing pension reform and in developing effective institutions for implementing and administering a new pension system. The report recognises that a “one size fits all” approach would be impractical and that the banks work with most Governments in this area was in implementing reforms to existing systems rather than designing and implementing the DC – focussed multi-pillar system advocated by the bank in 1994.

Stewart and Hughes (2009) describe how long term demographic projections of relative increases in the numbers of pensioners have resulted in many countries in the EU reforming their public pension systems to make them more affordable and sustainable. The changes include increasing the retirement age and indexing pensions in line with prices rather than wages. The resulting reduction in replacements rates (discussed below) has opened up a gap between expected and projected income in retirement and many countries have adopted
policies encompassing private pension arrangements to bridge that gap. The authors describe how personal pension plans have been introduced in France, Italy, Germany, Sweden, Denmark, the UK, Poland, Belgium and Ireland within the last two decades but, there is little evidence that individual pension accounts have improved or will improve the pension entitlements of most contributors. Minimum contribution rates, poor persistency and the lack of Government guarantees on security of capital invested or rate of return, are all listed as reasons for the lack of success. The authors question the potential for proposed auto enrolment schemes to succeed where previous pension plans have not succeeded, on the basis that the auto-enrolment schemes share many of the features of the voluntary pension plans which preceded them.

Vidlund, (2007) noted that continental/corporatist welfare states were most resistant to change with social partners having a decisive role in achieving successful reform. Some general trends among the variation of pension reforms were identified;

- Tightening the link between contributions and benefits, (most visible in Italy, Sweden, Poland and Latvia).
- Implementation of individual pension accounts.
- Establishment of various sustainability factors or demographic factors.
- Changes in pension indexation rules – cost of living index instead of wage index.
- Measures aimed at raising the effective retirement age.
- Pre-funding of pensions.

Vidlund concludes;

- There is no single roadmap, no “one size fits all”
- Institutions do matter – continuity in pension policy is a visible phenomenon when countries develop their pension systems.
- In many countries the income composition of the retiree will change- towards multipillar approach.
- Defined contribution savings accounts are high on the pension reform agenda. However there is a range of variation in the role of the State, individual’s freedom of choice, the provision of minimum pensions, overall coverage, regulation, investment rules and benefit guarantees.
- Pension reform policy is a “never ending story”
The EU (2010) launched a further public debate on the future of pensions with the issue of a Green paper which reviews the European pension framework in a holistic and integrated manner and seeks views on possible future actions at European level. The stated aim of the Green paper and consultative process is to address the following issues:

- "Ensuring adequate incomes in retirement and making sure pension systems are sustainable in the long term.
- Achieving the right balance between work and retirement and facilitating a longer active life.
- Removing obstacles to people who work in different EU countries and to the internal market for retirement products.
- Making pensions safer in the wake of the recent economic crisis, both now and in the longer term
- Making sure pensions are more transparent so that people can take informed decisions about their own retirement income"

EU (2010).

The consultation period will run for four months ending November 2010, after which the European Commission will consider further action to address these issues at EU level.

3.4.1 Replacement rates:

Earlier discussion of Stewart and Hughes (2009) raised the concept of a "replacement rate" as a means of assessing different pension systems. Replacement rates are a ratio of post retirement income to pre-retirement income e.g. ratio of pension benefits to earnings in the year prior to retirement/average of the highest three of the ten years prior to retirement. While such measures may be simplistic and ignore for instance, the value of leisure and free time, income versus consumption, ability to draw down the principal from accumulated savings and so on, they are the most commonly used measure of relative well-being post and pre-retirement. Boskin and Shoven (1984) concluded perhaps surprisingly, that the current generation of elderly retired persons in the US was wealthier than any elderly generation that had preceded it and in some respects was quite well off relative to the current younger generation of workers. Their results suggest, again surprisingly, that by the late 1970s replacement rates were substantially in excess of one for most income classes. Social security alone fully replaced average earnings for the elderly poor and replaced over half for middle-income elderly couples, once adjustments were made for child-rearing costs, taxes and risky earnings. Andrews and Hurd (1992,) also suggested that in the U.S., average replacement
rates as adjusted were quite high. On a pure income basis the elderly were little worse off on average than the rest of the population and taking into account income in kind (such as medical assistance) they may actually have been better off than the population average.

More recent work carried out in the Irish context, by Connell and Stewart (2004) suggest that retired households' relative income position worsened over the time period examined (1987-1994 and 1999/2000). The Household Budget Survey data examined by the authors show that households in Ireland headed by persons aged 65 and over had lower than average incomes, but accounted for a lower proportion of relatively poor households than other age categories. The largest single source of income for households headed by a person aged 65 and over consisted of the state old age pension. Households in the sample were relatively asset rich (with a majority owning their own home) but did not appear to own more liquid assets such as stocks and shares. Relatively small levels of income of the households sampled, came from occupational pension scheme, which the authors feel may be due to the relative immaturity of many pension schemes.

An adequate replacement rate is a core requirement for the long term success of any national pensions policy although it can be achieved by a combination of state and private provision. In the Irish context the Pensions Board (1998) argued that the problem of high rates of poverty in old age could be addressed by having a target replacement rate of 50 per cent of gross pre-retirement income and a minimum income of 34 per cent of gross average industrial earnings. The National Pensions Framework (Irish Government, 2010a) sets as a target a State contributory pension equivalent to 35 per cent of average earnings topped up by personal pension coverage. There is a necessary interaction between State and private provision in funding an adequate replacement rate. Many Governments are currently taking steps to reduce the costs of state pension by lowering state benefits, which in turn increases the dependency on private pension systems to ensure adequate replacement rates. As discussed above however, Stewart and Hughes (2009) report little evidence of private pension provision successfully filling the replacement rate “gap”. A sustainable balance between State and private replacement rate funding remains a fundamental challenge to many Governments in the quest for a sustainable pension system for all citizens.
CHAPTER 4.

The Role of Costs in Pension Fund Performance.

4.1. The Visibility and Impact of Costs.

Chapter 3 has shown from a literature review, that there is an acceptance among some academics (Bateman and Mitchell (2004), Bikker and De Dreu (2009)) and some policymakers (UK Pensions Commission (2005), that pension costs "over the lifetime of a scheme" can substantially erode retirement assets. However in individual scheme cases, this number or a best estimate of this number is rarely if ever reported. Indeed as discussed later in this chapter, there are inconsistencies and in many cases significant under – reporting of costs on an annual basis by pension schemes, and this in many ways means that there can be no easy tracking of the cumulative effect of costs. While pension scheme costs may or may not be a material number affecting the growth in scheme assets in any particular year, this is not necessarily the critical factor. What is critical is the cumulative effect of yearly costs over the lifetime of a scheme on the final fund value (ie the long-term rather than the short-term impact). The lack of focus on the annual effects of costs and as a result, on the cumulative effect over the lifetime of a scheme, explains in part at least, why yearly costs and cost levels are not a principal target to date in the reform of pension provision in Ireland.

It is appropriate to reiterate at the start of this chapter that costs are only one of a number of determinants in the growth and size of a pension scheme. The adequacy of the retirement income provided by any particular pension scheme is only in part determined by the net of costs rate of return earned by the scheme on its assets (Appendix 1). The net rate of return on scheme assets is in turn determined by many different factors only one of which is the cost/fee structure incurred by the scheme. This chapter does not argue that cost levels are the only key determinant in a pension fund's performance, but it is argued that their significance is not acknowledged by trustees, pension fund members and regulators, that cumulatively they are significant, that they are largely under -reported and accordingly have not to date been
addressed in terms of value for money, competitiveness within the industry and accountability to trustees and scheme members.

Costs faced by Irish pensions schemes may be levied in a variety of ways. This variety of charging mechanisms mirrors the pattern of pension fund cost structures elsewhere in the world as shown by the Whitehouse (2000) study of pension scheme costs across thirteen different countries (see Chapter 3 p.40). Costs may be fixed, charged on a transaction basis or a combination of both. They may be explicit or implicit, up-front (i.e. charged in a lump sum at the outset) or spread over the lifetime of the scheme. Cost rebates/discounts may be agreed depending on transaction volume or size of fund. The pension schemes of the larger financial institutions may benefit from cross subsidies where for instance the sponsoring company also provides investment management services to its pension scheme without charging at full rates or charging on an ad-hoc basis. All of the above have the effect of obscuring the cost structure of pension fund management and making the task of estimating/forecasting costs of pension fund management and administration difficult.

The Green Paper (2007a) describes explicit charges made by third party providers to funded supplementary pension arrangements as follows:

1. Fees, plus VAT charged by the service provider to the arrangement itself and /or to the sponsoring entity. These would include for example, legal fees, fees for accountancy services, fees charged by professional trustees as well as fees for investment advice and for custodial services;

2. Contract charges which can take a number of forms for example:-
   - A contribution charge, deducted by the provider before investment of the contribution. For example for every €100 contributed, only €99 is invested on the member’s behalf. This type of charge is particularly prevalent where the investment is in a third party managed unitised fund (Appendix 1). Of the €100 contributed, only €99 is allocated towards buying units in the fund.
   - A monetary charge, deducted by the provider before investment of a contribution, or deducted from the accumulated fund, or added to the contribution payable;
   - A fund based charge, typically expressed as a percentage of the fund, e.g. 1 per cent per annum. This is deducted within the fund before the setting of the unit price or fund value.
Implicit charges are additional to explicit charges. The Green paper includes as implicit costs, investment trading costs (e.g. commission and stamp duty) and margins in risk benefit premiums charged by insurers, in relation to anticipated future mortality and morbidity rates.

The charges listed above as either explicit or implicit are not a comprehensive list of all charges and how they are categorised. What is interesting and unsatisfactory in terms of transparency and management of pension fund costs, is that depending on the structures through which fund contributions are invested and managed (see Appendix 1), costs which are explicit for one scheme may be implicit for another. For example a larger scheme placing a block of funds with a particular fund manager for direct investment in equities and bonds may agree terms whereby all costs directly associated with management of the funds are explicitly stated in a periodic statement of account. Such a statement could include both investment trading costs as well as fund management fees and fees for related services. However, a smaller scheme investing in a series of unitised funds will on an ongoing basis typically have access only to daily "bid" and "offer" unit prices. Units are purchased at the offer price (the higher price) and encashed at the bid price. The bid/offer spread can be as high as 5 per cent and effectively represents a charge on the scheme. This charge is in addition to actual trading costs (i.e. costs of buying and selling the securities) and possibly also management charges, which would have been deducted from the fund before the bid/offer price was set. In this type of situation, a trustee or scheme member would find it difficult to determine the actual level of costs suffered as there would not be a statement of account produced which would collate the various types of cost incurred.

Employers may also incur costs in operating funded supplementary pension arrangements in relation to:

1. Processing employee pension scheme contributions- deductions from salary and payment to pension fund administrators.

2. Providing from the employer’s own resources of various administration services for the scheme- dealing with retirements, new entrant details, changes in tax law, and regulation, etc

3. Providing information and advice to employees in relation to operating a company pension scheme.
4. Making annual returns to the Revenue Commissioners in relation to contributions paid to the main scheme and subsidiary schemes such as, AVC schemes etc.
(Source: Green Paper (2007a) p. 187.)

Where this type of administrative support to pension schemes is provided by the employers’ own resources (for example the human resources department or payroll department), the incremental cost of the service may be difficult to quantify as the employer personnel providing the service may have duties and responsibilities outside of their duties to the pension scheme and accordingly apportionment of the related labour cost may not be straightforward. It is impossible to reliably estimate these particular costs across all schemes given that some employers will provide significantly more administrative support and exercise a greater duty of care towards employees than others who may merely meet their formal commitment to the scheme. However it is likely that these costs have risen through time due to additional regulation of pension schemes and scheme benefits.

Accordingly, depending on the size of the pension scheme, the structures through which, it makes its investments, the fee reporting arrangements with the service providers and the administrative resources available to the scheme, the quality and levels of data available to trustees and members on costs levels incurred by the scheme can be significantly different from scheme to scheme. This is exacerbated by the fact that there is no specific accounting or legal requirement for full and separate disclosure of all costs (see section 4.2 below). These are some of the reasons why there is no comprehensive data base of cost levels incurred by pension schemes and why developing such a data base is difficult. It follows therefore that this gap creates difficulties in assessing the value for money of services provided and in promoting cost competitiveness among fund management service providers.

Earlier, in Chapter 3, reference was made to assumptions on average annual fund costs incurred by Irish occupational pension schemes, incorporated in a widely referred to analysis of pension schemes in Ireland (Pensions Board (2006a) Appendix A - The Life Strategies/ESRI report). While the findings underpinning these assumptions were largely based on UK sources (James (2000), and other UK data sources), they are accepted by the industry in Ireland as being indicative of the Irish experience. In summary the Life Strategies/ESRI report (2006) makes the following assumptions on average annual explicit and implicit costs incurred by Irish occupational pension schemes;
Implicit trading costs of 0.65 per cent for equities, 0.25 per cent for corporate bonds and 0.1 per cent for Government and index-linked bonds. This means that if the gross return on equities for a given year is 6.00 per cent, the return after deducting trading costs is 5.35 per cent. If the gross return on corporate bonds is 4 per cent, the return after deducting trading costs is 3.75 per cent. If the gross return on Government and Index-linked bonds is 2 per cent, the return after deducting trading costs is 1.9 per cent.

Explicit costs of selling, processing and administering pension products and explicit charges paid to fund managers, equivalent in total, to a reduction in yield (RIY) of 1.5 per cent. This means that if the investment return earned by a fund after deducting implicit trading costs, was 5 per cent, the net return to the fund after explicit costs would be 3.5 per cent.

Once-off expenses incurred in purchasing annuities for retiring members of 3 per cent of the members fund prior to annuitisation, reflecting typical annuity commission rates of 2 per cent plus an assumed profit margin of 1 per cent.

The average equity holding by pension schemes was, close to 70 per cent (IAPF 2002-2008) during the period under review, so that trading costs incurred by most schemes were closer to 0.65 per cent of fund value (i.e. the trading cost for equities) rather than 0.25 per cent or 0.1 per cent. Combining this trading cost of 0.65 per cent of fund value with a fund management charge of 1.5 per cent and adding in some additional cost for purchasing annuities (currently, only a minority (35 per cent) of pensions in payment are annuitised), an average annual fund cost level of 2.2 per cent of fund value was calculated and used for the purposes of this research as representing actual average scheme experience.

Figure 4.1 below shows actual cost levels disclosed and reported in the financial statements of the schemes examined for the purposes of this research and compares them with an assumed average annual fund cost levels of 2.2 per cent of fund value.
Figure 4.1.

Disclosed fees as a % of fund value vs assumed actual fees of 2.2% of fund value

Note; Due to the skewed distribution the median figure for 2001, 2003, 2006 and 2007 is too close to 0 to register a reading on the graph (see chapter 2, p. 33).

The contrast depicted in Figure 4.1 is startling. If we assume that these schemes are experiencing actual costs close to the Life strategy/ESRI assumed average\(^{10}\), the degree of non-disclosure makes what is disclosed meaningless and misleading in terms of providing members and trustees alike with an accurate picture of actual costs incurred. In effect, if we accept the Life Strategies/ESRI assumed Irish cost levels as being reliable then mandatory full cost disclosure by pension schemes would be likely to result in an increase well in excess of 100 per cent in costs currently disclosed. The median figure for 2001, 2003, 2006 and 2007 is too close to 0 to register a reading on the graph and for the remaining years is also relatively very low. This reflects the fact that a high percentage of schemes disclosed no fees at all (see chapter 2 page 34)

\(^{10}\) As discussed on page 80 cost levels could be higher than this estimate particularly if funds engage in “specialist” investment funds.
It is not assumed in this thesis that costs are not being fully accounted for by pension schemes currently but rather that a significant portion of costs incurred are netted off against investment income in scheme financial statements rather than shown separately. Hence if returns were reported gross of costs with costs disclosed separately, the reported numbers for each would be higher.

Overall there were no significant increases in levels of disclosure over the years for which data was obtained (Figure 4.1 above) although there were fluctuations within industries (Figures 4.2-4.6 below). This would suggest that notwithstanding the acknowledged growing number of under-funded schemes, costs incurred and value for money of services received by such schemes, have yet to become a matter of any considerable focus for the industry, trustees or scheme members.

The scheme financial statements examined, were categorised by industry type - Services (other than financial services), Retail, Manufacturing, and Financial Services to assess whether disclosure rates varied across industries. As is evident from figures 4.2-4.5 (rates of disclosure across industry), significant non disclosure featured across all industry types and for all years under review.
Figure 4.2

Services Industry
Disclosed fees as a % of fund value vs assumed actual fees of 2.2% of fund value. 2002-2007

![Graph showing disclosed fees as a % of fund value vs assumed actual fees of 2.2% of fund value for the years 2002 to 2007.](image-url)
Figure 4.3

Retail industry

Disclosed fees as a % of fund value vs assumed actual fees of 2.2% of fund value.

Note: The mean and median figures are the same because of small sample size.
Figure 4.4

Manufacturing Industry
Disclosed fees as a % of fund value vs assumed actual fees of 2.2% of fund value.

Note: Due to the skewed distribution, the median figure for all years are too close to 0 to register a reading on the graph.
The financial services sector (figure 4.5 above) demonstrated increasing rates of disclosure in later years. This could be due to a number of factors, - increased costs, increased cross charging or sharing of scheme management fees by the scheme sponsoring company, growing awareness within this sector of the need for transparency of costs, and/or the fact that it might be expected that, financial service companies would have the information systems most suited to the identification and collection of cost data. One data issue was that the increased rates of disclosure could be attributable to changes in sample composition over time. To examine this possibility further the following regression was run:

\[
\text{Fees per cent fund size} = \text{Fund dummies} + \text{year dummies}.\]

The results indicated that disclosure trends over time for individual funds were consistent with the overall mean and median results. This suggests that changes in sample composition over time were not an influencing factor in the overall results.
Notwithstanding the overall increases in the rate of costs disclosed, many financial service schemes reviewed, disclosed little or no fund management charges at all and as Figure 4.6 suggests, overall, the rate of disclosed costs in schemes where the sponsoring company was either a financial services company or was part of a financial services group, was lower than rates of disclosure for other industries. This could suggest that the sponsoring financial services company or a related group company had incurred the costs and had not passed them on to the scheme or at least not in a transparent manner. It could however also suggest that financial service pension schemes are run more efficiently than non-financial service schemes.

**Figure 4.6**

Fees % of Fund Size: Parent (Financial Services) vs Parent (Non-Financial Services)- all years.

Note: The median figure for the financial services parent companies is too close to 0 to register a reading on the graph.
As demonstrated by figure 4.7, there is a negative relationship between the size of the pension scheme and the rate of costs disclosed – i.e. the greater the size of the scheme (over a certain minimum fund level) the lower the rate of disclosed costs (the straight line indicating overall a downward trend as size increases).

**Figure 4.7**

Scatter of Size of Fund (Ln) and Fees % of Fund Size

Note: The log of fund size was used because of the disparity in fund size

This inverse relationship between size and rate of costs disclosed is not entirely surprising as it is likely that while larger firms incur larger absolute costs, their cost ratio (i.e. costs as a per cent of fund size) would be smaller due to economies of scale.

Chapter 6 considers the role of professional trustees in the make up of trustee boards. Figure 4.8 shows the rate of disclosure of cost levels by schemes who employ the services of a professional trustee compared with schemes who do not.
Figure 4.8 suggests that for the years 2003 to 2006, disclosed fees were lower in schemes where a professional trustee was a member of the board of trustees while for 2002 and 2007 the reverse is the case. The reasons for this could be varied. One possibility is that in general the value added by professional trustees in terms of efficiencies in running the scheme (savings on other professional fees) and monitoring of cost levels, more than offsets the fees charged by the professional trustees themselves but professional trustee fees may increase disproportionately to other costs in years where the pension scheme requires incremental managerial effort (e.g. where scheme rules/benefits are being restructured etc). Another possibility could however be that the level of non disclosure has been traditionally greater in schemes with a professional trustee (because perhaps transparency and disclosure would require disclosure of professional trustee fees also) but that this may be reversing due to a growing awareness and acceptance by trustees of the need for transparency and indeed perhaps it also reflects the fact that professional trustee fees have increased somewhat disproportionately through time.

Figure 4.9 shows a stark difference in cost disclosure levels between DB and DC schemes.
Figure 4.9

Fees % Fund Size: Defined Benefit (DB) vs. Defined Contribution

Note: The rate of disclosure by DC schemes was too low to register on the graph.

One third of DC schemes (five schemes) indicated in their financial statements that administration expenses of the scheme were borne by the sponsoring employer (whilst not giving details of what or how much these costs were). This is significantly higher than the equivalent percentage for DB schemes which was a little over 14 per cent. The rate of costs disclosed by DC schemes was significantly lower than that of DB schemes. Figure 4.9 shows that the rate of disclosure by DC schemes was too low to register on the histogram. However it should be noted that the comparison is based on a very small number (15, see chapter 2) of DC schemes. The difference in the rate of disclosure between DC and DB schemes could be partly explained by the nature of investment by the DC schemes included in the study. Given that the majority of DC schemes included in this study are small schemes (Table 1.2) it is likely that the nature of such schemes' investment is through managed funds rather than direct investment. This means that scheme trustees present members with various fund management options, for investment of their contributions (e.g. whether to invest in an equity, gilt, property or mixed fund). The fund management options are quite often structured as unitised
funds where charges are made within the fund and not separately disclosed to members. The DC scheme assets may largely be units in various funds which are priced daily net of all costs and as a consequence analyses of costs are not readily available. It may be the case that for many of the DC schemes included in this study, administration costs are absorbed by the employer company (up to one third of the DC schemes included in this study) and fund management fees are charged within the investment vehicles used by the schemes. This combination could result, in the actual rate of costs disclosed by the DC schemes being significantly less than the DB schemes included in the study.

Table 4.1 below summarises in column 2, the mean and median comparative results over time (2002-2007) for levels of costs disclosed in each of the categories as follows; –

1. Schemes with and schemes without a professional trustee,
2. DB schemes compared with DC schemes,
3. Schemes where the sponsoring parent is a publicly quoted company and schemes where the sponsoring parent company is not publicly quoted,
4. Schemes with a sponsoring parent in the financial services sector and schemes where neither the sponsoring company or a related company was a financial services company.
5. Disclosure rates across the industry sectors, - financial services, services other than financial services, manufacturing, and retail.
Table 4.1
Fees disclosed as a percentage of fund size
Summary Statistics

<table>
<thead>
<tr>
<th>Column 1</th>
<th>Column 2</th>
<th>Column 3</th>
</tr>
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<tbody>
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<td>Summary Statistics</td>
<td>Significance Tests</td>
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<td>Median</td>
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<td>Professional Trustee</td>
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<td>Non-Professional Trustee</td>
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<td>Defined Contribution</td>
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<td>0.000</td>
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<td>Parent (Financial)</td>
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<td>Parent (Non-Financial)</td>
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<td>Manufacturing</td>
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<td>Services</td>
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<tr>
<td>Financial Services</td>
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<tr>
<td>Retail</td>
<td>0.172</td>
<td>0.201</td>
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<tr>
<td>Manufacturing vs. Financial</td>
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<tr>
<td>Services</td>
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<td>Financial Services vs. Retail</td>
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Note: This table reports the mean and median "fees disclosed as a percentage of fund size" for each of the categories of fund set out in Column 1 and by industry type. In column 3, the t and z-stats test the equality of means/medians, respectively between the two groups where ***, **, and * represents significance at the 1, 5, and 10 per cent level, respectively.

In column 3 of Table 4.1 (above) the t and z -statistics test for each of the categories examined, whether the mean/median differences are statistically different from one another. The summary statistics and significance test results reported in Table 4.1 suggest that fund type, i.e. whether the scheme is a DB scheme or a DC scheme is a significant determining factor in the level of costs disclosed (significance level in excess of 2 – t-test 5.58, z -test 5.65). The results also suggest that differences in cost levels disclosed between a scheme with a sponsoring parent in the financial services sector and a scheme with a non financial services parent are also statistically significant, (t-test 1.94). Finally, Table 4.1 also indicates that the increased levels of costs disclosed by schemes in the services industry (other than financial services) are statistically significant, compared with the manufacturing industry (t-test 2.46, z-test 2.24), or the financial services industry (t -test 1.66, z-test 1.49).
The univariate comparisons presented in Figures 4.1 - 4.9 and summarised in Table 4.1 do not take cognizance of the fact that more than one factor may be influencing the results. For example, relative to DC schemes, DB schemes report a significantly higher level of costs (as a function of size), and relative to the manufacturing industry, schemes of companies in the services sector (other than the financial services sector) also report greater levels of costs. However it may be that the majority of schemes within the services sector are also DB schemes so that more than one variable may be affecting the result. The multiple pooled regression analysis presented in Table 4.2 tests the strength of the principal correlation findings when other known factors are controlled for.

The results in Table 4.2, however fall short of establishing causation, because it must be accepted that there may be other factors, not controlled for, which may be driving the relationship. To test for multicollinearity, variance inflation factors (VIF’s) were calculated. The VIF is a measure of how much the variance of an estimated regression coefficient is increased because of collinearity. The VIF results were less than 3 for each calculation, i.e. significantly below the cut-off value of 10 proposed by Kutner, Nachtsheim and Neter (2004) in terms of an acceptable level of multicollinearity.
Table 4.2
Regression Estimates

<table>
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<td>Size of Pension Fund</td>
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<td>-0.043*</td>
<td>-0.061***</td>
<td>-0.062***</td>
<td>-0.062***</td>
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<tr>
<td>Defined Benefit</td>
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<td>-0.164</td>
<td>-0.167</td>
<td>-0.151</td>
<td>-0.221</td>
<td></td>
</tr>
<tr>
<td></td>
<td>[0.57]</td>
<td>[1.40]</td>
<td>[1.38]</td>
<td>[1.12]</td>
<td>[1.66]</td>
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</tr>
<tr>
<td>Public Company</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>[0.13]</td>
<td></td>
<td></td>
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<tr>
<td>Parent (Financial)</td>
<td>-0.062</td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>[0.27]</td>
<td></td>
<td></td>
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<tr>
<td>Services</td>
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<td></td>
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<td></td>
<td>0.431***</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>[3.59]</td>
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<tr>
<td>Financial Services</td>
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<td>[0.52]</td>
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<tr>
<td>Retail</td>
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<td></td>
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</tr>
<tr>
<td></td>
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<td></td>
<td></td>
<td>[0.38]</td>
</tr>
<tr>
<td>Time Dummies</td>
<td>Included</td>
<td>Included</td>
<td>Included</td>
<td>Included</td>
<td>Included</td>
<td>Included</td>
</tr>
<tr>
<td>R-Squared</td>
<td>0.035</td>
<td>0.037</td>
<td>0.105</td>
<td>0.106</td>
<td>0.106</td>
<td>0.180</td>
</tr>
</tbody>
</table>

Note: This table reports coefficient estimates from pooled ordinary least squares regressions, with t-statistics (absolute value calculated using standard errors adjusted for clustering at the fund level) reported underneath in square brackets.

The dependent variable is fees (disclosed) as a percentage of fund size. Size of Pension Fund is the log of the size of the pension fund (in euros) (The log is used to take account of the disparity in fund size). Professional Trustee, Defined Benefit, Public Company, and Parent (Financial) are dummy variables which are 1 if the pension fund has a professional trustee, is a defined benefit, is a public company, and whose parent is a financial services company, respectively. Services, Financial Services, and Retail are industry variables, where manufacturing is the excluded (and thus reference) industry class. The coefficients were bootstrapped to take account of sample size. Bootstrapping provides a way to account for the distortions caused by a specific sample which may not be representative of the population.

The multiple pooled regression analysis in Table 4.2 above demonstrate that when certain other known factors are controlled for, there remains a significant negative correlation between fund size and the levels of costs disclosed. This is most likely explained by economies of scale. The higher rate of disclosure of DB schemes over DC schemes remains significant also but this might be explained by more than one possibility – DC Schemes may be cheaper overall to operate, and/or the type of investment by DC schemes (unit – linked funds) may make identification of total costs difficult. Disclosure rates reported by the services industry other than the financial services industry remain significantly higher relative to the manufacturing industry. The reduction in levels of costs disclosed by schemes using the services of a professional trustee is found to be significant at the wider confidence levels only.

The inconsistencies in the level of disclosure of costs across schemes and overall low levels of disclosure of costs can be attributed to both the complexity of charging structures as set out
earlier in this chapter and in Chapter 3 as well as a lack of any statutory requirement with regard to specific disclosures on total costs to be included in the financial statements of pension funds (discussed below). However it could be argued that agency issues referred to in Chapter 3 also play a part. Charging structures are not inherently so complex as to make it impractical for service providers to furnish pension schemes with an annual statement of costs incurred by the scheme under all headings – whether the fees are explicit or implicit. It is likely to be the case that in what might be described as largely a self regulated industry (subject to statute) such as the pensions industry, it may be in the interests of major players in the industry, not to disclose cost levels incurred by effectively its customers.

### 4.2 Regulations Relating to Fee Disclosure

Given the poor levels of cost disclosure in pension scheme financial statements in practice, it is useful to consider statutory requirements in this area.

S.56 of the Pensions Act 1990 supplemented by Statutory Instrument Number 301 of 2006, (S.I. No 301 2006) requires the trustees of a pension scheme to have;

> "the accounts of such a scheme audited by the auditor of the scheme in respect of each scheme year which commences on or after 23 September 2005,"

(S.I No 301 (2006); p.7).

In addition the auditor’s report on the accounts of the relevant scheme shall include –

> "a statement, that, in his opinion, the accounts show a true and fair view of the financial transactions of the relevant scheme during the scheme year and of the amount and disposition of the assets and liabilities (other than liabilities to pay pensions and other benefits in the future) at the end of the scheme year;"

(S.I.No 301 (2006); p. 8)

> "Accounts of the scheme shall show a true and fair view of –

(a) the financial transactions of the scheme during the scheme year, and

(b) the assets and liabilities at the end of the scheme year.”

(S.I. No 301(2006); Appendix A)
An important issue is the question of whether pension fund accounts can be regarded as showing a “true and fair” view if all costs of the scheme for a particular year have been included in the accounts for that year irrespective of whether they have been disclosed separately or included by way of an offset against investment return. Up until 2007 there was no provision (in law or in best accounting practice) requiring investment return to be disclosed gross of costs with costs shown separately, for the purposes of satisfying the “true and fair” requirement. Typically for the purposes of satisfying the “true and fair requirement” items would be required to be shown separately if they are “material” in the context of the financial statements or a key item in the financial statements. In an era of falling and even negative investment returns, costs could indeed be regarded as sufficiently material in the context of investment return to warrant separate disclosure but this does not appear to have been a generally accepted interpretation. For accounting periods beginning after 1 April 2007, the Statement of Recommended Practice (SORP.) “Financial Reports of Pensions Schemes”(International Accounting Standards Board (2007) requires disclosure in pension scheme financial statements of administration expenses, investment management expenses and direct transaction costs but specifically excludes indirect transaction costs within “pooled investment vehicles”. Potentially this exclusion encompasses the majority of fees and expenses incurred by schemes who invest through third party funds rather than directly i.e. all but the very large schemes. Disclosure is not required as one total figure- e.g. administration expenses may be disclosed in one part of the financial statements while direct transaction costs may be disclosed in another note to the accounts. The SORP effectively lost the opportunity to require a full and comprehensive disclosure of total fees and costs incurred both directly and indirectly, in a way that could be meaningful to the users of the financial statements.

Table 4.10 replicates in columns 1 and 2 the reported Income and Expenditure account of one of the schemes surveyed – (to be known as Scheme A), for the year 2002. Scheme A was picked from the population of 58 schemes studied because it was one of the larger schemes and provided a detailed Income and expenditure Account (as such it is an effective illustrative example). The Income and Expenditure account of scheme A was included in the Fund Accounts issued by the scheme to its members for that year. It shows a return on investment for the year of - €66,532,000 i.e. a loss of €66,532,000 ( Col. 1, line 24). The only costs disclosed as being included in this figure of -€66,532,000 are investment manager and custodial fees of €501,000 (Col. 1 line 23). The Income and Expenditure Account as presented would lead an uninformed reader to understand that total fees and costs incurred for
the year was in fact €501,000 and that -€66,031,000 represents losses made on investments before costs are taken into account. However if it is assumed that the scheme actually incurred costs approximating 2.2 per cent of the scheme value at the beginning of the year (the Life Strategies/ESRI assumed actual cost level), then the scheme costs were in fact €6,352,000 (2.2 per cent of €288,709,000 – Col 1, line 32), suggesting that undisclosed costs amount to €5,851,000 (line 38). This would suggest that gross investment losses for the year before costs were €60,180,000 and that this loss position were exacerbated by costs and fees of €6,352,000.

Column 3 of Table 4.10 restates the income and expenditure accounts of the Scheme A for 2002 on a full cost disclosure basis, assuming average fund cost levels of 2.2 per cent (based on the Life Strategies/ESRI report). Investment return is restated on a gross basis with a separate distinct disclosure of costs incurred. While the “bottom line” result remains unchanged (i.e. the fund value at the end of the year is stated at €217,019,000 in both columns 1 and 2 – line 34), the body of the income and expenditure account is significantly more informative in terms of the absolute amount of costs incurred and the resultant impact on gross income earned.
Figure 4.10

Income and Expenditure Account of Scheme A for the year ended 31 December 2002

<table>
<thead>
<tr>
<th>As provided to Scheme members 2002</th>
<th>Restated to show costs of 2.2 per cent</th>
<th>Line</th>
</tr>
</thead>
<tbody>
<tr>
<td>Col. 1</td>
<td>Col 2</td>
<td></td>
</tr>
<tr>
<td>Contributions and benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company contributions: Normal</td>
<td>2778</td>
<td>1</td>
</tr>
<tr>
<td>Members contributions: Normal</td>
<td>2008</td>
<td>2</td>
</tr>
<tr>
<td>Transfers from AVC scheme</td>
<td>21</td>
<td>3</td>
</tr>
<tr>
<td>Transfers from other funds</td>
<td>210</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>5017</td>
<td>5</td>
</tr>
<tr>
<td>Pensions</td>
<td>6086</td>
<td>6</td>
</tr>
<tr>
<td>Commutations</td>
<td>2615</td>
<td>7</td>
</tr>
<tr>
<td>Death in service benefits</td>
<td>218</td>
<td>8</td>
</tr>
<tr>
<td>Refund to members leaving service</td>
<td>234</td>
<td>9</td>
</tr>
<tr>
<td>Transfers to other funds</td>
<td>534</td>
<td>10</td>
</tr>
<tr>
<td>Insurance premium</td>
<td>26</td>
<td>11</td>
</tr>
<tr>
<td>Net deductions from dealing with members</td>
<td>-5088</td>
<td>12</td>
</tr>
<tr>
<td>Return on Investments</td>
<td></td>
<td>13</td>
</tr>
<tr>
<td>Investment income</td>
<td>5592</td>
<td>14</td>
</tr>
<tr>
<td>Foreign exchange losses</td>
<td>-61</td>
<td>15</td>
</tr>
<tr>
<td>Overseas tax</td>
<td>51</td>
<td>16</td>
</tr>
<tr>
<td>(Loss)/profit on sale of investments*</td>
<td>-24076</td>
<td>17</td>
</tr>
<tr>
<td>Unrealised losses on investments**</td>
<td>-47537</td>
<td>18</td>
</tr>
<tr>
<td>Investment manager and custodial fees</td>
<td>-501</td>
<td>19</td>
</tr>
<tr>
<td>Net return on investments</td>
<td>-66532</td>
<td>20</td>
</tr>
<tr>
<td>Total costs and fees</td>
<td>-6352</td>
<td>21</td>
</tr>
<tr>
<td>Net decrease in fund during period</td>
<td>-71620</td>
<td>22</td>
</tr>
<tr>
<td>Net assets of the scheme:</td>
<td></td>
<td>23</td>
</tr>
<tr>
<td>At beginning of period</td>
<td>288709</td>
<td>24</td>
</tr>
<tr>
<td>At end of period</td>
<td>217089</td>
<td>25</td>
</tr>
<tr>
<td>Costs as disclosed:</td>
<td>501</td>
<td>26</td>
</tr>
<tr>
<td>Total costs</td>
<td>6,352</td>
<td>27</td>
</tr>
<tr>
<td>Costs not disclosed</td>
<td>5,851</td>
<td>28</td>
</tr>
</tbody>
</table>

* (Loss)/profit on sale of investments is the difference between the original cost and the selling price.

** Unrealised losses on investments are the differences between the original cost and the market value of the investments which are unsold at the end of the accounting period. Accounting standards and guidelines dictate that to comply with the "true and fair" requirement, market value is to be determined as follows:

- Quoted investments are valued at the middle market prices ruling at the close of business on the balance sheet date.
- The market value of unit trusts and managed fund units is taken as the average of the bid and offer prices at the balance sheet date.
- Unlisted securities are stated at the trustee’s valuation (based on expert advice)
- Market prices denominated in foreign currencies are translated into Euro at rates of exchange ruling at the balance sheet date.
- Property is valued at open market value. Property valuations are carried out by an independent external valuer, every three years. In the intervening years, the trustees update the valuations based on expert advice.

78
Two further schemes (scheme E and scheme F) were chosen (also because they were larger schemes and provided detailed Income and Expenditure Accounts) and the Income and Expenditure Accounts of both schemes were similarly restated to demonstrate the potential impact of full cost disclosure. Again, the impact is significant. These income and expenditure accounts are reproduced in Appendix 9.

Measures to require uniform full disclosure of total costs as one number in pension scheme financial statements (as in column 2 of Table 4.10) would focus the attention of trustees and members on cost levels. This could be achieved by guidelines from the Pensions Board to the effect that full disclosure of costs including indirect transaction costs, is required to satisfy the “true and fair” requirement already enshrined in legislation.

As mentioned in the introduction to this chapter, one of the important consequences of less than total disclosure of costs is that the impact of costs on fund performance in a particular year and over a longer time-frame, is neither immediately apparent or easy to determine. This means that members, trustees and regulators are more likely to look at factors other than costs incurred, in searching for reasons and answers to pension scheme deficits. It also impairs competition in the fund management industry as trustees are not in a position to assess with clarity the cost of services provided or on offer by different fund managers.

Figure 4.11 shows the RIY impact on fund values over a 5, 10, 15 and 20 year period, of an annual cost level of 2.2 per cent on a fund with a starting value of €20m, annual net contributions of €100,000 and an assumed average annual gross rate of return of 4.5 per cent. The RIY is determined by comparing the future fund value assuming no costs with the future fund value assuming annual costs of 2.2 per cent to bring the net rate of return down to 2.3 per cent.
The compound effect of costs over the lifetime of a fund can be considerable as shown by Figure 4.11 (in excess of €15m or 33 percent of the gross fund, based on the data in Figure 4.11). If equivalent details on actual schemes were generally available or ascertainable by trustees and scheme members it is likely that costs/value for money of such costs would become much more of an issue in the tendering for investment management services.

It may be the case that the average rate of 2.2 per cent discussed above understates rather than overstates the levels of costs incurred by pension funds during the years under review. It may not for example, reflect to any great extent, the impact of costs associated with investing in "new /emerging asset classes", including Hedge Funds, Global Tactical Asset Allocation, Strategic Currency Hedging, Currency Overlay, Global Small Capital Equities and Emerging Markets Equities. All of these specialist investment strategies command flat rate fund management fees of between 1 per cent and 2 per cent per annum plus performance related fees of up to 20 per cent although in some cases there is a hurdle return, which must be reached before the manager receives a performance fee. Stewart (2007) reports estimates of 20 per cent of European and American and 40 per cent of Japanese pension funds investing in hedge funds, with estimated investment levels of 5 per cent to 10 per cent of total assets (although this will have changed considerably with the recent market down – turn.).
4.3 Costs – An issue or not in dealing with pension provision into the future?

As mentioned in chapter 1, the UK Pensions Commission (2005) recommended as part of a package of reform measures, the provision of a low cost pension provision option, which would in the longer term achieve annual management charges of as low as 0.3 per cent. These charges are set at a lower rate than current management charges for similar pension products – recognition that in part at least the perception of excess fees/poor value for money relating to pension funds is responsible for lower returns on pension funds and the current low levels of coverage in the UK. These reduced rate management charges would apply to investment in a prescribed range of investment funds. The UK Pensions Act 2008 incorporates provisions to implement these recommendations which will become effective in 2012 although it is accepted that the 0.3 per cent will not be achievable in the short-term and there will be an additional contribution charge to cover set up costs of the scheme (see chapter 7). The UK Pensions Commission anticipated that the existence of a low – cost option would increase coverage in the UK from current levels of 55 per cent to 80 per cent notwithstanding that coverage is not just a function of costs. Earlier proposals to make pension scheme membership mandatory (proposals which were understandably controversial) would not be as pressing if such an impressive uptake in membership were to occur.

It is likely that the existence of a lower cost option in the UK will increase cost competitiveness in the fund management industry generally as fund managers and industry service providers compete with each other to provide services to the newly established fund. The market for fund management products may well become more defined with clear choices between low cost streamlined products and high priced products offering additional options and “add-ons”.

Reductions in annual management charges from rates approximating 2.2 per cent of fund value down to rates as low as 0.3 per cent of fund value would (if they could be achieved) result in significant savings over the lifetime of a fund. Table 4.12 shows the impact of a 0.3 per cent management charge (as recommended by The Pensions Commission (2005)) on the income and expenditure accounts for Scheme A. The effect is considerable even looking at one year in isolation – a saving of approximately €5.5m on a starting fund value of €288m. The composite effect over the lifetime of a scheme would be many multiples of a single years savings.
Figure 4.12

Income and Expenditure Account of Scheme A for the year ended 31 December 2002

<table>
<thead>
<tr>
<th></th>
<th>As provided to scheme members 2002</th>
<th>Restated to show costs of 2.20 per cent 2002</th>
<th>Restated to show costs of 0.3 per cent 2002</th>
</tr>
</thead>
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<tr>
<td></td>
<td>Col. 1</td>
<td>Col. 2</td>
<td>Col. 3</td>
</tr>
<tr>
<td><strong>Contributions and benefits</strong></td>
<td>(000's)</td>
<td>(000's)</td>
<td>(000's)</td>
</tr>
<tr>
<td>Company contributions: Normal</td>
<td>2778</td>
<td>2778</td>
<td>2778</td>
</tr>
<tr>
<td>Transfers from AVC scheme</td>
<td>21</td>
<td>21</td>
<td>21</td>
</tr>
<tr>
<td>Transfers from other funds</td>
<td>210</td>
<td>210</td>
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</tr>
<tr>
<td>Pensions</td>
<td>6086</td>
<td>6086</td>
<td>6086</td>
</tr>
<tr>
<td>Commutations</td>
<td>2615</td>
<td>2615</td>
<td>2615</td>
</tr>
<tr>
<td>Death in service benefits</td>
<td>218</td>
<td>218</td>
<td>218</td>
</tr>
<tr>
<td>Refund to members leaving service</td>
<td>234</td>
<td>234</td>
<td>234</td>
</tr>
<tr>
<td>Transfers to other funds</td>
<td>534</td>
<td>534</td>
<td>534</td>
</tr>
<tr>
<td>Insurance premium</td>
<td>26</td>
<td>26</td>
<td>26</td>
</tr>
<tr>
<td><strong>Net deductions from dealing with members</strong></td>
<td>-5088</td>
<td>-5088</td>
<td>-5088</td>
</tr>
<tr>
<td><strong>Return on Investments</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>5592</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange losses</td>
<td>-61</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overseas tax</td>
<td>51</td>
<td></td>
<td></td>
</tr>
<tr>
<td>*(Loss)/profit on sale of investments</td>
<td>-24076</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrealised losses on investments</td>
<td>-47537</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment manager and custodial fees</td>
<td>-501</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net return on investments</strong></td>
<td>-66532</td>
<td>-60180</td>
<td>-60180</td>
</tr>
<tr>
<td><strong>Total costs and fees</strong></td>
<td>-6352</td>
<td>866</td>
<td></td>
</tr>
<tr>
<td><strong>Net decrease in fund during period.</strong></td>
<td>-71620</td>
<td>-71620</td>
<td>-66134</td>
</tr>
<tr>
<td><strong>Net assets of the scheme:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At beginning of period</td>
<td>288709</td>
<td>288709</td>
<td>288709</td>
</tr>
<tr>
<td>At end of period</td>
<td>217089</td>
<td>217089</td>
<td>222,575</td>
</tr>
<tr>
<td><strong>Costs as disclosed:</strong></td>
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<td></td>
</tr>
<tr>
<td>Actual costs</td>
<td>6352</td>
<td>866</td>
<td></td>
</tr>
<tr>
<td>Potential saving</td>
<td></td>
<td></td>
<td>5486</td>
</tr>
</tbody>
</table>

The RIY impact and effect on fund value of a reduction in costs from 2.2 per cent (Life Strategies/ESRI assumed average) to 0.3 per cent, on a fund with a starting value of
€20,000,000, annual net contributions of €100,000 and a gross rate of return of 4.5 per cent is depicted in Figures 4.13 and 4.14 below.

Figure 4.13

R.I.Y Impact on Future Values - 2.20% versus 0.30% Annual Costs – Starting Fund €20m.

Figure 4.14

Increase in Fund Value at starting value of €20m, if Costs are reduced from 2.2% to 0.30% of fund value.
From these results, it is strange that there are no firm proposals to date for a low cost occupational pension scheme model in Ireland or indeed that costs do not have any prominence in the latest proposals for pension reform in Ireland,(see chapter 7).

4.4. The Active Vs Passive/Market Size Arguments.

One argument against investing pension fund monies in an all for one low cost bulk bought funds is that the return premium associated with “active” as opposed to “passive” fund management is effectively lost. The UK Pension Commission (2005), when formulating its proposals for a low cost option, dealt with this concern by suggesting an “opt out” right to facilitate those who favoured the active managed route in favour of the low cost passive option.

“Active” and “Passive” investment refer to the investment philosophy of the investment manager and his approach to stock selection and portfolio construction. The “Efficient Market” hypothesis argues that;

- Markets are efficient;
- Markets do a good job in reflecting information in prices;
- Adding value over market returns is not easy;
- Forecasting market out-turns is difficult.

Advocates of this theory believe that assets are fairly priced by the market and therefore the search for added value is futile. Investors should therefore adopt a passive approach to investing by replicating market or benchmark returns and designing portfolios that track as closely as is practicable, the risk and return outcomes of the market or benchmark. Some argue, the investment industry is set for a massive rebalancing from active to passive fund management (the proportion of assets managed passively is forecast to rise from 15 per cent to 25 per cent during the coming decade) as disillusionment about the ability of active managers to beat benchmark indices persists. Active investors, however reject Market Efficiency, and believe that there are pricing anomalies in the market that can generate additional value over market or benchmark returns, albeit at increased risk (O’Loughlin and O’Brien, 2006). Active investment management fees, are higher than passive fees, because of the incremental resources and skills required in active management and on the basis that successful active management has the potential to generate returns that more than compensate for the extra fees involved.
The results of earlier research, however, show that the degree of “herding” among fund managers raises questions as to how “active” active fund management really is? For example, the Irish Life managed “Consensus fund” (which is marketed as a passive fund), had an average holding in Equities in 2001 of 69 per cent with the balance of the fund invested in properties, bonds and cash. This compares with an average equity holding of 63 per cent by actively managed funds surveyed in previous research (McNally (2003)) suggesting strong similarities between active and passive fund managers in the equity weighting of investment portfolios. Myners (2001 p.75) found that UK fund managers tended to gravitate to holding the same asset classes as one another, in roughly the same proportions, thus reducing the risk of losing clients by generating returns noticeably lower than other fund managers. This raises a concern that funds may be paying active fees for what is effectively passive management. Also of concern are indicative comparative active versus passive returns (Table 4.3 below) provided by one of the respondent schemes (Scheme B) which clearly shows combined active returns falling far short of the passively managed fund returns for sustained periods. This gives rise to a double negative in that pension schemes are paying increased fees but achieving less than market or benchmark returns.

Table 4.3.

Comparison of Fund Performance; Active vs. Passive management – Scheme B.

<table>
<thead>
<tr>
<th>Performance relative to Index</th>
<th>Active managed Euro equities</th>
<th>Active managed global Equities</th>
<th>Passively managed fund.</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 months to 31/3/08</td>
<td>-2.4 per cent</td>
<td>-3.2 per cent</td>
<td>0.5 per cent</td>
</tr>
<tr>
<td>6 months to 31/3/08</td>
<td>-5.0 per cent</td>
<td>-0.3 per cent</td>
<td>0.7 per cent</td>
</tr>
<tr>
<td>9 months to 31/3/08</td>
<td>-4.4 per cent</td>
<td>3.2 per cent</td>
<td>0.9 per cent</td>
</tr>
<tr>
<td>1 year to 31/3/08</td>
<td>-5.0 per cent</td>
<td>4.6 per cent</td>
<td>0.9 per cent</td>
</tr>
<tr>
<td>2 years to 31/3/08</td>
<td>-5.3 per cent</td>
<td>1.5 per cent</td>
<td>1.0 per cent</td>
</tr>
<tr>
<td>3 years to 31/3/08</td>
<td>-3.7 per cent</td>
<td>2.6 per cent</td>
<td>0.8 per cent</td>
</tr>
</tbody>
</table>

Source: investment returns provided by scheme B.

4.5 Can the Irish market sustain a low cost fund management option?

A further concern arises as to whether there could be sufficient economies of scale in the size of the Irish market to generate and sustain a fund management service at costs as low as the levels envisaged in the UK proposals. Perhaps the best indicator of what is achievable in terms of economies of scale, can be obtained from looking at the experience of the National...
Pensions Reserve Fund (NPRF). The NPRF was established in April 2001 with the objective of providing in part for the costs of social welfare and public service pensions from 2025 onwards. The Annual Report of the NPRF for 2008 refers to a survey completed in 2007 which found that total fund costs including costs incurred by NTMA as manager and fees charged within third-party investment vehicles, were 0.28 per cent of average fund assets.

A review of the Annual Report of the NPRF for 2005 (chosen because 2005 is one of the years focussed on in this study in terms of cost disclosure rates for private pension arrangements) indicated similarly efficient cost ratios in earlier years. At the beginning of 2005, the fund had assets under management of €11,689m and these grew to €15,410m by the end of that year (NPRF Annual Report and Financial Statements 2005). In 2005, the fund employed both active and passive fund management techniques with approximately half of its large cap. equity allocation being passively managed (Financial Statements 2005, page 11.) The Financial Statements for 2005 report costs and fees charged to the fund of €23,813,896 and further costs incurred by the fund but borne by the Exchequer of €4,375,838 (page 19). The Financial Statements note that these costs are however, exclusive of fees and other operating expenses charged to the fund indirectly through its participation in third party investment vehicles in respect of emerging markets equities, commodities, property, and private equity. Reported costs (approximately €28m) as a percentage of assets under management excluding those assets held through third party investment vehicles were approximately 0.24 per cent. Even if this is increased to reflect implicit trading costs (0.65 per cent for equities, 0.25 per cent for corporate bonds and 0.1 per cent for Government gilts), it is still significantly less than standard equivalent charges incurred by private pension schemes. It is acknowledged in the NPRF 2005 annual report and financial statements that the funds size and position as a long term investor enables it to negotiate very competitive fees with investment managers.

It should be stated however that the NPRF would not have the administrative systems in place to collect pension contributions and allocate pension entitlements. The establishment of such systems would necessitate set up costs which (as with the UK proposals) could be significant.

4.6 Conclusion

The RIY impact of pension fund costs (administrative and all other charges) over the lifetime of a scheme highlights the need for greater focus to be placed on cost efficiencies and competitiveness in any proposals for pension reform in Ireland. The lack of full consistent
disclosure in fund financial statements, has contributed to the overall lack of emphasis on costs and hampers meaningful analysis and comparison. An immediate measure to require uniform full disclosure of total costs as one number in financial statements would help focus attention on costs levels and introduce cost competitiveness. Even a small percentage reduction in costs per annum can have a significant impact over the lifetime of a fund.

The introduction of a low cost occupational pension scheme model similar to the UK proposals should be considered in Ireland, as part of a wider range of measures to improve both coverage and pension adequacy. It could offer a very attractive option for existing schemes currently grappling with deficits (although it could only be one of a range of solutions which many of these schemes require, if they are to regain solvency) and for new schemes striving to avoid the by now well-documented plight of a considerable percentage of existing schemes. A transparent low cost structure would improve cost competitiveness in the industry generally. This could promote greater trust and confidence in the pension system and could improve voluntary coverage. It could also ease some of the concerns (in relation to costs and value for money), which are likely to prevail, in this country with regard to proposals for an auto enrolment pension system (see chapter 7).
CHAPTER 5

The Actuarial Process: A Critique

5.1 Introduction.

As discussed in chapter 1, this thesis seeks to demonstrate the importance of actuarial assumptions in the valuation of pension fund liabilities and how changes in actuarial assumptions can impact on the reported financial health of a pension scheme. This chapter examines the pivotal role of the scheme actuary and the actuarial process in the regulation of pension schemes. The scheme actuary is responsible for recommending the contribution level required to meet a scheme’s pension expectations/promises. The actuarial valuation of a pension scheme is a “key performance indicator” in the assessment of the scheme’s capability to meet these expectations/promises. It is a key component of the regulatory framework within which pension schemes operate. This chapter looks at the actuarial process and argues that the role of the scheme actuary is subject to conflicts of interest. It also argues that from a regulatory and a monitoring perspective “less is more”. The more subjectivity facilitated in the actuarial valuation process the less informative it is as a performance indicator for both regulators and trustees, and the easier it is to “manage” the valuation result to coincide with the expectations of the target audience.

5.2 The Role of the Actuary

Actuarial Science is defined as the discipline that applies mathematical and statistical methods to assess risk in the insurance and finance industries (Wikipedia, 2009). Actuarial science includes a number of interrelated subjects, including probability and statistics, finance and economics. The science has gone through revolutionary changes during the last 30 years due to the proliferation of high speed computers and the synergy of stochastic actuarial models with modern financial theory (Frees, 1990).

A less “respectful” definition of the role of an actuary is:-
"An actuary is a person who passes as an expert on the basis of his or her prolific ability to produce an infinite variety of incomprehensible figures calculated with micrometric precision from the vaguest of assumptions based on debatable evidence of confusing data derived by persons of doubtful reliability for the sole purpose of confusing an already hopelessly befuddled group of persons who never read the statistics anyway"

Gallagher M. (2010).

The Society of Actuaries in Ireland is the professional body representing the actuarial profession in Ireland. It describes itself as dedicated to serving the public through the provision by the profession of actuarial services and advice of the highest quality. These services and advice are provided not only to trustees and employers in relation to occupational pension schemes but also to financial institutions in the design and supply of pension products, and to public bodies charged with regulating the pensions industry.

The Society of Actuaries (2008d) in its submission to the Department of Social and Family Affairs on the Green Paper (2007a) identified a number of substantial changes over recent years in the environment in which pensions are delivered. A number of the key changes are set out below and they provide evidence that actuarial modelling and assumption setting is constantly evolving in the context of the design, maintenance or redesign of pension plans and pension provision. In particular:

- There have been significant improvements in life expectancy across all ages. These are forecast to continue.
- The demographics of the Irish population are such that the ratio of retired persons to social welfare contributors is likely to treble over the next 40 years.
- Interest rates have fallen, impacting adversely on the cost of securing pensions. A protracted period of relatively low stock market returns coupled with more volatile investment markets has created a more challenging set of financial conditions.

In the context of a defined benefit pension scheme, the role of the actuary will typically be as advisor to the trustees and sponsoring employer at the initial design of the scheme and start up stage, advising on such matters as contribution levels, benefit levels, regulatory matters etc. Thereafter his/her principal involvement on an ongoing basis will be to carry out the periodic valuations of the scheme which are required by regulation and by the scheme trustees, liaise
with the scheme auditors regarding the schemes’ annual financial statements and with the auditors of the sponsoring employer with regard to the reporting requirements in the financial statements of the sponsoring employer. A valuation exercise for a defined benefit pension scheme typically has two main objectives. It estimates the annual contribution rate (payable by the employer in full, or by the employer and employees in accordance with a predetermined formula set out in the rules of the scheme) which is required to ensure sufficient resources within the fund to support the cost of benefits to pensioners, deferred pensioners, current staff and their respective dependants. From this, the sufficiency of current contribution rates becomes apparent. A pension scheme valuation also determines, based on predefined criteria, the extent to which the existing assets of the scheme are capable of meeting the scheme’s liabilities in respect of benefits attributable to completed pensionable service i.e. the scheme “surplus” or deficit at a given point in time.

The members of a defined contribution scheme carry the investment risk rather than the sponsoring employer, and once the initial start up and design stage has been completed, the role of the actuary in the context of a defined contribution scheme is primarily to advise on the level of contribution required to meet a particular level of benefit. Defined contribution schemes are generally speaking not subject to the “Minimum Funding Standard” (see below) and the “accounting” requirement in the sponsoring company’s financial statements is typically limited to reflecting the annual commitment which the sponsoring company has to make in terms of contributions to the scheme. The concepts of “surplus” and “deficit” do not arise.

Since the role of the actuary of a DB scheme has more far reaching impact in terms of both the sponsoring employer and the scheme itself than the role of a DC scheme actuary, the issues discussed below relate primarily to the valuation of DB schemes.

### 5.3 The Actuarial Valuation Exercise

The valuation of a defined benefit pension scheme’s assets and liabilities is required in at least three different circumstances. It may be required for the purposes of determining whether the fund satisfies the minimum funding standard valuation set down by the regulatory authority (see section 5.4). The fund trustees may also require a valuation for the purposes of their annual trust report to the members of the pension scheme (section 5.5). Finally in the case of a defined benefit scheme, a valuation may be required for the purposes of the financial
statements of the sponsoring company, to recognise the “fair value” of the surplus or deficit in the pension scheme (section 5.6).

What is interesting is that there is no specific requirement for consistency in the valuation assumptions used in each of the three valuation processes. At any given valuation date therefore, a defined benefit scheme may have three different valuation results, required for three different purposes, each of which would be regarded as fully acceptable for its specific purpose and to its specific target audience. Indeed, as can be seen below, the prescribed guidelines to be followed in each of the three valuation processes in themselves necessitate differing assumptions and calculation bases and different emphasis in the produced results.

5.4 Minimum Funding Standard requirement- “Discontinuance” or “Winding Up” valuation.

The objective of this valuation is effectively to establish whether the scheme is holding sufficient assets to meet the benefits, which have already accrued to members at the date of the valuation, i.e. if the scheme were to be wound up on the valuation date. Irish pension schemes are regulated by the Pensions Board, a statutory body set up by the Government under the Pensions Act 1990. The Minimum Funding Standard was introduced by the Pensions Board in 1991 (it was provided for in S. 44 of the Pensions Act 1990) in order to set out the minimum assets that a defined benefit scheme must hold and what steps must be taken if the assets of the scheme fall below this minimum. The funding standard is satisfied if, broadly, in the actuary’s opinion, the scheme’s assets on the date of the valuation are more than the sum of;

- The transfer values at that date (see below) to which the members would be entitled to; and
- The estimated expenses of winding up the scheme

All pension schemes are required to register with the Pensions Board and subject to some exceptions\(^\dagger\), all defined benefit schemes (where members are promised a defined pension on retirement based on their length of service, and level of salary on retirement) must submit an Actuarial Funding Certificate (AFC) to the Board every three years. This certificate states

\(^\dagger\) Defined Benefit schemes of certain public sector organisations are also exempt from the funding standard.
whether in the Actuary’s opinion, the resources of the scheme would/would not be sufficient, if the scheme were wound up, to provide for the liabilities of the scheme under the Pensions Act, and the estimated expenses of administering the winding up of the scheme, i.e. whether the scheme satisfies the funding standard of the Act.

If an AFC indicates that, in the actuary’s opinion, the scheme does not satisfy the funding standard, the scheme trustees must submit a funding proposal with the AFC to the Pensions Board. The funding proposal must set out the contribution plan to be undertaken which the scheme actuary can certify as being sufficient to allow the scheme to satisfy the funding standard within the period of the proposal. The period of the proposal was restricted to three years up until 2003 but since 2003, given the growing number of DB schemes in deficit, the Pensions Board has allowed in certain circumstances a longer period of exemption—(this is discussed further in chapter 7).

The guidelines to be followed by a scheme actuary in valuing the assets and liabilities of a pension scheme for the purposes of determining whether it complies with the Funding Standard, are included in Actuarial Statements of Practice (ASP PEN-3 and ASP PEN-2) issued by the Society of Actuaries in Ireland (2008c, 2008b). The legal basis for the guidelines is Section 42(4) of the Pensions Act 1990 which refers to “applicable professional guidance issued by the Society of Actuaries in Ireland “

An important point to note with this valuation process is that the actuary need only concern himself with the position had the scheme been wound up at the effective date of the certificate—ie what the scheme’s assets and liabilities were on the date of the issue of the certificate. This reduces the level of estimate required on matters such as future salary increases over and above inflation, early retirement/disability possibilities, etc, and brings some precision into the calculation. While the Pensions Act requires the actuary to have regard to such financial or other assumptions as he considers appropriate on the effective date of the certificate, A.S.P. PEN 3 states that the actuary should interpret this as;

“a prudent view of the future without taking into account every conceivable unfavourable development”

and

“excluding the possibility of events which he cannot reasonably be expected to have allowed for in a prudent best estimate approach”
For the purposes of the funding standard, assets must be valued at their realisable value at the effective date with allowance being made for the expenses of sale where appropriate. Net realisable value is not necessarily the same as market value as it may reflect any discount the pension scheme might be forced to absorb by virtue of having a forced sale of its assets within a short period of time. Liabilities can broadly be split between pensions currently payable to pensioners and deferred pension entitlements (for all active members i.e. employees and former employees who have not yet reached retirement age and have future pension entitlements from the scheme). The cost of pensions in payment can be determined by reference to the cost of an equivalent annuity or annuities. The value of deferred pension entitlements is taken as the individual transfer values to which each member would be entitled if he or she had transferred out of the scheme at that date. The transfer is calculated by projecting the benefit payments to which the members will be entitled based on their employment to date, including an appropriate margin for mortality improvement and assuming a prescribed investment return rate as a discount factor, calculating the size of the fund required in today’s terms to meet the projected benefit payments. The prescribed investment return is calculated assuming investment in equities (assumed to generate a return in excess of the fixed interest rate, i.e. an equity premium or a return over and above the fixed interest rate to compensate for the fact that equities are a riskier investment), until 10 years before normal retirement age and thereafter, a mix of equity and fixed interest investments with the proportion of fixed interest investments gradually increasing to 100 per cent by normal retirement age.

ASP PEN 3 accepts that the funding standard may not necessarily be the same as that typically used in assessing solvency for the purposes of advice to trustees. It sets out some examples of areas of difference:

- The fact that the funding standard refers to a position at the effective date
- There may be differences between the scheme rules on winding up and established practice of the trustees (assuming continuation of the scheme), in relation to discretions, options etc.
- Likely changes in membership, remuneration, early retirement policy, augmentation of benefits, etc, can be more readily considered in an ongoing valuation.
The approach to be taken by the actuary in a discontinuance/winding up valuation is largely prescribed and allows for little discretion on a number of key assumptions. As such this valuation result could be regarded as a suitable benchmark calculation for all pension schemes regardless of their size or the industry they represent. One very significant criticism of the calculation is that, as mentioned above, it is based on a rate of investment return which assumes an equity premium (a return on equities greater than that on short dated Government bonds) in the period leading up to retirement (see Table 5.1.). In other words, a key assumption underlying the calculation is that the schemes’ funds are more heavily invested in riskier assets such as equities rather than Government bonds and that the equity investment actually delivers a return in excess of the return which would be obtained on Government bonds. This means that, for active and deferred members, the calculation of the individual transfer values results in a lower capital value for each member’s deferred benefit than if it were calculated based on government bond yields (because bond yields are lower than assumed equity yields). Accordingly even where a scheme satisfies the statutory minimum funding standard, if the scheme were to be wound up, employees could receive a transfer value which is unlikely to be sufficient to provide benefits in line with their previous expectations unless the underlying capital sum is invested in risky assets and these risky assets actually deliver in terms of their expected return.

The Society of Actuaries (2008d) recommends that to improve benefit security the minimum funding legislation be strengthened by requiring that liabilities be valued on an “economic basis” (present value of the benefit promise based on prevailing yields on government fixed interest stock of suitable term and realistic estimates of mortality, including allowance for future mortality improvements). This significantly higher figure would be divided into a minimum funding level with a requirement to repair under-funding below this level over a 9 to 12 month period and a higher “target funding level” with scope to address under-funding below this level over a longer (15 year) period.

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12 The most recent version of ASP PEN –2 (effective 1/9/2009) sets out the prescribed assumptions for use in the calculation of transfer values in a discontinuance valuation. These include: discount rate – pre retirement -7.75 per cent, long term discount rate – post retirement - 4.5 per cent, rate of price inflation – pre retirement – 2 per cent, long term rate of price inflation – post retirement – 2 per cent.
Section 56 of the Pensions Act 1990 (supplemented by S.I. No 301 of 2006), requires the trustees of a defined benefit pension scheme to have audited financial statements produced annually for the scheme and to have the assets and liabilities of the scheme valued by the actuary of the scheme at such times as may be prescribed. When the legislation was first introduced, the requirement was for a valuation every 3 or 3 and 1/2 years, depending on the nature of the scheme and when it was established. With effect from 23 September 2005, the period between valuations became 3 years for all schemes. The main purpose of this valuation is to assess an appropriate funding/contribution rate from the employer/employees for the scheme. What is an appropriate funding rate will depend on the benefits to be provided by the scheme and the projections of the trustees and the sponsoring company in terms of how the required level of funding should be built up. For instance the objective may be to have a stable contribution rate or for the employer to contribute higher amounts in years where profit levels are high and reduce the contribution rate during poorer performing years. Another approach would be to target a certain minimum level of funds to achieve a given level of security for the benefits accrued to date.

As mentioned in chapter three, Actuarial Standard Of Practice PEN 1 (ASP PEN 1) Funding Defined Benefits- Actuarial Reports,(Society of Actuaries 2008a) sets out the blueprint for actuaries carrying out a valuation for the purposes of S.56 of the Pensions Act 1990, or any other situation where an actuary is providing advice on the contributions required to meet a particular level of benefit.13 Where the report is intended to satisfy a statutory obligation (e.g. under pensions legislation) the actuary must confirm in the report that the valuation has been carried out in accordance with ASP PEN 1 and the actuary signing the report must have an up to date practicing certificate. ASP PEN 1 primarily applies to defined benefit pension schemes.

A valuation report issued in accordance with ASP PEN 1 must state the value of the schemes’ assets (at market value), and a statement of the benefits payable under the scheme. This will include the value of accrued liabilities (in respect of past service) and liabilities in respect of future service. It should also state the funding level on which the valuation is based and recommend the level of contribution required, consistent with the funding objectives of the scheme until the next actuarial valuation. The level at which the employer and/or the

13 Actuarial Statements of practice are given legal standing through the Pensions Act 1990.
employees must contribute to the scheme in order to meet their commitments under the scheme i.e. the funding level, will be based on a wide variety of assumptions. These include projected rates of return on contributions invested, numbers and ages of members entering and leaving the scheme, mortality rates of members, early retirement rates and salaries of members on retirement. These assumptions can only be estimated based on previous experience (for example, mortality rates) and expectations for the future (for example future returns). ASP PEN 1 states that it is not intended to restrict the actuary’s freedom of judgement in choosing the method of valuation and the underlying assumptions employed in deriving the level of contribution required but it is intended to ensure that the methods and assumptions used are properly explained and that variations between the assumptions chosen and actual experience are analysed in the report. The report must contain a summary of the demographic and economic assumptions made explicitly and implicitly, in valuing the liabilities, target benefits and scheme assets.

The level of subjectivity in an “ongoing valuation” is far greater than in a “wind up” or “discontinuance” valuation given that the former valuation will encompass assumptions on future outcomes in a number of key areas. If the exercise is to be a thorough one, it must at a minimum be a three way process involving the actuary, the trustees and the employer company with meaningful dialogue on employer plans in terms of numbers joining and leaving the company and hence the scheme, projected salary levels etc. and the impact of these in terms of demands on the scheme. Even with this dialogue, the result can still only be a “best estimate”. The investment strategy of the scheme is also of importance as is the sensitivity of the valuation result to variances between actual and estimated investment return.

If trustees do not understand and question the key variables in the valuation calculations they cannot satisfy themselves as to the robustness of the reported valuation and the range within which it could fluctuate should actual experience differ from that forecast. Notwithstanding the existence of investment advisors to the scheme, trustees could find themselves exposed to a legal challenge for non-performance of duties if they are not informed sufficiently as to the robustness of the valuation result and try to abdicate their responsibilities in this regard in favour of the actuary.

5.6. “The Accounting Approach”

Accounting for defined benefit plans in the financial statements of the sponsoring company is a complex matter. The complexity arises because the employer must in each accounting
period, recognise as an expense in its income statement/profit and loss account the cost to the employer of the retirement benefits that will eventually be paid to employees as a result of the services that they have provided during the period. Because these benefits may be payable in many years time and their cost will depend on a number of factors (e.g. mortality, return on investments etc.), which are difficult to determine in advance, the calculation of the expense which should be recognised in an accounting period is not straightforward. As the sponsoring company carries the risk of any shortfall arising on a defined benefit scheme (i.e. if amounts contributed by both the employer and the employee, together with the net investment return on such contributions were insufficient to pay the scheme pensions and benefits as they fall due), such a shortfall if it were to exist, would constitute a medium to long term liability of the sponsoring company, over and above its annual funding commitment and would need to be recognised as such in the sponsoring company’s financial statements. The converse also applies in that any excess of assets in the pension scheme (i.e. surplus) which could reduce the sponsoring company’s payments or commitments in the future would also be required to be recognised as an asset in it’s financial statements.

The International Accounting Standard No. 19 (IAS 19) (International Accounting Standards Board 2008) provides the internationally recognised guidance on accounting for and disclosure in Financial Statements of defined benefit pension benefits and obligations. This standard in fact deals with the accounting for and disclosure of all kinds of employee benefits but it is in the area of defined benefit pension plans that IAS 19 provides most complexity and arguably controversy.

The first stated objective of IAS 19 is to ensure that an employer’s balance sheet reflects a net pension liability/asset in respect of employee benefits to be paid in the future. This is known as the “balance sheet” approach. The second stated objective of IAS 19 is to ensure that the employer’s Income Statement recognises an expense when the employer consumes an economic benefit arising from the services provided by the employee in exchange for employee benefits. Notwithstanding, these stated objectives, the IAS also incorporates provisions to facilitate a more “smoothed” result in the published financial statements (the “corridor” approach.).

Accounting for defined benefit plans is complex because actuarial assumptions and valuation methods are required to measure the balance sheet obligation and the income statement expense. The plan liabilities (the defined benefit obligation) and the plan assets are measured at each balance sheet date. The plan assets are measured at fair value (not necessarily the
same as either "net realisable value" or market value). The defined benefit obligation is measured on an actuarial basis and discounted to present value. The difference between the fair value of the plan assets and the present value of the defined benefit obligation is a surplus or deficit. A surplus is regarded as an asset to the extent that the employer gains an economic benefit from it. A deficit is regarded as a liability to the extent that the employer has a legal or constructive obligation to make it good. It is the accrued net cost to date at the Balance Sheet date (over and above the employers' normal contribution rate,) of the promise inherent in a DB scheme that the employer will make good any shortfall in the schemes funding. Subject to certain conditions, a surplus or deficit should be recognised as appropriate as an asset or liability on the employer’s balance sheet.

IAS 19 avoids implying that a surplus in a defined benefit scheme is “owned” by the employer. But conceptually an employer does not have to own a surplus in order to recognise the surplus as an asset. It is sufficient that the employer has access to future economic benefits from the surplus such as the ability to reduce future contributions, take a contribution holiday or recover a refund of past contributions. Consequently a surplus can be recognised as an asset to the extent that the employer can access any of these future benefits.

Ownership of surpluses in DB schemes is a key issue particularly because predator firms may seek to strip out surpluses after taking over another firm. Davis (2001) contends that while seizing assets held for the benefit of members, may be seen as an abuse of tax privileges, it could also be argued that since the ultimate parent firm is responsible for making good any deficit, the surplus should belong to it.

IAS 19 requires the amount recognised in the employer company’s balance sheet as a defined benefit liability (deficit) or asset (surplus) to be the net total of the following amounts:

- The present value of the defined benefit obligation at the balance sheet date;
- Plus any actuarial gains less any actuarial losses not yet recognised as income or an expense because of the smoothing afforded by the corridor approach;
- Minus any past service cost not yet recognised;

It remains unclear as to the legal ownership of any surplus which might arise as a result of a valuation exercise where contributions have been made by both the sponsoring company and the scheme members. This is a question to be resolved on a scheme by scheme basis, depending on individual scheme rules.

Differences between reality and the actuarial assumptions used will occur frequently. Immediate recognition of these differences has the consequence that the total pension cost in the employer’s financial statements may become hugely volatile. In order to reduce this volatility IAS 19 allows flexibility as to the recognition of certain of these actuarial gains or losses depending on their size relative to the overall assets/liabilities of the scheme. This is known as the corridor approach.
• Minus the fair value at the balance sheet date of plan assets out of which the defined benefit obligation is to be settled directly.

The defined benefit obligation is defined as reflecting "expected future payments required to settle the obligation resulting from employee service in the current and prior periods". It comprises not only legal obligations under the formal terms of the plan, but also constructive obligations arising from the employer's informal practices e.g. an established practice of facilitating early retirement even though this may not be specifically provided for in the terms of the scheme. The calculation of the liability includes a projection of the benefit earned to date to each future point that the benefit could be paid with allowance for salary increases and probabilities of payment. This requires assumptions on mortality, both during and after employment, rates of employee turnover, disability and early retirement, the proportion of plan members with dependants who will be eligible for benefits and claim rates under medical plans. The liability must then be discounted back to the current valuation date using the yield on high quality corporate bonds (AA).

Lane, Clarke & Peacock (2008) (see Chapter 3), noted from the IAS 19 valuations of 29 Irish schemes reviewed, that widely varying assumptions were used in key areas across the schemes. Life expectancy assumptions adapted by the schemes surveyed ranged from 83.5 years to 87.1 years for a male and 86 years to over 90 years for a female. Discount rate assumptions (based on "high quality" corporate bond rates) ranged from under 5.6 per cent to 6.5 per cent, inflation assumptions ranged from 1.75 per cent to 2.5 per cent and expected return on equities ranged from 7 per cent to 9 per cent.

Because assumptions on future experience are key to this valuation process there is undoubtedly scope to "manage" results or smooth an actuarial surplus or deficit, as can be seen from Tables 5.2 and 5.3 below.

5.7 One question, three correct answers, or perhaps more?

In summary, some of the key determinants in an actuarial valuation process can have differing meanings and different calculation bases, depending on the basis under which the valuation is carried out, as can be seen in Table 5.1 below.

Past service costs arise when an employer grants pension rights for service rendered prior to the establishment of the pension plan or when an employer grants an increase in pension benefits also for service rendered in past periods. Past service costs may be vested in which case they are recognised immediately as an expense/liability or they may be conditional on further future employment in which case they are recognised on a spread basis.
Table 5.1. Comparison of the three valuation approaches to measuring pension fund performance.

<table>
<thead>
<tr>
<th></th>
<th>Column 1</th>
<th>Column 2</th>
<th>Column 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Funding standard</td>
<td>Realisable Value</td>
<td>Market Value</td>
<td>Fair value</td>
</tr>
<tr>
<td>(ASP Pen 3)</td>
<td></td>
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<tr>
<td>Valuation of Assets</td>
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<tr>
<td>Valuation of liabilities</td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>Discount Rate</td>
<td>Prescribed rate of investment return</td>
<td>Assumed expected return on investments.</td>
<td>Yield on high quality corporate bonds</td>
</tr>
<tr>
<td></td>
<td>pre and post retirement which assumes an equity premium in the period prior to retirement.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortality</td>
<td>Based on most recent mortality tables but with assumptions on future trends.</td>
<td>Based on most recent mortality tables but with assumptions on future trends.</td>
<td>Based on most recent mortality tables but with assumptions on future trends.</td>
</tr>
<tr>
<td>Annuity factor</td>
<td>Based on mortality assumptions and the gap between the expected rate of pension increase and the discount rate.</td>
<td>Based on mortality assumptions and the gap between the expected rate of pension increase and the discount rate.</td>
<td>Based on mortality assumptions and the gap between the expected rate of pension increase and the discount rate.</td>
</tr>
</tbody>
</table>
Under a standard Revenue approved defined benefit pension scheme, the annual pension entitlement of a scheme member at normal retirement age is calculated as follows:

\[
\frac{n}{60} \times \text{pensionable salary} \quad \text{(final salary or an average of a number of years salary, e.g. last three years), where } n \text{ is the number of years of pensionable employment completed by the scheme member and cannot exceed 40 years. The member may opt to take part of his pension entitlement as a lump sum on retirement and a correspondingly reduced annual pension thereafter.}
\]

The calculations are relatively straightforward once the scheme member reaches retirement age. The difficulty arises in estimating accurately what the final pension entitlement (and hence the scheme's liability to each member) will be at any point before the member reaches normal retirement age. A number of variables are used in the calculation, requiring further elaboration;

1. **No. of years of pensionable employment** = the number of years the member will be in the scheme if he remains working for the scheme employer until normal retirement age. Tax legislation sets the maximum pension entitlement for a tax approved pension scheme at \( \frac{1}{60} \) of final pensionable salary for every year of completed service subject to a maximum of \( \frac{40}{60} \).

2. **Pensionable salary** - expected salary on retirement or some average, calculated based on expected annual earnings over a number of years, up to the date of retirement. Expected salary at date of retirement is current salary increased by the estimated annual rate of salary increase for each year remaining up to retirement. Generally the expected salary on retirement is reduced to reflect the fact that the pensioner will be entitled to a state pension also on reaching state retirement age. However for the purposes of the examples below, this will be ignored.

3. **Annuity factor** – calculated based on number of years an employee is expected to live post retirement and if an employee has a spouse, the number of years the employee’s spouse is expected to outlive the employee thus becoming eligible for a spouses’ pension. This factor is determined by mortality tables which are actuarially calculated and compiled based on historic mortality experience and also taking into account both

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17 As discussed in chapter 1, Revenue approval is necessary if the pension scheme is to benefit from the favourable tax treatment available to revenue approved pension schemes – see also Appendix 2.
the discount rate and expected pension increases but it may be adjusted to reflect assumptions on expected mortality experience into the future.

Discount rate – used to estimate the present day value of the future liability.

Table 5.2 below shows the comparative calculations and liabilities under the three methods of valuation assuming the following base data,

**Base Data**
Employee (female) age, 40 years,
Joined scheme at age 30
Status- Active
Retirement age, 65 years
Expected lifetime – 91 years (based on latest available mortality tables)
Current salary - €45,000
Expected annual rate of salary increase – 5 per cent
Expected annual rate of pension increase – 2.5 per cent (assume this is also the rate prescribed by the Pensions Board for the Minimum Funding Standard (MFS) valuation)
Expected inflation – 2.5 per cent - (assume this is also the rate prescribed by Pensions Board for MFS valuation)
Estimated investment growth rate – 7 per cent
Corporate Bond rate (AA) – 5.6 per cent
### Table 5.2  Comparative results under three valuation bases

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Minimum Funding Standard valuation</th>
<th>Ongoing trustee valuation</th>
<th>IAS 19 valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/60* (45 * (1.025 ^ 25))</td>
<td>35/60 *(Note 1)</td>
<td>10/35<em>35/60</em> (45,000*1.05^25)</td>
<td></td>
</tr>
<tr>
<td>*22.872046 * .154727686</td>
<td></td>
<td>*0.256095558 *19.33577823</td>
<td></td>
</tr>
<tr>
<td>Pensionable salary (45 * (1.025 ^ 25))</td>
<td>(45 * (1.05 ^ 25))</td>
<td>(45,000*1.05^25)</td>
<td></td>
</tr>
<tr>
<td>Discount Rate</td>
<td>.154727686 (Note 2)</td>
<td>0.256095558 based on</td>
<td></td>
</tr>
<tr>
<td>Discount rate</td>
<td></td>
<td>corporate bond rate - 5.6%</td>
<td></td>
</tr>
<tr>
<td>Annual factor</td>
<td>22.872046 - based on mortality and the gap between rate of pension increase and prescribed post retirement discount rate</td>
<td>16.36503325 - based on mortality and the gap between rate of pension increase and discount rate.</td>
<td></td>
</tr>
<tr>
<td>Valuation Result</td>
<td>€49,207</td>
<td>€268,030 of which €76,580 relates to past service and 191,450 relates to future service.</td>
<td>€125,764</td>
</tr>
</tbody>
</table>

Note 1
Maximum pension entitlement is 1/60 of final pensionable salary for every year of completed service subject to a maximum of 40/60. In this example, the employee joined the scheme at age 30 and therefore has a potential maximum number of years of completed service of 35.

Note 2
Discount factor (pre-retirement prescribed investment return) – 7.75 per cent.
Discount rate (post-retirement prescribed investment return) – 4.5 per cent
The discount rate of 0.154727686 is a composite rate based on the discount rates pre and post retirement and a market value adjustment (M.V.A.) to reflect the gradual transfer out of equities to fixed interest stocks in the 10 years prior to normal retirement age.

Interestingly, the liability in respect of service to date is lowest under the Minimum Funding Standard (MFS) valuation, which is supportive of the Society of Actuaries (2008) submission.
to the Green Paper that the MFS calculation should be more conservative and a higher minimum funding requirement (to be achieved possibly over a longer time frame) should be introduced. The IAS 19 valuation produces the highest liability calculation, however as the Lane Clarke and Peacock (2009) research discussed earlier indicated, there is significant opportunity to manage this particular calculation within the range of what might be considered "acceptable" assumption setting.

In the case of a group scheme (more than one member), the sum of the individual liabilities for each of the scheme members whether active, deferred or pensioners is accumulated to arrive at the total service liability for inclusion in the valuation exercise. Given the deviations in the results of the three calculations above for one individual employee, there is potential for significant differences to arise in schemes with large numbers of employees. The above examples do not reflect the complexities of early retirement options, disability clauses or a spouses' pension (if payable) all of which would impact on the calculations although not necessarily in equal measure across all three.

As mentioned earlier, changes in the assumptions feeding into the calculations can affect the results. In an "ongoing valuation" and under the "accounting" approach, changes in the "gap" between the discount rate and expected salary increases and the discount rate and expected pension increases will produce varying results. As Table 5.3 demonstrates, this provides opportunities to "manage" the results emerging in the context of an ongoing trustee valuation and an "accounting" valuation. However, prescribed pre- and post-retirement rates of investment return, and prescribed rates of inflation/pension increases, restricts the actuary from managing the MFS valuation by changing these particular assumptions.
### Table 5.3
Impact of assumption changes on the calculation of pension scheme liabilities:

<table>
<thead>
<tr>
<th></th>
<th>Minimum funding standard - liability</th>
<th>Ongoing trustee valuation- liability</th>
<th>IAS 19 – liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base data (see.p.104)</td>
<td>49,207</td>
<td>76,580</td>
<td>125,764</td>
</tr>
<tr>
<td>Base data but rate of pension increase - 2.00 per cent</td>
<td>49,207</td>
<td>72,196</td>
<td>118,048</td>
</tr>
<tr>
<td>Base data but rate of pension increase - 2.25 per cent</td>
<td>49,207</td>
<td>74,344</td>
<td>121,824</td>
</tr>
<tr>
<td>Base data but rate of pension increase - 2.75 per cent</td>
<td>49,207</td>
<td>78,909</td>
<td>129,875</td>
</tr>
<tr>
<td>Base data but rate of pension increase-3.00 per cent</td>
<td>49,207</td>
<td>81,336</td>
<td>134,166</td>
</tr>
<tr>
<td>Base data but rate of salary increase – 4 per cent</td>
<td>49,207</td>
<td>60,286</td>
<td>99,005</td>
</tr>
<tr>
<td>Base data but rate of salary increase- 4.5 per cent</td>
<td>49,207</td>
<td>67,966</td>
<td>111,617</td>
</tr>
<tr>
<td>Base data but rate of salary increase– 5.5 per cent</td>
<td>49,207</td>
<td>86,237</td>
<td>141,624</td>
</tr>
<tr>
<td>Base data but rate of salary increase – 6 per cent</td>
<td>49,207</td>
<td>97,058</td>
<td>159,394</td>
</tr>
<tr>
<td>Base data but inflation rate 2.25 per cent and rate of pension increase 2.75 per cent</td>
<td>49,207</td>
<td>78,909</td>
<td>129,875</td>
</tr>
<tr>
<td>Base data but inflation rate 2.25 per cent and rate of pension increase 2.25 per cent</td>
<td>49,207</td>
<td>74,344</td>
<td>121,824</td>
</tr>
<tr>
<td>Base data but discount rate increased by 0.5 per cent</td>
<td>49,207</td>
<td>64,428</td>
<td>105,122</td>
</tr>
<tr>
<td>Discount rate, salary/pension increase rate, increased by 0.5%</td>
<td>49,207</td>
<td>76,942</td>
<td>126,085</td>
</tr>
</tbody>
</table>
As Table 5.3 demonstrates, in the case of a trustee valuation or an IAS 19 valuation, changes in assumption rates can affect the calculation of scheme liabilities significantly – as high as 25 per cent in some of the calculations reflected in Table 5.3.

Figures 5.1, 5.2 and 5.3 further illustrate the capacity for the IAS 19 and the ongoing trustee valuation (OTV.) results to change, with changes in underlying assumptions on rate of pension increase, and rate of salary increase while the Minimum Funding Standard (MFS.) valuation remains unchanged because assumptions in relation to these particular variables are largely prescribed for the purposes of the MFS valuation.

**Figure 5.1**

**Impact of changes in assumed rate of pension increase on pension scheme liabilities.**
Figure 5.2

Impact of changes in assumed rate of salary increase on pension scheme liabilities.

Figure 5.3

Impact of changes in assumed rate of inflation on pension scheme liabilities.
Figure 5.1 above demonstrates the impact which increases or decreases in the assumed rate of pension increase has on the valuation results. Figure 5.2 demonstrates the impact of changes in the assumed rate of salary increase, while Figure 5.3 illustrates that changes in the assumed rate of overall inflation do not impact on either the IAS 19 or the Trustee ongoing valuation. It is interesting to note that in each set of circumstances, the IAS 19 valuation yields the greater liability while the MFS valuation consistently produces the lowest result.

For one particular scheme included in this study, the impact of changes in the assumed investment return (all other assumptions remaining unchanged) on recommended funding rates may be seen in table 5.4.

Table 5.4. Scheme D - Impact of changes in assumed investment return of required funding contribution rate.

<table>
<thead>
<tr>
<th>Base Assumptions (investment return 6%)</th>
<th>Investment return + 1%</th>
<th>Investment return - 1%</th>
<th>Investment in bonds (return 4.5%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total past service liabilities €'000</td>
<td>92,019</td>
<td>76,811</td>
<td>111,782</td>
</tr>
<tr>
<td>Assets €’000</td>
<td>67,712</td>
<td>67,712</td>
<td>67,712</td>
</tr>
<tr>
<td>Past service deficit €’000</td>
<td>24,307</td>
<td>9,099</td>
<td>44,070</td>
</tr>
<tr>
<td>Funding level</td>
<td>73.6 per cent</td>
<td>88.2 per cent</td>
<td>60.6 per cent</td>
</tr>
<tr>
<td>Required funding rate to fund past service deficit</td>
<td>6.4%</td>
<td>2.6%</td>
<td>10.6%</td>
</tr>
<tr>
<td>Future service liabilities €’000</td>
<td>81,298</td>
<td>61,215</td>
<td>109,406</td>
</tr>
<tr>
<td>Future Service contribution rate for retirement benefits</td>
<td>23.1%</td>
<td>19.3%</td>
<td>27.9%</td>
</tr>
<tr>
<td>Total required contribution rate</td>
<td>29.5%</td>
<td>21.9%</td>
<td>38.5%</td>
</tr>
</tbody>
</table>

Notes:
Assets are stated at market value.
The liability for pensioners is determined by reference to the estimated actual cost of annuity purchase.
The transfer values for non-pensioners are calculated by projecting the benefit payments to which the members will be entitled including an appropriate margin for mortality improvement and assuming a prescribed investment return calculating the size of the fund required in today’s terms to meet the projected benefit payments.
In the case of scheme D, the range of investment return assumptions outlined above (4.5 per cent -7 per cent) potentially reduced the overall funding rate requirement computed by more than 30 per cent (moving from the most conservative – 4.5 per cent to the most optimistic -7 per cent).

The funding rate that is adopted for a particular pension scheme is a function of both the chosen level (pace) of funding and the actuarial assumptions made. There is no perfect set of actuarial assumptions to be made as to the future experience of a pension scheme. For a particular scheme, one set of assumptions will be stronger (more conservative/prudent) or weaker (more optimistic) than another and the spectrum of assumptions made by actuaries in the on-going valuation of pension schemes range from the strongest to the weakest with some broad general agreement as to where the “average” lies. If a particular company wishes to “front end” its contributions i.e. put incremental funds into its pension scheme against the prospect of less profitable times in the future, the actuary may make quite conservative assumptions to equate the capitalised value of current and prospective assets with current and prospective liabilities. The financial implications for the future, should the assumptions prove too conservative would need to be understood by the company (i.e. a fund surplus and reduced contributions at some point in the future) and notwithstanding the actuary’s discretion as to the assumptions used, the assumptions cannot be so strong as to advance the funding of the scheme to a level unacceptable to the taxation authorities (Revenue Commissioners).

However as is more likely to be the case, a company may not wish to increase its annual commitment to the pension scheme particularly during periods where its cash reserves may be stretched or its profit levels falling. In these situations, a balanced position between the capitalised value of the schemes’ assets and liabilities may only be obtained by use of a weak valuation basis (i.e. more optimistic assumptions). This is a more difficult situation for the actuary. While the actuary may draw the company’s attention to the fact that he/she considers the funding rate to be too low and to the consequences that will ensue if the experience of the scheme proves his concerns to have been well founded, it is the company that will ultimately decide on what level of contribution will actually be paid. The actuary is faced with a potential conflict of interest. Should he adopt an “average” basis of valuation which would show a considerable deficit on the scheme given the company’s funding policy and in doing so, perhaps create friction with the sponsoring employer in terms of the adequacy of its ongoing contribution commitment and the need to contribute further, or should he adopt a weaker set of assumptions showing a smaller deficit and reducing or eliminating the reported
deficit which the sponsoring employer is required to fund? In the case of some schemes, this conflict of interest can potentially be an ongoing issue for the scheme actuary.

As Table 5.5 demonstrates, the range in valuation results between the prudent and optimistic “ends of the scale” can be relatively significant. Yet at any given time, all three sets of assumptions could be considered within an “acceptable” range under ASP PEN 1 and IAS 19.

Table 5.5 - Impact of assumption changes on valuation result.

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>Base</th>
<th>More prudent approach</th>
<th>More optimistic approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount Rate</td>
<td>4.65 per cent</td>
<td>4.5 per cent</td>
<td>4.8 per cent</td>
</tr>
<tr>
<td>Salary Increases</td>
<td>3.5 per cent</td>
<td>4.0 per cent</td>
<td>3.0 per cent</td>
</tr>
<tr>
<td>Pension increases</td>
<td>2.25 per cent</td>
<td>2.5 per cent</td>
<td>2.0 per cent</td>
</tr>
<tr>
<td>Inflation</td>
<td>2.25 per cent</td>
<td>2.5 per cent</td>
<td>2.0 per cent</td>
</tr>
<tr>
<td>Pre retirement duration</td>
<td>15 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Post retirement duration</td>
<td>12 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gaps – pre</td>
<td>1.15 per cent</td>
<td>0.5 per cent</td>
<td>1.8 per cent</td>
</tr>
<tr>
<td>Gaps – post</td>
<td>2.4 per cent</td>
<td>2.0 per cent</td>
<td>2.8 per cent</td>
</tr>
<tr>
<td>Effects</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pre retirement</td>
<td>-9.22 per cent</td>
<td></td>
<td>10.09 per cent</td>
</tr>
<tr>
<td>Post retirement</td>
<td>-4.59 per cent</td>
<td></td>
<td>4.79 per cent</td>
</tr>
<tr>
<td>Total</td>
<td>-13.81 per cent</td>
<td></td>
<td>14.87 per cent</td>
</tr>
<tr>
<td>Funded Status</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets – assumed</td>
<td>€5,000</td>
<td>€5,000</td>
<td>€5,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(-€6500)</td>
<td>(-€7,397)</td>
<td>(-€5,533)</td>
</tr>
<tr>
<td>Surplus/Deficit</td>
<td>(-€1,500)</td>
<td>(-€2,397)</td>
<td>(-€533)</td>
</tr>
</tbody>
</table>

Several actuarial methods exist to determine the funding pattern for pension benefits. These different methods result in different funding patterns for the same pension benefit. The most commonly used methods can be divided into two sub groups, namely accrued valuation methods and projected valuation methods. Accrued valuation methods take into account only service rendered to date and not future service in determining the amount to be funded. The amount to be funded in a particular year under this method is the present value of the benefit accrual in that year. Only the accrued or earned pension rights are financed under this method. Under the accrued valuation method expected future salary increases can be taken into account as well as in combination with service already rendered. This is known as the projected unit credit method. This method is the method recommended by IAS 19.
Alternatively the projected valuation methods calculate the total pension benefit an employee will receive on retirement taking into account total expected service and expected salary level on retirement. These methods allocate that final amount over the working life of the employee as a yearly fixed amount or as a fixed percentage of salary. The main difference in the funding patterns is that under the accrued methods, the amounts to be funded at the start of an employee’s career are lower than under the projected valuation method which takes into account from the start the whole expected service period.

Actuarial Guidance Statement ASP PEN 1 requires the actuary to encourage the trustees to seek advice from both the actuary and other industry experts on funding principles, including the determination of the technical provisions, sufficiently early in the process of completing each actuarial valuation.

The required advice envisaged by the statement includes,

- The overall solvency level, which would correspond to the objectives of the scheme being exactly met;
- The potential impact on the scheme of the risks associated with any proposed policy for meeting the statutory funding objective. This must include the impact on the solvency position of the scheme, the stability of future contribution rates and the scope for paying any discretionary benefits or granting other enhancements;
- The risk that the scheme sponsor may not be able to continue to pay contributions or make good deficits in the future;
- The risk that future investment returns on assets will be insufficient to meet the funding objective;
- The risk that falls in asset values will not be matched by similar falls in the value of liabilities, thereby reducing the funding and/or solvency levels of the scheme;
- The risk that unanticipated future changes in mortality will increase the cost of the benefits;
- The risk associated with the potential exercise (by members or others) of options against the scheme.

The actuary can therefore be faced with a serious conflict of interest between his obligations to scheme trustees and scheme members and his desire to avoid confrontation with the sponsoring company who may directly or indirectly be paying the actuary for his services and
to whom the actuarial firm may be providing a range of related services\textsuperscript{18}. The trustees can likewise find themselves in difficulty with scheme members if it can be demonstrated that having been made aware of the various risks involved and the impact of those risks, they presided over sustained periods of inadequate funding levels and high risk investment strategies.

As mentioned previously, gaps between the assumptions are often more important than the absolute value of the assumptions in isolation. In the case of a "minimum funding standard" valuation, the scope for subjectivity around these differences is narrowed given the detailed rules for determining the funding standard benefit for each member as laid down by Actuarial Standards of Practice, ASP Pen 3.

"In summary, the rules are as follows:

- The liability for pensioners should be determined by reference to the estimated actual cost of annuity purchase; and
- The transfer values determined for non-pensioners should be worked out assuming future investment returns prescribed by the Pensions Board. There are also prescribed assumptions for future price inflation, statutory increases in deferred pensions and earnings linked pension increases"

(Green Paper (2007a), p.151)

There is much discussion currently as to the rigidity of the Minimum Funding Standard and in the light of the increasing number of schemes in deficit or failing to meet the Standard there is an increasing view that the Standard is too high and should be lowered. As discussed earlier - the opposite view however is also strongly held (in particular by the Society of Actuaries) i.e. that the Standard is too low and should be strengthened. This view of the Society of Actuaries is supported by the results of this thesis which demonstrate that the MFS valuation always produces a lower result that the equivalent trustee valuation or IAS 19 valuation. It must also be accepted that the rigidity of the Minimum Funding Standard calculations from the regulators perspective can provide a common benchmark, and a meaningful basis for comparison across pension schemes. From an individual trustee’s perspective, it can provide comfort that the scope for subjectivity by the actuary in terms of the underlying assumptions has been minimised. This assurance for the trustee cannot be underestimated given the

\textsuperscript{18} Many of the actuarial firms also provide a range of related services- e.g. Mercer, a leading provider of actuarial services is also a “leading provider of consulting outsourcing and investment services”. 

112
diversity of results, which could conceivably arise from the three valuation approaches outlined above.

5.8. Conclusions

The assessment of pension fund liabilities is a complex exercise and little understood outside the actuarial profession. The potential for different acceptable valuations for one scheme only serves to compound the complexities. The high level of estimation required in setting certain assumptions which are key to a trustee's ongoing valuation and a valuation prepared for the sponsoring company's financial statements, requires trustees and other interested parties to understand the key assumptions driving the result rather than just accept the result as the only possible correct answer. If trustees do not understand the potential impact of changes in certain key assumption on a valuation result, they cannot contribute fully to an informed debate of appropriate contribution rates and accordingly cannot discharge their trustee obligations entirely. This necessitates greater transparency on the acceptable "range" for each assumption, where the adopted assumption fits within that range and what would be the impact of a more prudent/optimistic approach.

The accounts preparation and audit exercise coupled with the actuarial valuation processes are relied on by all scheme stakeholders, - trustees, members and employers alike to gain assurances in relation to the financial health of a pension scheme, or at least to be presented with up to date facts which will facilitate planning for remedial action. In the first instance, members will assume that trustees are adequately informed so that they the members can in turn be adequately informed. Assumptions underpinning the actuarial valuation exercise are critical to this monitoring process. Trustees must understand the assumptions underlying each of the three possible valuation results if they are to make informed decisions on required contribution rates, investment strategies, discretionary bonuses etc. This would necessitate for all but specialist trustees, specific education on the alternate methods of valuations and the reasons for the significant differences that can arise between these valuations (this is discussed further in chapter 6). It is not appropriate that these decisions be entirely delegated to the actuarial profession. Trustees cannot defray their responsibilities by remaining largely aloof from the actuarial exercise and relying on their own assumption that the "expert" i.e. the actuary is always right.
While the Minimum Funding Standard valuation is being heavily criticized, particularly currently given the turmoil in the financial markets, one advantage it can boast is that it is the least subjective of all three valuation approaches and as such provides a common benchmark against which the financial health of pension schemes can be assessed. It reduces the potential conflicts of interest for the scheme actuary and agency issues arising from the relationships between the trustees, the sponsoring company and the actuary. While regulators are being forced to relax on the time period given to schemes to bring their funding back within the minimum limits (see chapter 7), they should be slow to reduce the rigidity of the valuation itself. Indeed as this thesis demonstrates that the MFS valuation produces consistently lower results than either the equivalent trustee or IAS 19 valuations it supports the view of the Society of Actuaries that the level at which the Minimum Funding Requirement is set should be reviewed upwards. From a regulatory perspective, it is important that actuarial assumptions used for the purposes of a minimum funding standard valuation are appropriate both in the context of the life of the scheme and the point in time at which the valuation is made. In this context, prescribed pre and post-retirement returns of 7.75 per cent and 4.5 per cent respectively (see footnote page 95) could, in the current economic environment be argued to be overly optimistic.
CHAPTER 6

Trustees: Their Role in Pension Scheme Management.

6.1 The role of the trust instrument in the pension scheme model.

Earlier chapters have drawn attention to possible conflicts of interest which may arise from the various contractual relationships which exist between pension scheme actuaries, investment advisers, sponsoring employers and scheme trustees. Managing these conflicts in the interest of the pension scheme as a whole is important in ensuring that overall scheme objectives rather than the objectives of a particular interest group, are and remain at the forefront of the scheme’s decision making process. Most pension schemes are organised as trusts (see below) and the board of trustees of the pension scheme has ultimate responsibility for the management of the pension scheme’s business. This chapter looks at the role and responsibilities of trustees as set down by Statute and case law. It draws an analogy between the role of pension scheme trustees and the role of non executive company directors. While case law might suggest that a pension scheme trustee’s statutory responsibility could be regarded as akin to that of an executive director, the practice of scheme trustees more closely correlates with the practice of non executive directors. But while directors, executive and non–executive, have a code of corporate governance to supplement legislation and employment/service contracts prescribing how they should behave, there are marked inconsistencies in the level of training and guidance afforded to trustees. This potentially limits the ability of trustees to understand and carry out their trustee responsibilities and may leave them with a case to answer to pension scheme members who suffer financial loss from scheme collapses or major restructurings.

A widely cited definition of a trust is as follows:-

“ A trust is an equitable obligation binding a person (who is called a trustee) to deal with property over which he has control (which is called the trust property), for the benefit of persons (who are called beneficiaries…) of whom he may himself be one, and any one of whom may enforce the obligation. Any act or neglect on the part of a trustee which is not authorised or excused by the terms of the trust instrument, or by law, is called a “breach of trust”.”

A trust is a widely used structure for the ownership of assets by individuals partly because the tax treatment of trusts makes it advantageous to hold certain types of property through trusts and partly because the trust structure facilitates ownership structures/arrangements which may be complex. Examples of this type of ownership arrangement would include situations where ownership is shared e.g. a family property trust, situations where the owner is a minor and the property is being held in trust until he/she reaches full age and situations where one individual has the use of property for his life only (i.e. a life interest) with no right to bequeath it in his/her will. In these types of situations, the trust structure can be used to achieve the long term objectives on ownership structure.

Most Irish pension funds are organised as trusts. This is primarily because Irish tax law requires the pension scheme to be established as a trust in order to qualify for tax exempt status (Appendix 1) but also because as discussed by Myners (2001 p.41), the trust structure has a number of advantages for pension schemes:

- A trust is a separate legal entity. This means that the assets it holds are entirely separate from the sponsoring company and its creditors.
- As trustees are obliged to act solely in the interests of the beneficiaries on whose behalf the assets are held, a trust is a means of protecting those beneficiaries.
- A board of trustees can provide common ground between different interest groups (employees, the sponsor company and so on) because each can nominate trustees.\textsuperscript{19}

The Pensions Board (2006d) in its report on Trusteeship, recognises these advantages but also accepts that there are disadvantages to the trust model. These are primarily focussed on internal scheme governance, particularly the ability of trustees to manage entities with large financial assets in an increasingly complex environment, the bureaucracy and cost associated with operating pension scheme trusts and the potential for conflicts of interest where the trustees represent different interest groups. The Pensions Board concludes in its report that the trust model continues to offer protection to pension schemes that justify its continuance and that disadvantages to the trust form such as the lack of expertise of trustees, potential conflicts

\textsuperscript{19} The UK Pensions Act 1995 introduced a requirement that members should have the right to nominate one-third of trustees. The equivalent Irish legislation (Pensions Act 1990) provides that members of schemes with 50 or more members are entitled to select member trustees but it is not mandatory that they do so. If a member trustee selection process is invoked under the Act, members can choose between having an election for member trustees or they can adopt trustee arrangements put forward by the employer.
of interest which may affect trustees and the need for further trustee support, may be overcome at least in part through a renewed focus on measures to improve the regulatory framework and the internal governance of pension schemes.

Myners (2001) devotes some discussion to the responsibilities of trustees. One interesting point is that while all trustees have a clear responsibility towards the scheme's beneficiaries, different standards may be expected according to whether a trustee is a lay trustee or a professional trustee. He refers to the Goode Report (1993), according to which the trustees must:

"exercise, in relation to all matters affecting the fund, the same degree of care and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide and to use such additional knowledge and skill as the trustee possesses or ought to possess by reason of the trustee's profession, business or calling."

Goode Report (1993, paragraph 4.9.7)

This raises a number of issues;

- In the event of successful litigation against a board of trustees, individual trustees may be found to have different levels of liability by virtue of their profession and or education, notwithstanding that decisions of the trustees would have been taken in concert.
- A trustee who does not have the required financial or investment expertise, to participate fully in the investment function of the board of trustees should obtain the necessary financial/investment advice from an expert, and should understand the ramifications of the advice, the levels of uncertainty inherent in the recommendations and the impact for the pension scheme should the advice once followed, result in an unsuccessful outcome.
- There may be a case for a requirement to have at least one independent professional trustee on every board of trustees with incremental responsibilities to ensure that the business of the trust board is conducted correctly. However the existence of a professional trustee on the board of trustees, cannot be used by fellow trustees as a

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20 The Goode Report was issued in 1993 under the auspices of the Pensions Law Review Committee in the UK and represents the conclusions of fourteen months of investigative work following the collapse of the pension schemes within the business empire of Robert Maxwell in 1991.
defence in the event of legal proceedings against the board of trustees subsequently – i.e. "We followed the "lead" of the professional trustee."

6.2 Trustee Obligations and Responsibilities – the governing sources of law.

The obligations and responsibilities of pension trustees are derived from three distinct sources:

- The trust deed. Each pension fund has a trust deed setting out the trust’s parameters. There will also be a set of rules governing the operation of the trust. The trust deed, together with the rules acts as the pension scheme’s constitution.
- General trust law, much of which has been established by case law.
- Pensions legislation.

Source: Myners, (2001)

In the Irish context specifically, the applicable legislation is largely contained in The Pensions Act 1990 as amended by subsequent Statutory Instruments and Social Welfare and Pensions legislation.

As mentioned at the start of this chapter, a trust is an "equitable" obligation. Delaney (2007) describes “equity” as a branch of law or body of principles aimed at achieving a fair and equitable result in all cases coming before it and of mitigating the severity of the rules of common law. Delaney describes the trust as one of the most important and enduring creations of “equity” principles. Some aspects of the law relating to trusts are set out in legislation, primarily the Trustee Act 1893 and the Trustee Act 1931 which make provision in relation to such issues as the appointment, retirement and removal of trustees and some of the powers of trustees, but the legislation is not comprehensive in nature. The Irish Law Reform Commission Consultation Paper (2005) stated that in the Irish context, trustee legislation has not kept up to date with the changing economic and social nature of trusts. Irish trust law lags behind UK and other European legislation in this area, and many key aspects of trustee law now covered by legislation in England, such as a trustee’s duty of care, and the delegation of trustee functions, remain, in the Irish context, covered by principles developed in case law (and not necessarily Irish case law).

Delaney (2007) draws on case law to illustrate the principal duties and responsibilities of trustees. The first duties of a trustee once appointed are to ascertain the nature and extent of
the property which the trust holds and to ensure that he/she understands the terms of the trust instrument. Trustees are required to act in good faith and in a responsible and reasonable manner in performing their functions and they must inform themselves, before making a decision, of matters that are relevant to that decision. Where trustees have discretion in relation to the management of a trust, the court will not take this discretion out of their hands but it will intervene if necessary if it is exercised improperly. The question of the circumstances in which a court will intervene on the grounds that a trustee has exercised his discretion unreasonably is a complex one and depends to an extent on the nature of the trust. In the case of Edge v Pensions Ombudsman, (1998) (Delaney 2007), Scott VC stated:

"The judge may disagree with the manner in which trustees have exercised their discretion but, unless they can be seen to have taken into account irrelevant, improper or irrational factors, or unless their discretion can be said to be one that no reasonable body of trustees properly directing themselves could have reached, the judge cannot interfere"

Trustees are under an obligation to inform themselves before making a decision on all matters relevant to that decision. In exercising a discretionary power they should take into account all relevant considerations and ignore all irrelevant or extraneous matters. Trustees must act in good faith, responsibly and reasonably.

It is generally accepted that in relation to the management and administration of a trust, unpaid trustees are expected to use such diligence and care as an ordinary prudent man would use in the management of his own affairs. The trustee has a duty to safeguard trust assets and to invest trust property with a view to ensuring a steady income for the beneficiaries currently entitled to an interest while at the same time preserving the value of the capital for the benefit of those who may subsequently become entitled to an interest in the property. The standard of care and prudence which must be employed by a trustee in exercising his powers of investment has been considered in numerous cases. In Learoyd v Whitley (1886)

23 Tempest v Lord Camoys, (1882), (cited in Delaney 2007).
26 Speight v Gaunt (1883), Re.Lucking’s Will Trusts (1967), (cited in Delaney 2007).
27 Re Brogden, (1888), (cited in Delaney 2007).
(Delaney 2007), it was stated that a trustee would have to take not only such care as a prudent man would take if he had only himself to consider but the care that an ordinary prudent man would take if he were making investments for the benefit of those for whom he felt morally bound to provide. An important principle confirmed in the case of Bartlett v Barclays Bank Trust Co Ltd, (1980) (Delaney 2007), was that a higher duty of care is expected of a professional trustee which carries on the specialized business of trust management. Notwithstanding this, however, there is no reported case in which a trustee has been found liable for a breach of trust arising from investment within the ambit of that authorised by the trust instrument or the general law where the trust capital has simply continued to erode as a result (As Table 6.1 demonstrates the majority of complaints by scheme members dealt with by the Irish Pensions Ombudsman relate to the administration rather than strategic management of the scheme). One reason for this is that as Doyle (1991) argues the burden of proof facing potentially litigious beneficiaries is prohibitively high.

Trustees have a duty to maintain equality between beneficiaries and this includes acting in a fair manner in making investment decisions which may have different consequences for different classes of beneficiary. A trustee is under an obligation to ascertain the identity of those who are entitled to benefit under the trust instrument and to take the necessary steps to ensure that the trust property is distributed in accordance with its terms. Where a reasonable doubt exists about the respective claims of the beneficiaries, a trustee may apply to the court for directions and will be protected from liability in this regard provided he follows these directions.

A trustee is obliged to keep clear and accurate records of the trust property and a beneficiary is entitled to inspect these accounts. It is a well established rule that a person who occupies a fiduciary position is not entitled to make a profit from that position unless expressly authorised to do so, or to place himself in a situation where his interest and duty may conflict. As a general principle, a trustee is not entitled to remuneration for work carried out by him in his capacity as trustee. A professional trustee would have a contract for services with the board of trustees under which a fee arrangement would be agreed. Outside of this type of arrangement there is no established practice whereby pension scheme trustees are remunerated for their services as trustees.

30 Re Londonderry’s Settlements, (1965), (cited in Delaney 2007).
31 Moore v Mc Glynn (1894), (cited in Delaney 2007).
32 Bray v Ford, (1896), (cited in Delaney 2007).
33 Re Ormsby, (1809), (cited in Delaney 2007) .
Interestingly, case law has consistently suggested that trustees cannot entirely delegate their responsibilities. In the early case of Turner v Comey, (1841) (Delaney 2007), it was stated:

“trustees who take on themselves the management of property for the benefit of others have no right to shift their duty on other persons; and if they employ an agent, they remain subject to the responsibility towards their cestuis que trust, for whom they have undertaken the duty.”

The principle set out in this early case remains the legal position. While trustees will often be required to take advice from appropriate experts, in Scott v National Trust for Places of Historic Interest or Natural Beauty (1980) (Delaney 2007), it was stated that

“it is for advisors to advise and for trustees to decide”

Even where an agent is properly appointed, a trustee must still exercise a reasonable degree of supervision over the agent’s activities. Accordingly while legislation and trust deeds may allow/require trustees to delegate the investment function of a pension scheme to investment/fund managers, a residual responsibility must always remain with the trustees collectively if only in terms of the selection of investment advisors and fund managers, the investment mandate pursued by these experts and the ongoing appraisal of their performance.

The Pensions Act, 1990 brought together the duties and responsibilities of pension scheme trustees. There is a high degree of overlap between trustees’ duties under the general principles of trust law and their duties as prescribed in the Act. The trustees’ duties under the Act are:

- To register the scheme
- To ensure that contributions are received
- To provide for proper investment of the resources of the scheme. With effect from September 2005, following the enactment of the Occupational Pension Schemes (Investment) Regulations 2005 in Ireland, all schemes except small schemes (less than 100 members) must prepare a Statement of Investment Policy Principles (SIPP) which is intended as a description of the investment policies of the trustees with comments on investment objectives, investment risk measurement methods, risk management processes and strategic asset allocation with respect to the nature and

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duration of the pension liabilities. One of the objectives of the SIPP is presumably to require trustees to formulate and take ownership for the investment policy of the pension scheme.

- To make arrangements for paying benefits to scheme members.
- To ensure that records are kept.
- To preserve or transfer benefits.
- To ensure that the funding standard is met.
- To ensure that specified documents and information on the scheme and its operation are made available to scheme members and other specified persons.
- To apply equal pension treatment.
- To apply the resources of the scheme on a wind-up.
- To report the matter in writing to the Pensions Board where there is reason to believe that material misappropriation or fraudulent conversion of a scheme's resources has occurred, is occurring or is to be attempted.

The Pensions Board (2007b) in its guide for trustees, makes some interesting observations in relation to a number of the trustees' duties as outlined above. In relation to a trustees' duty to invest, the Guide states that where the trustees delegate the actual conduct of the scheme's investments to a professional investment manager, the responsibility for monitoring the conduct of the manager and the performance of the assets rests finally with the trustees. Where a scheme has not appointed an investment manager, the trustees of the scheme must demonstrate to the Pensions Board that they possess among their membership the appropriate qualifications and experience to assess and advise on investment options and make the investment decisions in relation to the scheme's resources. Alternatively the trustees can employ an advisor with such qualifications and experience subject to the Board's approval.

In relation to the requirement to ensure that the funding standard is met, the Pensions Board states in its guide that it is important that the trustees have a good understanding of the provisions relating to the preparation of the AFC (Actuarial Funding Certificate) and a funding proposal35 and that this is an area which should be discussed in detail with the actuary and or the scheme advisors. The Guide cautions that a trustee, who is negligent, or does not act in good faith or does something which is contrary to the rules of the trust, can be sued by the beneficiaries. The trustee can be held to be personally liable for the whole of the

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35 As discussed in Chapter 4, where a pension scheme does not satisfy the "funding standard" as set down by the Pensions Board, the trustees must submit a "funding proposal" to the Pensions Board setting out a contribution plan aimed at securing that the scheme will satisfy the "funding standard" within the period of the proposal.
amount of any loss which occurs. A trustee has no power to negotiate or to vary the terms of the scheme. He or she can only carry out the terms of the trust deed and rules. No matter who appoints the trustees, they must act in accordance with the scheme rules, and not as a representative of the employer or the members. For all trustees, this can be problematic on occasion, when perhaps the interests of a particular party or parties to the trust may be at odds with the wider objectives of the pension scheme as a whole. It may be a particular issue for a professional trustee who may have been appointed by the employer company or who may provide other services in addition to trustee services, to the trust and or to the sponsoring employer either directly or through a related company. Many of the industry specialist firms offer trustee services as part of a package of services\(^3^6\). Unlike the provision of auditing services by the accountancy profession, there are no restrictions on the provision by the same firm (albeit by different departments of the same firm) of trustee services in conjunction with for instance fund management or advisory services. In such situations, the challenge is to provide the trustee services independently of any other service provided. This may lead to conflicts of interest particularly where the fees charged for trustee services are less that the fees charged for advisory and related services.

Scheme members or potential beneficiaries who feel they have suffered financial loss due in part to the actions or inactions of trustees may seek redress through the Courts or they may have their complaints dealt with by the Pensions Ombudsman. The Pensions Ombudsman investigates and decides complaints and disputes in relation to occupational pensions schemes. Rulings by the Ombudsman are enforceable through the Courts should the parties to the dispute fail to comply with the ruling. A review of the type of complaint dealt with by the Ombudsman in the three years to 31/12/2008 (Table 6.1) indicates that the nature of complaints to date have been around the administration of scheme rules and the processing of scheme contributions rather than complaints against trustees for mismanagement or not fulfilling their duties completely. Notwithstanding this, there has been some increase recently in the number of complaints concerning fund values, and misinformation and this may be indicative of a growing deeper questioning by scheme members of the responsibilities of scheme trustees over and above scheme administration.

\(^3^6\) For example, Mercer, a leading provider of trustee services is also a “leading provider of consulting outsourcing and investment services.
Table 6.1.
Schedule of Complaints received by the Pensions Ombudsman

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of complaints</td>
<td>439</td>
<td>515</td>
<td>727</td>
</tr>
<tr>
<td>Complaints re fund values</td>
<td>0</td>
<td>0</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Complaints re mis-selling</td>
<td>0</td>
<td>1 per cent</td>
<td>2 per cent</td>
</tr>
<tr>
<td>Complaints re incorrect info giving rise to false expectations/financial loss</td>
<td>2 per cent</td>
<td>0.4 per cent</td>
<td>1 per cent</td>
</tr>
<tr>
<td>Complaints re administration, remittance of contributions, calculation of entitlements.</td>
<td>98 per cent</td>
<td>98.6 per cent</td>
<td>92 per cent</td>
</tr>
</tbody>
</table>


The Pensions Board may also take an action against trustees for non-compliance with the Pensions Act 1990. The Board may bring and prosecute summary proceedings in the District Court or, depending on the seriousness of the alleged offence, may refer the file to the Director of Public Prosecutions who may bring and prosecute proceedings on indictment.

Persons found guilty of an offence under the Pensions Act 1990 are normally liable:

> On summary conviction to a fine not exceeding €5,000 or to imprisonment for a term not exceeding one year, or both.
> On conviction on indictment to a fine not exceeding €25,000 or to imprisonment for a term not exceeding two years or both.

There is an alternative to Court proceedings. Under the alternative provisions which commenced in 2007, the Pensions Board may notify a person in writing that it is alleged that a specified summary offence has been committed. The Board will specify in this notice that the
offender has 21 days to remedy the offence and pay the appropriate fine. If there is compliance, the prosecution will not proceed.

The Annual Report of the Pensions Board for 2008, states that in 2008, 181 new complaints against pension schemes were investigated. These complaints principally related to alleged failure by employers to forward pension contributions which had been deducted from employees’ pay. The Annual Report lists one case which came before the High Court for non-payment by an employer of pension contributions and criminal proceedings have also been instigated against a director of the employer company in this case. Fine notices were issued in 2008 by the Pensions Board to trustees of 23 DB schemes for “administrative errors” concerning their failure to submit AFCs within the required time deadline, as required by the Pensions Act. Outside of these “administrative errors” there were no reported cases of any disciplinary steps been taken against trustees in 2008 by the Pensions Board.

The Pensions Board (2006d) in its report on trusteeship, recommended that legislation be introduced to require employers to arrange trustee training for each individual trustee within six months of their appointment and at least every two years thereafter. The Social Welfare & Pensions Act 2008 (Attorney General 2008) introduced with effect from 1 February 2010, a requirement for sponsoring employers to arrange for scheme trustees to receive “appropriate” training. The training should cover pension legislation and any other legislation governing the operation of the pension scheme and the duties and responsibilities of trustees generally. There is however no common prescribed standard of knowledge which trustees should attain and no prescribed level of education in actuarial principles as recommended in chapter 4. While the Pensions Board have “approved” a number of training courses, employers are not obliged to use one of these approved courses and the employer can use other means of trustee training so long as it is considered “appropriate”. While the introduction of mandatory training as such is a welcome development, it falls short in ensuring a consistent level of quality training for all trustees.

6.3 Trustees duties and responsibilities – Some empirical results from survey schemes.

From the foregoing it would be reasonable to conclude that there is a legal and a regulatory framework to give guidance to trustees as to their duties and responsibilities and a system of penalties in place in the event that they are considered by the Courts and/or the Pensions Board to have failed in those duties and responsibilities. Notwithstanding this, based on the
information contained in the financial statements of the schemes surveyed for the purposes of this research (see below), it can be argued that the regulatory framework has been ineffective in ensuring a consistent level of expertise and training for all trustees and it is hard to see how trustees (other than professional trustees) can have the appropriate training to fully discharge their duties. It must be that reliance is being placed on professional investment advisors and pension scheme administrators to discharge the day to day administrative and the strategic running of pension schemes.

Only 5 per cent of schemes included in this study reported expenditure incurred on trustee training during the years under review.

An examination of the schemes' annual reports found that a further 2 per cent of schemes studied indicated in their financial statements that trustee training was incurred by the employer company but no details of actual amounts expended were disclosed.

The number of trustees per scheme included in the study ranged from one listed trustee up to eleven trustees. Based on the information disclosed, the trustee boards included mainly scheme members, trade union representatives, professional trustees, representatives from the employer company, and for some of the larger schemes investment, actuarial and legal experts. Over a quarter (26 per cent) of schemes reported only a professional trustee with no other scheme trustees (Figure 6.1.). When examined in terms of fund size, all of the schemes with professional trustees only had funds under management of less than €30m (i.e. they were the relatively smaller schemes in the survey) It might be inferred in these situations that the influence of the employer company on strategic management issues might be greater than might otherwise be the case if decisions were governed by a more disparate group of trustees.
In total, 34 per cent of schemes reported using the services of a professional trustee (Figure 6.2). Where the professional trustee was contracted in addition to “non professional trustees” (8 per cent of schemes) the assumption can perhaps be made that the professional trustees would be in a position to guide the remaining trustees on matters of importance- although this would not necessarily be sufficient to have discharged the responsibilities of the non professional trustees should difficulties subsequently arise.
22 per cent of schemes gave no trustee details at all (Figure 6.1). Study results found that only 16 per cent included a statement required by the Pensions Board that the trustees had access to appropriate training and guidance. This could largely be due to the fact that this is a relatively recent requirement of the Pensions Board – introduced in 2005.

The study found that only 7 per cent of schemes gave any details as to the number of times trustees held a full board meeting and for schemes who did give this information, the number of meetings ranged from 2 to 4 a year with only one trustee board meeting more than 4 times a year.

These findings are consistent with the findings of the more elaborate UK pension scheme trustee survey carried out for the Myners Report (2001) and detailed in Appendix 7. It would appear that a similar pattern can be found in both Ireland and the UK. As Myners (2001, p.5), states-

"Larger schemes are more likely to have the resources to recruit and train more knowledgeable trustees and the use of professional trustees has grown in recent years. But generally speaking, pension scheme trustees, whether of defined contribution or defined benefit schemes, are able to bring limited time and expertise to the investment decision-making aspects of their work."

The author goes on to comment that legislation and regulation is framed around ensuring that members interests are not damaged by gross incompetence or mismanagement of the scheme, but this does not necessarily produce rational and well-informed decision making on a consistent basis.

Trustees have ultimate stewardship over pension fund assets, estimated at the end of 2005 at €77.9bn and the end of 2008 at €66.7bn (IAPF (2005) and (2008)). While they may delegate various aspects of this stewardship to practitioners and acknowledged experts, final responsibility continues to rest with them. As more and more pension schemes fall into deficit in the current economic environment, trustees may find themselves being called to account in terms of their ultimate responsibility and perhaps having to defend their performance in a way which they may not previously have had to. If they are called to account in this way it will be difficult for a board of trustees (with varying levels of expertise) who have met perhaps only two, three or four times in a financial year to demonstrate that they understood and discharged in full, the totality of their responsibilities. Unless there is clear evidence through trustee
board minutes or other documentation of full understanding and consideration of trust strategy, of ongoing monitoring by trustees of agents, of necessary communication and conflict resolution between trustees, actuaries, sponsoring employers and other interested parties, there is a serious risk that a nominal number of trustee board meetings a year would be regarded by the Courts as merely paying “lip – service” to the responsibilities of trustees. Trustees could be found to have failed in their primary duty as trustees.

Thornton (2001) describes how many trustees have indemnities from the sponsoring employers or under the terms of the pension scheme itself in the event of any law suit filed against them for breach of trustee responsibilities. It may be that the existence of indemnities and or third party insurance reduces what trustees see as the extent of their role and responsibilities or perhaps increases the risks they are prepared to take. Perhaps the existence of a “professional” trustee on the Board of trustees enables the “non professionals” to take a more relaxed approach on the basis that “the professional “ will ask the right questions and ensure that all the “boxes are ticked” as far as the regulator is concerned. Perhaps even the Pension Board’s approach to trustee training/responsibilities suggests the focus for trustees should be on the administrative function rather than more strategic management issues. Whatever the reason, trustee boards generally comprise a disparate group of people with responsibility for in some cases, significant amounts of other people’s money but who typically off – load this responsibility to administrators /investment managers who carry out the day to day executive function. Trustees meet too infrequently to have any meaningful executive involvement in the pension scheme’s affairs. The question is whether in the event of a legal challenge, this would be considered sufficient to meet their legal obligations?

During the “Celtic tiger” years in particular, trustees of DB schemes would not have faced the difficult decisions which they can be expected to face during the current financial economic crisis. It could well be argued that there was no great demand from pension scheme stakeholders for trustees to be unduly concerned or indeed knowledgeable of the running of a scheme. High performing markets meant strong investment returns. Forecasts by market “experts” for continuing high performances enabled actuaries to be optimistic/bullish in their assumptions so as to minimise contribution commitment requirements. Delegating the principal strategic matters to “experts” - investment advisors and fund administrators allowed trustees to satisfy themselves that they were discharging their duties satisfactorily and given that most schemes were in surplus, and pensioners were getting full entitlements there was little obvious cause for discontent on the part of any of a pension schemes’ stakeholders.
The current recession has brought an increasing number of schemes to the point where a view is taken that the scheme cannot effectively “trade out” of its deficit- and the employer company cannot or will not commit to the incremental contributions necessary to restore the solvency of the scheme. This means that employees are facing loss of part or all of their pension rights, increased contributions or both. The Pensions Board in its Annual Report for 2008 states that it is concerned that the investment and funding of many DB schemes are based on aggressive investment return assumptions and do not take enough account of investment risks and down-sides. It is inconceivable to imagine that the recriminations, which undoubtedly follow financial calamities, will not focus in these situations, at least in part on the scheme trustees. We may well be entering into a new era for scheme trustees, one where trustees may be questioned on issues or called to account for actions which during the Celtic tiger years were the accepted norm – for example:

- Why a mature or relatively mature scheme should have had held in excess of 60 percent of its assets in equities? (IAPF., 2002-2008)
- Why a scheme should have had a disproportionate exposure to Irish banking shares?37
- What steps trustees had taken to address under performing fund managers?
- What monitoring trustees had carried out on fees charged by advisors and fund managers to the scheme and whether any attempt was made to assess the “value for money” of such fees?
- How familiar the trustees were with the actuarial exercise, in particular the assumptions underpinning the contribution rates recommended by the actuary, and the consequences for the solvency of the scheme in the event of the assumptions proving to be unrealistic.

While, as mentioned earlier, there is no reported case of a successful conviction of a trustee for breach of trust arising from investment of trust assets within the ambit of the trust rules, occupational pension schemes do not have a long history, (established in their current form in Ireland since the early 1960s) and many schemes would have only had their first generation of retirees within the last 10 to 15 years. It may well be therefore that the current recession is the first time for many schemes to encounter deficits of a size which cannot be ignored and it may be that the questioning of trustees may become a lot more aggressive in its attitude with the unfolding seriousness of scheme deficits. It may therefore be naive of trustees to take comfort from the lack of successful litigation against trustees in the past. This may in turn lead

37 Up to and exceeding 40 per cent of the total equity portfolio of Irish pension schemes was comprised of Irish equities in the period from 2002 to 2008 (IAPF., Asset Allocation Survey 2002-2008)
prospective trustees of DB schemes in particular, to question why they should take on a role, on an entirely voluntary basis which is potentially confrontational and can leave them exposed to potential litigation. Even where the employer provides the trustees with an indemnity and/or there is third party indemnity insurance, the trustees may still have a case to answer in proving that they acted within the terms of the employer indemnity.

6.4 How to improve Pension Scheme Governance.

The fact that trustee training in a prescribed format and to a certain standard is not mandatory, potentially creates the situation that a significant number of scheme trustees are not competent to discharge fully their duties and responsibilities as trustees. Given that only a small percentage of schemes included in this study reflected expenditure incurred in their financial statements on trustee training, it could be suggested that this may indeed be the case. The question is what needs to be done to ensure a minimum level of knowledge and competence amongst trustees sufficient at least to be in a position to knowledgeably assess the advice provided to them by experts and instruct accordingly.

It is interesting in this regard to draw an analogy between the role of the non-executive company director and the role of a pension scheme trustee. While neither are expected to have a day to day involvement in the running of the company or scheme, nonetheless in the event of a serious breech of either law or principles of good governance, both could be called to account. However the development of corporate governance has resulted in an elaborate set of rules and principles to guide both the appointment of non-executive directors and their behaviour once appointed. These rules and principles are effectively mandatory for quoted companies and while as discussed below, it is clear that there are significant flaws in current corporate governance standards, it is useful to consider how some of these principles, might be successfully transported by the Pensions Board into pension scheme regulations, to develop a framework for a minimum standard of competence and good governance on the part of pension scheme trustees.

The Financial Reporting Council (1992) it its “Cadbury Report” provide a synopsis of the development of corporate governance in the UK and Ireland as it has evolved and adopted. The Report listed nineteen recommendations – “The Cadbury Code” which is mandatory for listed companies. These recommendations relate to the composition of the Boards of Directors of listed companies, the role and responsibilities of both executive and non-executive directors, their qualifications and basis of appointment, their remuneration basis and
the need for disclosure in relation to these issues. The Cadbury Code also includes recommendations in relation to the nature of the relationship between the Board and the company auditors and the need for a sub-committee of the board – an audit committee which would liaise directly on an ongoing basis with the auditors.

The recommendations of the Cadbury Report and later reviews of corporate governance were consolidated into the Combined Code on Corporate Governance (Financial Reporting Council 1998). This code became part of the Stock Exchange listing requirements. As such it is an obligatory code for Irish and UK listed companies although there are several corporate scandals to suggest that many listed companies have not in the past complied fully with the code. Indeed, it is argued that breaches of corporate governance were a significant contributory factor in the current global financial crisis. It remains a voluntary code for non-listed companies notwithstanding that corporate governance issues have relevance to organizations beyond listed companies. The development of practical, workable acceptable and effective corporate governance concepts is an ongoing process. There have already been a number of reviews of the Combined Code and further reports are expected in the future with the objective of being more inclusive and generally more comprehensible. More and more international codes are coming together to form a common understanding of how corporate, commercial and public life should be conducted. There is an acceptance that further developments in this area are required perhaps particularly in relation to application and enforceability of corporate governance principles.

Notwithstanding its shortcomings and the flaws in current corporate governance standards, a number of the provisions of the Combined Code might nonetheless usefully be adapted by Pension Fund regulators in overseeing the stewardship of pension schemes by their trustees. In particular;

- Trustees should be of sufficient calibre (i.e. have sufficient knowledge and expertise in the core decision making areas of the trust either by virtue of their profession or as a result of trustee training or other forms of acquiring knowledge) and they should be sufficient in number for their views to carry sufficient weight.
- Trustees should meet regularly, retain full and effective control over the pension scheme and monitor the executive management (i.e. scheme actuary, fund managers, investment advisors, fund administrators etc.).
- Trustees should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments and standards of conduct. This
would of necessity require mandatory training to provide trustees with a specified level of expertise which could be supplemented as required by third party expert advice.

- There should be an agreed procedure for trustees, in the furtherance of their duties, to take independent professional advice if necessary at the pension scheme’s expense

- The majority of trustees should be independent of management and free from any business or other relationship which could materially interfere with the exercise of independent judgement. This would require radical changes to the composition of most pension scheme trustee boards where the majority of trustees normally are either members of the scheme and/or past and present employees of the employer company. This would help to avoid a situation whereby an employer nominated trustee or a trade-union/employee nominated trustee had undue influence over the trustee board to the detriment of the exercise of independent judgement.

Formalising good practice requirements such as those above would undoubtedly lead to calls that trustees taking on such responsibilities should be appropriately compensated (Lawler (2006) in research carried out for the Pensions Board (2006) found virtually no support among trustees or other industry respondents for trustee remuneration and no evidence that payment would increase trustee performance.). While pension schemes can ill-afford to increase their cost base, it might well be “money well spent” particularly for pension schemes with assets over a certain specified level. Informed trustees engaged in regular monitoring and questioning of investment performance, risk strategies, asset/liability matching or mis-matching (more likely to be the case), cost levels, value for money being provided by service providers and funding levels, would at a minimum result in tighter controls and a greater focus on overall pension scheme objectives. For the circa 75 per cent of DB schemes who currently fail the minimum funding standard, there must be a sizeable percentage where the implications of the level of investment risk assumed in their investment strategy could not have been fully appreciated by scheme trustees or at least not in circumstances where trustees felt they had control over investment strategy or would be held responsible in the event of adverse consequences resulting from the high risk investment strategy pursued. As surviving pensions schemes restructure and take steps to reduce their current deficits it may well be that the trustees of the future, may indeed be required to assume a more executive and accountable

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38 The chief executive of the Pensions Board warned in the Boards Annual Report for 2006 about the risks of over investment in equities and that “It is not always clear to the Board that the trustees are aware of the investment risks they are taking” (Pensions Board 2007a)
role, a role for which they will be required to be adequately qualified. This raises issues as to how this can be achieved.

6.5 Conclusion.

There have not been to date any reported cases of a successful conviction of a pension scheme trustee for breach of trust arising from poor strategic management, due perhaps to the high burden of proof required in criminal proceedings but possibly also due to the emphasis to date by regulators on the administrative rather than the fiduciary responsibilities of trustees. However, as more and more schemes struggle with deficits, the size of which cannot be ignored, legal actions by scheme members against a party or parties, one of which might be the scheme trustees may become more common place. Even where trustees have the comfort of an employer indemnity or third party insurance, they may still have a case to answer as to whether they have discharged their primary duty as trustees. Research for the purposes of this thesis (only 5 per cent of schemes surveyed indicated expenditure incurred on training during the years surveyed and only 16 per cent of schemes surveyed included a statement in their financial statements to the effect that trustees had access to appropriate training and guidance) suggests an inconsistency in the calibre of trustee and trustee training across Irish occupational pension schemes, which mirrors the UK position as set out by Myners (2001). This raises the question as to whether there should be mandatory qualifications in terms of academic qualifications or approved trustee training in a standardised format which all trustees should comply with. Given the size of the portfolio of assets held by Irish pension schemes and thereby effectively controlled by pension trustees (and given the high percentage of such schemes currently in deficit), the issue of a code of conduct for trustees similar in principle to the Combined Code applicable to non-executive directors should be considered. This may increase the reluctance of prospective trustees to take on such a role which may in turn raise the question of whether trustees should receive remuneration for their role. The use of a professional trustee appointed by the employer company, acting alone or with other non-professional trustees helps ensure that trustee administrative responsibilities are met, brings expertise and guidance to bear on some of the more strategic issues which trustee boards may have to address and should mean that “all the boxes are ticked” as far as the regulator is concerned. However there is a risk that it leads to conflicts of interest where the professional trustee provides directly or indirectly other services to the pension scheme or employer company. It can also inhibit active questioning and in depth analysis from non-professional trustee colleagues who may be more comfortable with taking the lead from the professional trustee on all matters of importance on the basis that “he is paid to know these things” This in
turn may lead the non–professional trustee exposed to claims of negligence albeit that he may not have as great a case to answer as his professional counterpart.

"trusteeship of both DB and DC schemes is a difficult (and sometimes thankless) task at the best of times, but in the current environment it is down-right unpleasant" (Sunday Business Post – 2009)

If DB and DC schemes are to continue in trust form trustees need clear guidelines, adequate training and expertise and accountability commensurate with responsibility.
CHAPTER 7

Pension Reform – Ireland, EU; Common threads but no uniform pattern.

7.0 Introduction

Earlier chapters raised issues in relation to the transparency of the cost structures of occupational pension schemes, on the effectiveness of existing pension scheme regulation and on the expertise and accountability of scheme trustees. These issues should feature as a component of any programme for reform of private pension arrangements in Ireland. However the future of private pension arrangements in Ireland must be considered in the wider context of reform of retirement provision generally: the balance between the public and private systems and between funded schemes and “pay as you go” arrangements. Reform of one aspect of the pensions system can have consequential effects on other areas of pension provision. For example, Stewart and Hughes (2009), discuss how demographic projections of ageing populations and concerns about financing have resulted in some countries replacing pay-as-you-go flat rate social welfare/State pensions with pay-as-you-go notional defined contribution schemes (where an individual’s entitlement is a function of their contributions) and that these reforms have significantly reduced the replacement rate of new State pensions compared to old State pensions. This reduction in State pension creates an income gap which may or may not be filled by private pension coverage in some form. Potentially the requirement for well regulated efficient private pension systems is increased.

Reform of the Irish system must also be considered in the context of developments at EU level, the growing emphasis within the EU on private sector provision generally and in particular EU legislation to provide a common framework for pension provision throughout the EU.

There has been some pension reform in Ireland over the past ten years. This chapter looks at the progress of that reform particularly in the area of costs, regulation and the role of trustees. In this context it considers the most recent proposals (Irish Government 2010a) in the area of pension reform. It also looks at recommendations for reform contained in reports commissioned by the Irish Government and recommendations put forward by the pensions
industry and other interested parties. Given that there are strong similarities between Ireland’s pension system and the pension system of our nearest neighbour, the UK (which also has an almost universal social welfare pension system although at a low rate, supplemented by private pension provision), this chapter also examines reform measures taken in the UK, again with specific reference to costs, regulation and the role of trustees. One might expect a convergence of policies because of the similarities in the underlying pension systems and also because of EU objectives for harmonisation in relation to the funding and regulation of occupational pension schemes. However despite common origins and common problems there is little in common between the reform measures of the two countries and Ireland lags considerably behind the UK in attempting to address the high cost of pension provision.

7.1 EU Directive.

Given the EU common market policy and EU objectives for harmonisation across countries in areas of fiscal policy such as taxation, insurance and pension cover, it might be expected that pension reform in the UK and Ireland and throughout the EU would follow a similar pattern. The Occupational Pension Funds Directive 2003/41/EC (European Parliament 2003a), which came into force in 2003 for implementation no later than 2005 aimed to provide a common framework across the EU for occupational pension schemes in relation to funding, regulation and information provided to members. It aimed to allow “Institutions for Occupational Retirement Provision (IORPs), established in one member state to be sponsored by employers in other member states- in effect a “pan – European pension system”. The Directive focuses on two issues: security and efficiency. Insufficient protection is a threat to retirement benefits. Inefficiency increases the cost of saving. Consequently, the Directive seeks to ensure high standards of protection for the income of future pensioners and the efficiency of pension arrangements particularly regarding the investment function and cross border transactions.

The Directive includes strict prudential rules to protect beneficiaries. Members and beneficiaries must be properly informed of the terms of the scheme, the financial status of the pension scheme and benefits promised under the scheme. Benefits promised must be calculated prudently and be covered by sufficient assets. The supervisory authorities in each member state must have the necessary powers to monitor adequately the schemes for which they are responsible. Investment rules are set out aimed at securing effective savings management. The Directive stipulates that while IORP’s should be allowed a certain freedom in determining the investment policy which best suits their commitments, their asset

39 Both pension systems have their origins in the early part of the 19th Century. The formative legislation was the UK Superannuation Acts 1834 – 1919 (Irish Government, 2000).
allocation strategy should be in line with the “prudent person principle”. This principle provides that assets must be invested in the best interest of members and be widely spread at all times, in order to ensure the security, quality, liquidity and profitability of the portfolio. The Directive however also provides that investments in shares and in risk capital should not be unduly restricted. Member States have the option of subjecting IORPs established within their jurisdiction to more detailed investment rules, but they cannot prevent such institutions from investing up to 70% of their portfolio in shares and corporate bonds and up to 30% in currencies other than the currency of their future pension liabilities.

The Directive contains rules to facilitate cross border management of occupational pension schemes, i.e. enable one institution to manage a number of schemes within different member states, while respecting local social and labour law requirements. This would necessitate mutual recognition of supervisory regimes and cooperation procedures between supervisory states where occupational pension schemes are managed on a cross-border basis. Economies of scale could be achieved through centralising and amalgamating certain core functions.

Organising social protection and pension schemes remains a matter for Member States. The Directive leaves this national prerogative untouched. The choice between pay-as-you-go schemes and funded schemes, the balance between these schemes and the encouragement of other forms of retirement saving are entirely up to each Member State.

“It is designed to enable the Internal Market to be exploited to the full, in the interests of future pensioners and in accordance with National prerogatives, recognising that a coherent EU framework enhancing the security and efficiency of IORP’s and enabling them to profit fully from the Internal Market is a major asset for those Member States which wish to develop the role of occupational pension schemes in their pension systems.

(European Parliament 2003b)

The Directive was signed into law in 2003 and was due to be implemented by all member states within a two-year period. Ireland implemented the Directive through inclusion of statutory requirements in the Social Welfare and Pensions Act, 2005 (Attorney general 2005) and underlying Regulations while the UK Pensions Act 2004 (UK Government 2004) gave effect to many of its’ provisions in the UK. However 11 member states failed to meet the
2005 implementation deadline and there is as yet no true pan-European pension system in place. Instead as mentioned earlier, pension reform throughout the EU has been patchy but with a growing emphasis on personal pension provision. Since the directive sets out objectives to be achieved rather than mechanisms for achieving those objectives (i.e. the directive is "principle based"), it is not merely a case of whether it is implemented by a member State, but also how it is implemented and once implemented how it is applied and how effectively it is enforced. Particularly in the area of investment strategy, the proposed investment bands (up to 70% in shares and corporate bonds and up to 30% in foreign currencies), retains much flexibility within the Member State.

Although the Directive recognises that private pension arrangements may be either pre-funded or pay-as-you-go systems, at the heart of the Directive and indeed more recent EU pronouncements in this area (European Union 2010), is the supposition that occupational pension arrangements are pre-funded rather than pay as you go arrangements. While this is largely the case in countries such as the Ireland, UK, and Netherlands, funded occupational pension arrangements are not a primary feature of pension systems in France, Sweden, Italy or Spain. The wider relevance of many of the EU proposals which centre very much on investor led funded schemes is therefore in doubt.

7.1 EU Tax Harmonisation For Pensions.

A key factor in the development of occupational pension schemes worldwide has been the availability of tax incentives and tax concessions for occupational pension schemes to promote and encourage provision for future retirement income. The cost of these tax incentives is considerable. The Green Paper (2007a) estimates the cost to the Irish Exchequer of tax and PRSI reliefs for private pension provision in 2006 at €2,900m and one would expect equivalent costs levels to prevail elsewhere throughout the E.U. In the context of reform of pension systems throughout the E.U. the effectiveness of the current systems of tax incentives for private pension schemes warrants consideration. As discussed below, at a minimum, consistency of tax treatment across EU countries is necessary to promote pan-European pension systems and avoid tax leakage.

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Within the E.U., given that individual member states have their own individual taxation systems, there is no automatic consistency in the tax concessions afforded across all member states. This could potentially result in inadequate coordination of the taxation of occupational pension schemes. The difficulties with such a lack of symmetry is that it can hamper the freedom of movement of workers, lead to tax evasion/avoidance mechanisms (by pensioners moving countries of residence so as to avoid taxation of pensions) and prevent the creation of a genuine single market in occupational pension schemes. If some Member States taxed contributions while others taxed benefits, a consequence would be either double taxation or no taxation of migrant workers or persons who chose to retire in another Member State. Further inequalities in treatment could stem from differences in the conditions for tax recognition of schemes and allowable deductions. In 2001 the EU Commission issued a “Communication” (European Parliament 2001) seeking to solve the problem of inconsistencies in the taxation treatment of occupational pension schemes without creating a specific EU directive. The Communication made a number of key points:

1. The Commission recommended the uniform implementation of the EET system (exempt contributions to the scheme, exempt investment income and capital gains of the pension scheme, tax benefits).

2. The Commission referred to the jurisprudence of the European Court of Justice which held that the unequal treatment of foreign pension schemes compared with domestic pension schemes is in violation of the EU Treaty and concluded that there was no need for a specific ban in a directive to combat this situation.

3. The Communication introduced the concept of a pan-European pension system but accepted that Member States had concerns that the opening of the market in private pensions could hamper the implementation of national policies and that Member States would require domestic pension schemes to inform national tax authorities of the payment of any pension benefits (including lump sums) and in some cases deduct tax at source. The Commission recommended that provisions already in place for the exchange of information between Member States be more effectively implemented.

For the most part the recommendations of the Communication are reflected in either the domestic legislation of Member States or the double – tax treaty agreements which exist between Member States. However there are still some countries that do not give tax relief for contributions but do not tax pensions and there are also inconsistencies across countries in the tax treatment of accumulated lump sums. There are also difficulties around the exchange of information between Member States. If for example a pensioner living in one Member State
receives a pension from an occupational pension scheme established in another Member State, a double tax treaty between both countries may provide that no tax should be charged by the Member State from which the pension is paid but that tax should be charged by the member State in which the pensioner is living. However there may be no automatic third party reporting of the pension to tax authorities of the Member State in which the pensioner is living– it may be the obligation of the pensioner to self report and account for the tax. Some complications continue to exist also in relation to the tax treatment of pension lump sums and the treatment of the pension scheme itself as a tax exempt vehicle. In the area of investment return, there may be difficulties with withholding taxes on dividends and interest (which in some instances continue to be deducted at source so that a refund must be claimed by the pension scheme) and also where pension schemes invest in unit trusts and similar investment vehicles where tax may be charged within the investment vehicle.

7.2 The Pattern of Pension Reform to date in Ireland.

The essential purpose of the Green Paper (2007a) on pension reform in Ireland was to;

   carefully consider the issues involved, before making appropriate decisions for ourselves and future generations.

It promised a consultation process to allow all stakeholders to contribute towards shaping a framework for addressing the pensions challenge over the longer term. It reiterated the Government objective of achieving an affordable, sustainable and modern pension system to meet the individual needs of those currently in retirement and secure the same objective for younger generations. Since the Green Paper (2007a), there have been some developments, precipitated by the global economic downturn and these are discussed below. While these developments are welcome in themselves, actions taken to date do not represent an all-encompassing address of the issues at stake and in terms of a possible role for the State in the provision of occupational pension cover, merely represent tentative first steps. The “National Pensions Framework” proposals (Irish Government 2010a) seek to set out a wide ranging series of proposals covering the State system and private pension systems, however as discussed below many of the proposals are aspirational in nature with no firm implementation procedures or implementation date.
7.2.1 Irish response to growing pension crisis.

In 2009, a number of measures were introduced (Attorney general, 2009), designed to support workers in pension schemes. A new Pensions Insolvency Payment Scheme (PIPS) was established to assist employees and former employees of companies where the employer becomes insolvent and the defined benefit scheme is in deficit. Effectively scheme trustees can now purchase annuities from the State. As PIPS are intended to be cost neutral to the State, the perceived benefit is that the cost of these annuities should be lower than an equivalent purchase from a profit-making organisation. The reduced annuity cost should lessen the drain on the pension scheme and consequently improve the prospects of employees yet to retire.

We are in a situation where defined benefit schemes are being wound up and some employees and former employees are ending up with less than they are due. I want to make it easier for people to get more. The new Government scheme will provide for pensions at a lower cost, leaving more funds available for those who have yet to retire.

(Irish Government 2009)

The National Treasury Management Agency was delegated powers by the Minister for Finance to price the cost of purchasing annuities on a not-for-profit basis.

Changes were also announced (Attorney General 2009) to the way funds would be disbursed if a defined benefit scheme in deficit is wound-up. Pensioners will continue to get first priority for their pensions but any future pension increases will not be granted until workers who have also contributed to the scheme, and have yet to retire, receive their share of benefits.

Previously, if a scheme was being restructured, only the rights of existing employees could be affected. For the future, current and former employees and future pension increases can be included in any restructuring. For those already on pensions, the existing level of pension will not be affected, but future pension increases may be restricted.

Regulation is being strengthened to make it easier to prosecute employers who do not pass on the pension contributions made by employees to the pension scheme and anyone convicted of this offence will also face much harsher penalties.
Coinciding with these legislative provisions is a relaxation of requirements by the Pensions Board with regard to funding proposals which scheme trustees must lodge with the Pensions Board where the scheme fails to meet the minimum funding standard. As discussed in Chapter 5, where a funding certificate is prepared which certifies that the scheme does not satisfy the Funding Standard on the effective date of the certificate, a funding proposal must be submitted to the Board. The funding proposal must be designed to put the scheme in a position that it could meet its liabilities no later than the effective date of the next actuarial funding certificate i.e. within 3 years or by such later date as may be allowed by the Board under the provisions of the legislation. Previously, the general policy of the Board had been to consider specifying an effective date no later than 10 years after the effective date of the actuarial funding certificate giving rise to the necessity for a funding proposal. Guidelines from the Board issued in February 2009 state that the Board will now consider an effective date of more than 10 years in appropriate circumstances.

"In considering applications for terms of more than 10 years, the Board will have particular regard to the following:–

(a) the extent to which a longer term reduces the contribution rate below that required to fund a 10 year proposal;
(b) the existence and quality of any enforceable guarantees provided by the employer;
(c) the proposed investment strategy of the fund, and the extent to which the fund will be exposed to investment risk over the course of the funding period;
(d) any exceptional circumstances which differentiate the scheme from other underfunded schemes. It should be noted that inability to pay, on its own, is not considered by the Board to constitute exceptional circumstances."

Pensions Board (2009b)

The Board will in any event only consider an extended period longer than the average future working life of the active members where there are no active members or where the active members have a relatively short future average working life and comprise only a minority of the liabilities of the scheme. Trustees must demonstrate in their funding proposal that their proposed investment strategy is grounded in sound risk management and investment principles. In this regard the Board will take into account;
- the matching of liabilities with appropriate assets
- the trustees’ consideration of the implications of possible investment losses or increased liabilities.
- the approach the trustees take to investment risk particularly where the trustees have stated that the sponsoring employer is unable or unwilling to pay a higher contribution rate. However where the trustees are changing the scheme’s investment strategy, the Board would not expect this change to be made in an inappropriately short time.

With an estimated 75% of pension schemes currently in deficit, the take up of the new proposals (in particular the possibility of restoring funding levels over a period longer than 10 years) will be widespread. However it may be that funding proposals, no matter how long their extended duration, may serve just to delay recognition of the inevitable – that the real cost of delivering the promised benefits is unaffordable for lots of reasons, - previous low contribution levels, high administrative and fund management costs, improving mortality, and a concentration of investment in riskier assets (e.g. equities) which did not yield high expected returns. In these situations, which are likely to be numerous, trustees will be faced with the prospect of either restructuring the pension scheme in terms of its benefit promises or winding the scheme down. The Irish Government (2010a) discussed below, makes references to the establishment of a revised and more secure DB scheme model which existing schemes may wish to consider if restructuring in the future. The proposed model scheme would promise levels of benefit which would be significantly lower than under a typical current DB scheme, but the benefits would be provided to a greater degree of certainty. However there is no detail on the structure of the new model scheme, how existing schemes might be restructured in terms of benefits and obligations to coincide with the new model provisions or whether certain schemes in difficulty might be required by the regulator to restructure in line with the new model provisions.

Measures in 2009 discussed above, were focussed on specific difficulties with the current Irish pension system pending the publication of reports from a number of expert groups and ultimately an overall policy document by the Government (Irish Government 2010a). One of these reports (Commission on Taxation 2009) made very significant recommendations in the area of tax relief for employee and self-employed contributions which can perhaps be summarised as aiming to increase coverage among lower paid workers whilst restricting the scale of tax relief available to higher paid workers. The report recommends abolishing tax
relief for employed and self-employed contributions and replacing it with a matching Exchequer contribution. The suggested rate of matching contribution is €1 for every €1.60 invested by the individual irrespective of the marginal tax rate of the individual. The Commission recommends that in the first five years of pension provision by an individual, there would be a €1 for €1 matching contribution by the exchequer. As a consequence of the matching provisions, employers would no longer be granted PRSI relief for employee contributions. The effect of the matching contribution proposal is that high rate tax payers contributing to their pension will suffer a tax cost in that the State’s matching contribution will be less than tax, PRSI and levies which they will pay on the income out of which they pay the contributions. Low rate tax payers will earn a tax benefit compared to the current position. However as is currently the case, the higher the salary/income level of the taxpayer (subject to a generous income cap), the greater the absolute amount of tax relief available.

The Commission on Taxation (2009) also recommends a retirement savings scheme modelled on the SSIA scheme. This was a very popular (but costly for the State in terms of tax reliefs) once off five year savings account scheme offered by the Government in 2001 and 2002. Approximately 42 per cent of the total adult population joined the scheme (Hughes and Stewart, 2009). The proposed new savings scheme is designed for an employee who is not already a member of a defined benefit scheme and the suggested Exchequer contribution is €1 for every €2 contributed by the individual. The maximum amount which could be contributed by an individual in any one year is €2,200. Any return earned on the amount saved would be taxable but the principal (amounts contributed by the individual and the Exchequer) could be withdrawn on retirement without taxation. Pre-retirement access to the funds would be allowed in exceptional circumstances such as acquisition of a home or serious illness but in such cases, the Exchequer contribution would have to be repaid.

The Commission makes a number of other recommendations:

- There should be correlation between the annual earnings limit for employed and self-employed contributions and the cap on the size of pension funds at retirement (provisions were introduced in the Finance Bill 2011 (Irish Government 2011) to reduce the annual earnings limit to €115,000 and cap the size of future pension funds on retirement).
- The tax free element of pension lump sums on retirement should be capped at €200,000 with the balance taxed at the standard rate of income tax (provisions were
introduced in the Finance Bill 2011 (Irish Government 2011) to reduce the tax free
element of pension lump sums to €200,000).

- Anti avoidance legislation should be introduced to prevent the manipulation of
contributions and salary levels in the final years of employment where this is
designed to maximise the allowable pension on retirement.

The stated overall objective of the commission report is to achieve a more equitable and
stable tax base rather than to increase the tax take to the exchequer and this can be seen in the
specific proposals relating to the pensions industry. In terms of its effect on coverage levels
and replacement rate levels the potential outcome is unclear. Higher rate taxpayers would be
discouraged from making additional contributions to their pension scheme because the tax
relief is capped. They would need to be convinced that any incremental pension scheme
investment is a worthwhile investment outside of the tax relief and this could in turn increase
the focus on pension scheme fund performance including cost levels. Lower paid workers,
particularly in times of recession might not be in a position to afford investing in the proposed
pension arrangement and it may not be rational for them to do so, given their financial
circumstances. Even for those who could and did invest, the replacement rates offered by the
new arrangement are unlikely to be significant. A further concern is that typically tax relief
schemes result in increases in the underlying cost of the service being provided (e.g. dental
fees, maternity fees which increased dramatically when tax relief for them was introduced). If
this trend was to result in higher charges and costs being charged to the new arrangements any
anticipated improvement in replacement rates would quickly be eroded.

McCarthy (2009) included many recommendations about and references to State and public
sector pension reform. The measures focussed around cost reductions for the State rather than
increasing coverage or replacement rates and include recommendations on increasing the age
of retirement, increasing employee contributions, modifying the earnings linking of pensions,
moving to the calculation of pensions on the basis of “career average” earnings, reducing
social welfare pensions by 5% and introducing better transparency on the true cost of accrued
pension arrangements.

A more all embracing overhaul of the pensions system in Ireland (both public and private)
was put forward by TASC41 (2010). The TASC pension model is based on two tiers, an
increased universal State pension and a social insurance –based second tier pension, which

41 TASC is an independent think-tank dedicated to combating Ireland’s high level of economic inequality and ensuring that
public policy has equality at its core.
together would guarantee contributors 50% of their final wage or salary up to a specified maximum. TASC recommend that the increased and universalised State pension be funded by reducing tax reliefs available on private pension contributions (e.g. occupational pension schemes and other personal pensions). The TASC pension model can be summarised as follows:

- Increasing the Social Welfare pension to 40% of gross average industrial earnings over a five year period.
- Universalising the increased Social Welfare pension so that all long term residents of Ireland are entitled to it on reaching the age of 65.
- Establishing a new, Social Insurance (retirement) Fund. This would be a defined benefit scheme and would provide an earnings-related pension allowing contributors to save for retirement while removing the risk and uncertainty associated with private pension provision. When taken together with the State pension, contributors would be guaranteed 50% of their final wage or salary up to a specified maximum.
- Funding the reforms by standard – rating all pension-related reliefs at 20% and reducing to €75,000 the ceiling on earnings which may be taken into account for contribution relief purposes.
- Introducing comprehensive pension protection systems for existing and future defined benefit and defined contribution schemes.
- Amending Company Law to restrict the payment of dividends by sponsoring companies who fail to meet their commitments to defined benefit schemes which are in deficit.
- Introducing stronger financial regulation enabling the regulator to impose more stringent requirements on private pension providers in relation to managing risk and fund administration charges.

7.2.2 National Pensions Framework.

The Irish Government (2010a) set out the National Pensions Framework which is a result of the consultation process that began with the Green Paper (2007a) and was informed by the McCarthy Report (2009) and the Report of the Commission of Taxation (2009). The intended implementation dates for many of the proposals in the new Framework is 2014 and beyond – still some years away and even these targeted implementation dates may have to be reviewed.
in light of economic conditions over the coming years (Irish Government 2010b). The proposals are wide ranging and include changes to the current social welfare pension as well as changes to occupational pension schemes and other private pensions. Mandatory social welfare coverage will continue but the system will move towards a total contributions based approach (rather than a flat rate) in 2020 and the retirement age for State Pension (which will have a target level of 35% of average earnings) will increase to 66 in 2014, 67 in 2021 and 68 in 2028. Tax relief for qualifying pension contributions made by individuals will be at a rate of 33% (this will mean reduced tax relief for individuals on the top income tax rate but greater relief for individuals on the standard tax rate, however there are no details as to the mechanisms for achieving this). There are references to stronger regulation, greater transparency of charges and rationalising pension vehicles but again very little detail on how these proposals will be delivered. There are also references to a revised and more secure DB scheme model which existing schemes may wish to consider if restructuring in the future. As discussed earlier however, while proposals of this nature would surely attract much interest from trustees of existing schemes in deficit, no details are provided as to the detailed terms and conditions of the new model and how existing schemes might be restructured in terms of benefits and obligations to adopt the new model rules.

One of the principal proposals is that of a new auto-enrolment DC scheme from 2014. Employees aged 22 or over will be automatically enrolled unless they are a member of their employer’s scheme (which provides higher contribution levels or is a DB scheme). Automatic enrolment means instead of choosing whether or not to join a pension scheme provided by their employer, all eligible workers will have to actively decide not to be in a scheme. It is proposed that employees will be required to make a fixed percentage contribution to the scheme and there will be matching State and employer contribution. The State contribution will be 33% tax relief. Employees can opt out of the scheme but they will be re-enrolled every two years. Contributions to the new scheme will be made within a band of earnings – (not determined as yet but stated to target lower and middle income earners) and the contribution rate in total will be 8% of salary (Employee 4%, Employer 2%, and State contribution 2% (State contribution will be 33% of employee and employer contributions)). Based on these contribution levels, the levels of pension income which can be expected from the new scheme will be quite small. The National Pensions Framework document assumes an investment return on contributions of 7% each year and sets out indicative retirement pensions based on a 7% investment return annually for 40 years. However a consistent investment return rate of this level is unlikely to be achieved. Unlike the UK proposals for an auto-enrolment scheme (discussed below) which promises an AMC as low as 0.3% of fund
value in the long term and 0.5% in the short term, the Irish proposals do not guarantee a low
cost scheme. However it is proposed that pension contributions will be invested in a
designated range of funds including a low-risk default option, and this bulk investment may
itself generate economies of scale which would not be available generally to smaller schemes.
It is anticipated that the new scheme will be administered through the existing PRSI network
but again the exact mechanisms have yet to be determined. The existing PRSI system would
not for instance easily facilitate traceability of fund entitlements where employees had a
choice of a range of funds into which their contributions could be made and/or employees
change jobs a number of times over their career. While 2014 is the target start date for the
new scheme latest indications (Irish Government 2010b) suggest that given current economic
circumstances, the target date may not be realistic (National recovery Plan, 2011-2014, p.71).

The National Pensions Framework also sets out proposals for a New Public Service Pension
for all new entrants to the Public Service which will be less generous than the existing Public
Service pension arrangements and therefore more affordable for the State.

There are aspects to the Framework proposals which capture many of the recommendations
put forward by The Commission of Taxation Report, The McCarthy Report and the TASC
proposals. It is clear that affordability and sustainability of the State system and coverage of
private pension systems so as to ensure adequate replacement levels of income for all
individuals, are the key drivers behind the proposals. However the Framework document is
lacking in terms of detail which makes it very difficult to assess in terms of its effectiveness
to provide for income adequacy in retirement for all, in a sustainable manner. It is unlikely
that the proposed auto –enrolment scheme will succeed in a significant number of lower paid
workers (particularly from single income families) committing to a savings pattern for their
retirement at a time when day to day financial concerns are so pressing. As mentioned above,
there may be difficulties in traceability of benefits where individuals change
employment/residence a number of times over the course of their career and this may lead to
dormant accounts and resulting high administrative costs. Given the relatively low
contribution levels, (8% of a low to middle income earnings band) its potential in combating
pensioner poverty must also be questioned. It is likely that further prolonged periods of
discussion and refinement of the proposals will ensue in the run up to 2014 and beyond.

Concerns raised in Chapter 4 in relation to the level of existing scheme costs, in Chapter 5 on
the subjectivity of actuarial valuations and in Chapter 6 on the level of training and expertise
applied by trustees, are largely ignored in the National Pensions Framework, although the
stream-lined nature of the auto – enrolment scheme which will be DC in nature and have a
limited number of investment options may mean comparatively reduced costs for that scheme and a narrower defined role for its trustees. For existing DB and DC schemes, however, aside from the proposal of a new model DB scheme (in respect of which very little detail has been given), there are no proposals to restructure the current DB/DC system to improve efficiency, governance, security and sustainability. For the large numbers of these schemes currently in deficit, the National Pensions Framework provides very little by way of a possible solution to managing the difficulties they face.

7.3 Pension Reform in the UK

As mentioned earlier, the UK and Irish pension systems have common origins dating back to the early 19th century. Both have a near universal State system which is supplemented by funded occupational pension schemes and personal pensions. There has however been divergence in recent years. In particular, there has been a greater emphasis in the UK on individualised pension arrangements although this has never been entirely successful for the UK and did result in significant mis-selling practices and consequent payment of significant compensation by pensions providers to individuals who had suffered financial loss through mis-selling practices. Similar to Ireland, the number of employees in UK DB plans has declined in recent years due to increased compliance and higher company contributions. Replacement ratios from UK DC plans have also fallen. This has lead to both coverage and adequacy problems, again similar to the Irish experience. As discussed in Chapter 1, there has been a significant consultative process in the UK over the past ten years on the matter of pension reform. This has culminated in legislation to give effect to a number of reform measures (including a pension protection system and a proposed new DC auto-enrolment scheme) albeit that some commentators consider the latest UK developments (discussed below) as yet another individualised pension arrangement in an already piecemeal system of individualised pension arrangements (existing “Personal Pensions” and “Stakeholder Pensions” will continue to exist). A review of the main aspects of pension reform in the UK with particular reference to proposals in the area of costs, regulation and the role of trustees is nonetheless useful in highlighting how Ireland lags behind its neighbour in producing and implementing proposals in these areas.

7.3.1 UK Pension Commission – First Report.

The UK pensions Commission (2004) in its’ first report on private pension provision in the UK set out to stimulate debate on future reform. The report sets out to be fact based but poor
Employers have a key role to play in meeting the pensions challenge and in debating the way forward for society.

An increase in the average age of retirement will be a key element of the required solution. Age discrimination legislation will make it illegal for companies to make people redundant solely on the grounds of age, and the Commission has opposed the idea that there should be a ‘default age’ of 65 beyond which this legislation does not apply.

Business needs to treat this legislation as a spur to creative thinking about how to harness the talents of an older workforce.

Voluntarism is not at present delivering the level of pension saving needed to meet the demographic challenge. If higher taxes devoted to pensions or compulsory savings are to be avoided, employer involvement in pension provision must rise. New ideas on how to achieve this are needed.

Employers need to be involved in the debate about risk sharing within the pension system. The DB to DC shift is taking us from pension schemes where employers take all the risk and employees none, to those where all risk is borne by the employees.

Creative redesign of pensions schemes could deliver intermediate and sustainable risk sharing arrangements.

The report only includes a discussion of costs in Chapter 6 specifically in the context of encouraging voluntary individual private pension arrangements. It suggests that cost levels are one of the big barriers to the success of a voluntary pension saving system in the UK. This is on the basis that for low to medium income earners, reductions in yield arising from providers charges can absorb 20 percent to 30 percent of an individuals’ pension saving even though they have fallen to a level which is unprofitable for providers. The Report suggests that there is a fundamental question of whether a voluntary market for pension provision can work for low income customers.

7.3.2 Recommendations of the UK Pension Commission;

As discussed in Chapter 1, one of the principal proposals of the UK Pension Commission (2005) in its’ second report was the creation of a low cost national funded DC pension savings
scheme into which individuals would be automatically enrolled but with a right to opt out. The scheme would require a modest level of compulsory matching employer contributions and would attract tax incentives at least equivalent to existing tax approved pension arrangements in the UK. One of the principal features of the proposed scheme was a low annual management charge of 0.3% per year or less. Contributions would be collected in a cost effective fashion such as under the PAYE system and members would have an option of investing in six to ten low cost funds, bulk bought from the fund management industry.

The report describes the target of 0.3 per cent as essential to ensure that all people can avail of cost efficient pension saving previously enjoyed only by employees of larger firms, public sector employees and high income individuals. It envisages that a low cost structure will increase the incentive to save. The report recognises that to achieve the targeted low cost structure, a cost efficient payroll deduction process for contributions, is required, together with a structure for aggregating individual funds to allow bulk buying of fund management services (as well as generating economies of scale, bulk bought fund management services would eliminate the need for individual regulated advice which adds to overall cost levels.)

There has been much discussion subsequently as to the feasibility of the targeted 0.3 per cent annual management charge. The Pensions Commission (2006) in its final report concluded that an AMC of 0.3 per cent was a reasonable target rate in the longer term. This was on the basis that the use of automatic enrolment should reduce the costs of marketing and acquisition, that the establishment of a central body would increase portability and reduce the number of times high start up costs for accounts would be incurred, and that there would be greater persistency of saving which would reduce the costs of saving through fewer but larger pension funds.

The UK Government (2006a) in its consultative document “Security in Retirement: towards a new pensions system” set out the detail of how the proposed auto-enrolment scheme would work. Crucially, it acknowledged the importance of low charges illustrating that for a median earner (£23,000) who saves in a pension for 40 years, there could be a difference of up to 20 per cent in the size of his final pension fund depending on whether the AMC is 0.5 percent or 1.5 percent. In its subsequent White Paper the UK Government (2006b) suggest that an AMC of 0.3 per cent might not be achievable in the short term because of the set up costs of the auto enrolment scheme but that an AMC of 0.5 per cent was achievable in the short term falling to below 0.3 per cent in the longer term. This would compare favourably with existing charge structures for individual accounts in the UK of 1.5 per cent in the first ten years falling
to 1.0 per cent thereafter. The UK Government (2007) in its discussion of the responses it received to its White paper states that while there was some scepticism as to whether the 0.3 per cent charge level could be achieved, the responses received highlighted the importance of low charges. The Pensions Policy Institute (2007) also argue that a low rate of 0.3 per cent AMC is not possible at least in the early years given the wealth of regulation that surrounds pension schemes.

7.3.3 UK Pensions Act 2008.

The Pensions Act 2008 (UK Government 2008) enshrined in legislation the detailed proposals of the UK Pensions Commission as refined by the subsequent UK Government consultative process. It provides that from 2012 all eligible workers42 who are not already in an occupational pension scheme will be automatically enrolled into either their employers’ pension scheme or a new savings vehicle- a personal account scheme (NEST). The legislation provides that the personal account scheme will be a new low cost saving vehicle to which both the employer and employee will contribute and which will qualify for the same tax incentives as apply currently to Inland Revenue approved pension schemes.

A contribution of 8% of band earnings must be paid per annum with the employer paying at least 3%. Band earnings are earnings between £5,035 and £33,540 (in 2006/7 earnings terms). People can opt-out of the scheme and if they do, no contributions need to be made on their behalf. Employers need to re-enrol employees who opt out, at least once every three years. There will be a ban (to be enforced by the regulator) on “encouraging” employees to opt out, by for example offering higher salaries or once off bonuses.

Wain (2009) questions whether the proposed personal accounts will succeed where previous attempts at individualised pension provision have failed, whether they will “meet the test of adequacy”, the suitability of the accounts for individuals with interrupted work histories and if the promise of very low transaction costs can be realised. The UK Government (2010) in its review of the auto enrolment scheme while stating that 0.3 per cent is the expected AMC of the new scheme, adds that an additional charge of 2% of contributions will be levied until the set up costs of the scheme have been met (the combined costs are estimated to be equivalent to an AMC of 0.5 per cent). NEST have subsequently announced a reduction in the set up

42 Job holders aged between 22 and State pension age earning more than £5,035 per annum.
charge from 2% to 1.8% (www.nestpensions.org.uk 2010) but the charge is expected to stay in place until at least 2030 (UK Government 2010)

Interestingly UK Government (2010) also recommends that as a matter of urgency the question of transfers between NEST and employer sponsored schemes should be reviewed and the question of whether the existing regulatory regime for DC workplace pensions remains appropriate in the post automatic enrolment world should be considered. Accordingly while the introduction of NEST was not established as a solution to the high cost regime of existing UK occupational pension schemes, it may none the less be significant in the future for the cost structures of UK occupational pension schemes generally and DC schemes in particular, if a facility whereby existing DC schemes may transfer into the new arrangement is envisaged. In addition the emergence of NEST onto the fund management market generally could be expected to increase competition in the fund management industry generally.

7.3.4 Regulation, compliance and the role of trustees – UK Developments

From an employer’s perspective, the UK Pensions Act (2008) brings major new responsibilities on employers. Employers who do not have a pension scheme or do not have schemes covering the full workforce need to introduce provision. The compulsory 3% employer contribution may be a significant employer cost in some instances while employers currently paying more than this may consider reducing this to offset their contribution down to the minimum 3% level. The impact of the provisions of the Act will vary enormously depending on the employer’s circumstances.

In tandem with the “almost compulsory” coverage provisions, the Act also includes provisions strengthening the powers of the Financial Regulator. The Regulator will be able to issue a contribution notice to require a contribution to a scheme where an act or failure to act has detrimentally affected, in a material way, the likelihood of members’ benefits being received. Another new power enables the Regulator to appoint trustees to a scheme in specified circumstances where it is satisfied that it is “reasonable” to do so (previously the test was whether it was “necessary”). This power can be exercised also when such an appointment would “protect the interests of the generality of the members”. Interestingly (in the context of the discussion on trustee responsibilities in Chapter 6), the Regulator will also be able to intervene in the event that the trustees fail to take account of prescribed matters for determining a scheme’s actuarial liabilities This will be the case even if the employer and trustees have reached agreement on the actuarial liabilities and the scheme actuary has
certified those liabilities as being appropriate. These increased powers of the Regulator to intervene in trustee matters should in themselves force trustees to take greater care to be adequately informed before taking decisions which the regulator might subsequently have cause to examine.

NEST is established as a trust and as such its trustees would have the same responsibilities as trustees of any other DC occupational pension scheme. The initial primary role of NEST trustees will include ensuring that NEST is accessible to all employers, that contracts are put in place for scheme administration and to set up the fund options available under the scheme and in particular the default option fund. Unlike the vast majority of pension schemes however, the NEST Board of trustees consists of individuals who are all expert in varying aspects of the pensions industry, the trustees themselves are contracted to a time commitment of at least 30 days a year (the chairman, one day per week). They are supported in their role by a full time executive management team and a number of select committees including an audit committee, and investment committee and a governance committee. Because NEST is DC in nature many of the investment making decisions which DB trustees would have responsibility for will not be the responsibility of the NEST trustees. Nonetheless early indications are that NEST trustees are setting in place high standards of professionalism, transparency and comprehensiveness for the performance of their duties. The Trustee code of conduct, corporate governance statement, and procedures for the conduct of meetings are all included on the NEST web site as are details as to procedures and progress to date in choosing fund managers and projected publication date for the Statement of Investment Principles. Indeed many of the requirements for good governance which might be included in the “Combined Code” for trustees discussed in Chapter 7, appear to be embraced by NEST. This is encouraging for the future in so far as it formalises a new “modus operandi” for scheme trustees which existing and new boards of trustees may be required by scheme members and other stakeholders to follow, one which is more professional, more informed and more transparent and which in turn will lead to greater accountability.

7.4 Conclusion

Both the Irish and UK pension systems are predicated on a two-fold pension strategy, a State pension guaranteeing a certain minimum pension topped up by private pension arrangements. The programme of reform measures being introduced in the UK while subject to criticism, is more far reaching than anything introduced or proposed to date in this country and go some

43 www.nestpensions.org.uk

155
way towards addressing issues of cost, efficiency and governance which are common to both countries. The proposed low cost auto enrolment scheme if successful in terms of achieving its’ targeted low cost structure and expanding to facilitate transfers in from other DC occupational pension schemes could be a blueprint for an efficient DC occupational pension scheme into the future. Increased competition in the fund management industry which may be a consequence of the proposed scheme and the transparent form of governance of the scheme may have consequential positive impacts for DB schemes (as DB scheme stakeholders demand similar facilities) and private pension provision generally. While there are significant questions as to whether NEST can achieve its objectives, its underlying principles in terms of efficiency and transparent governance must be regarded positively.

In contrast, the proposed Irish auto enrolment scheme is deficient in terms of provisions to ensure reduced management and operational costs and as yet there are no details available as to its governance structures. Furthermore, at this stage there is nothing in the proposals which suggest that existing DC schemes could transfer into the new scheme. The proposed new DB scheme model incorporates no provisions which might ensure that the new DB schemes would run more efficiently than existing DB schemes and there are no details available as to the detail of the legislation that will necessarily be required to give effect to the benefit structure which the model scheme will adopt. Latest Irish Government pronouncements (Irish Government 2010b) would also suggest that the rollout date for many of the provisions of the National Pensions Framework may be deferred given current economic circumstances. As such the National Pensions Framework provides very little by way of answers to the many existing Irish DB scheme currently in deficit and little by way of reducing costs and improving governance to avoid the mistakes and inefficiencies of the past being repeated into the future.

Ireland can learn from the UK experience both in terms of the positive aspects of UK reform as discussed earlier but also from the shortcomings and criticisms of the UK system; overlapping reforms resulting in multiple sources of retirement income and potentially cumbersome and inefficient systems and the potential for mis-selling in individualised pension arrangements. There is a window of opportunity to revisit the proposals of the National Pensions Framework and address the issues at present not addressed fully so that when the proposals do come to be implemented, they will represent a more complete response to the fundamental concerns of adequate and sustainable pension provision in a cost efficient, transparent and properly regulated environment.
CHAPTER 8

Conclusion.

This thesis examines some of the key determinants, other than investment strategy in the reported performance of Irish occupational pension schemes and the role that these determinants might play in any comprehensive set of proposals for reform of pension provision and coverage in Ireland. It incorporates a study of the financial statements of 58 Irish pension schemes for the period from 2002 to 2007. The schemes included in the study had assets under management of 24.4 per cent of total pension fund assets at the end of 2007. Specifically this thesis looks at the levels and transparency of fees and costs incurred by pension schemes, the subjectivity of actuarial assumptions upon which scheme liabilities are based and the expertise and training of and contribution by, scheme trustees in the management of pension schemes. The thesis also examines Ireland’s progress to date towards achieving secure, adequate and sustainable retirement income for all its pensioners.

Chapters 1 to 3 set out the context for the thesis, the data sources and methodology applied and a review of relevant literature on the aspects of pension fund performance which are the focus of this thesis.

Chapter 4 highlights the lack of transparency currently, in total costs incurred by pension schemes, both on an annual basis and cumulatively over the lifetime of a scheme. This chapter demonstrates the impact of costs on pension fund performance and the positive impact that cost efficiencies can have on pension fund values. It also demonstrates how requirements for full and separate disclosure of costs in scheme financial statements could add to the informative value of the financial statements, which in turn could establish greater cost competitiveness within the fund management industry. By examining the RIY over the lifetime of a scheme, of pension fund costs, the need for greater focus to be placed on cost efficiencies and competitiveness in future pension provision policy decisions, is readily apparent. Even a small percentage reduction in costs per annum can have a significant impact over the lifetime of a fund.
Chapter 4 concludes that the introduction of a low cost occupational pension scheme model similar to the UK proposals should be considered, as part of a wider range of measures to improve both coverage and pension adequacy. A transparent low cost structure would improve cost competitiveness in the industry generally, promote greater trust and confidence in the pension system, and this in turn could improve voluntary coverage. It could also ease concerns, which currently prevail, in this country with regard to any form of mandatory pension provision. The auto enrolment scheme proposed in the National Pensions Framework is significantly deficient in providing for a low cost framework.

Chapter 5 highlights the role of actuarial assumptions in the valuation of pension fund liabilities and how changes in actuarial assumptions can impact on the reported financial performance of a pension scheme. The importance to scheme trustees (if they are to carry out their role as trustees effectively), and regulators (for good governance), of greater transparency in and understanding of, the actuarial assumptions used to value pension fund assets and liabilities, is evident. This chapter concludes that from a regulatory perspective and as a benchmark comparison, there are advantages to a standardised valuation process such as the Minimum Funding Standard (MFS) valuation, which limits the subjectivity of the valuation result. It also provides evidence which supports the Society of Actuaries call for the MFS to be strengthened.

Chapter 6 concludes that the inadequate training and expertise of trustees, which necessarily requires them to delegate significant areas of their trustee responsibilities to third party advisors, may lead trustees exposed to legal challenge by scheme members/beneficiaries if pension schemes fail to deliver on pension promises/expectations.

This thesis also concludes that self regulation in the pensions industry and inadequate expertise on the part of trustees are resulting in an inadequate level of real governance of schemes. Examples of the dangers of self regulation are demonstrated throughout this thesis:- in chapter 4 in terms of the lack of any requirement for full and consistent disclosure of costs incurred in financial statements of pension schemes and how this has contributed to an overall lack of emphasis on costs and hampers meaningful analysis and comparison,- in Chapter 5 in terms of the subjectivity inherent in the actuarial process and the flexibility to “manage” actuarial valuation results in certain circumstances and,- in Chapter 6 in the inconsistencies in levels of qualification and training of trustees of the schemes studied and apparent focus by the regulatory authority (The Pensions Board) on the administrative aspects of a trustees’ role rather than the more strategic management aspects to a trustees’ duties and responsibilities.
Finally, given that there are strong similarities between Ireland’s pension system and the pension system of our nearest neighbour, the UK, Chapter 7 assesses reform measures being taken in both jurisdictions, with specific reference to costs, regulation and the role of trustees. The chapter concludes that there is no clear common way forward between the two jurisdictions and Ireland lags considerably behind its’ neighbour in attempting to address the high cost of pension provision. The programme of reform measures being introduced in the UK while subject to criticism, is more far reaching than anything introduced or proposed to date in this country and go some way towards addressing issues of cost, efficiency and governance which are common to both countries. In contrast, the proposed Irish auto enrolment scheme is deficient in terms of provisions to ensure reduced management and operational costs and as yet there are no details available as to its governance structures. Furthermore, at this stage there is nothing in the proposals which suggest that existing DC schemes could transfer into the new scheme. The proposed new DB scheme model incorporates no provisions which might ensure that the new DB schemes would run more efficiently than existing DB schemes and there are no details available as to the detail of the legislation that will necessarily be required to give effect to the benefit structure which the model scheme will adopt. As such the National Pensions Framework provides very little by way of answers to the many existing Irish DB schemes currently in deficit and little by way of reducing costs and improving governance to avoid the mistakes and inefficiencies of the past being repeated into the future.
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APPENDIX 1

Employee Pension Schemes – An Overview.

A “typical” employee pension fund is organised as follows: the employer and or employee make a contribution to a fund as a certain proportion of salary. The pension payment is tax deductible to the employee and for the employer, is a deductible expense in calculating taxable profits. The contributions are paid to the pension fund which is established under Trust law and subject to approval by the tax authorities (Revenue Commissioners). The growth of the pension fund is a function of the number and size of the contributions and the rate of return (net of costs) earned on them.

In the case of a DC scheme, at the point of retirement, the accumulated growth in the employee’s fund is used to purchase an annuity for the pensioner. In the case of a DB scheme, where the pensioner has a pre-determined pension entitlement, the employer commits to make good any shortfall in the pension fund necessary to provide the pensioner with the agreed pension.

Collection, Investment and Pension payment mechanisms.

Employee contributions to occupational pension schemes are collected through a payroll deduction mechanism. Employers generally speaking make lump sum contributions.

Many schemes invest their funds (i.e. employer and employee contributions) and provide benefits through some form of insurance contract. At a minimum, certain contingencies, e.g. death or disability of members are insured by the pension scheme. The standard type of investment structure used is either a unit-linked insurance contract or a “with profit” contract. In the unit linked arrangement, the pension scheme would buy units in one of the investment funds of the insurance company e.g.
the Irish Equity fund, the fixed interest fund or perhaps a managed fund incorporating a broad mix of assets. The value of the scheme’s units would fluctuate with the value of the underlying fund. The assets in the underlying fund remain the property of the insurance company; the scheme’s assets are the units it holds in the fund. When a member reaches retirement age, his entitlement in units is effectively cashed in. The resultant lump sum is used to fund the members’ pension, generally by means of an annuity from an insurance company, the objective of which is to provide the member with an annual income for the remainder of his life. A “with profit” contract will to some extent guarantee a benefit at retirement equivalent to a specified rate of return. Where investment performance exceeds the rate guaranteed, the insurance company may declare an additional bonus. However, since 2002, many “with profit” contracts have either not declared an additional bonus, or reduced projected payouts (Prudential, Norwich Union, Standard Life, Legal & General and Scottish Widows).

The pension scheme could however manage its funds itself and not go the insurance route. Typically, in this situation, the scheme would place its funds with one or more fund managers who would invest and “manage” the funds in line with investment strategies which should be agreed with scheme trustees.

Benefits on retirement take the form of a pension or a reduced pension and a lump sum. The pension scheme may choose to make the pension payments directly from its funds or it could purchase an annuity from an insurance company sufficient to fund its obligations to the retiring member and his dependants. In the latter situation, the pensioner looks to the insurance company for payment of his benefits rather than the pension scheme.

Once a pension commences to be paid, the pension scheme rules may allow it to be increased in future years in accordance with an agreed scale, generally speaking in line with CPI or a similar agreed index.
Accordingly the investment/pension payment routes might be represented as follows:

**Investment/Pension payment Routes**

**Figure 1.1**

*May incorporate an insurance contract*
Main Determinants of Pension Fund performance.

The “performance” of a pension scheme is defined for the purposes of this research as the increase or decrease in its capability to meet its liabilities as they fall due. Performance is measured by reference to a specific time period and the performance of a pension scheme is denoted by the change in its valuation over that specific time period. Under Pension Fund regulations an actuarial valuation of a schemes assets and liabilities is required at least every three years. If the value of the schemes assets as determined by the scheme actuary (in accordance with actuarial and regulatory guidelines) exceeds the value of its accrued liabilities, the scheme has a valuation surplus. If the reverse applies, the scheme has a valuation/funding deficit.

In carrying out the valuation exercise a number of key assumptions need to be made:

- The projected rate of investment return on scheme assets (necessary to calculate their value) and any adjustment for costs and expenses.
- Rates of salary, state pension and scheme pension increases (necessary to project benefits)
- Mortality rates and allowances for future improvements therein.
- The discount rate or the annuity rate appropriate to the valuation of pension benefits.
- Allowances for options such as commutation.
- Rates of change in the membership including new entrants, leavers and retirements.
- Contribution rates and the timing/frequency of contribution payments.
The main determinants in pension fund performance is pictorially illustrated below.

Main Determinants of Pension Fund Performance.
Regulatory Structure of Irish Occupational pension schemes

The Pensions Act of 1990 created a framework for occupational pension schemes for the first time. It defined, clarified and extended areas of law already in existence in relation to pension schemes in Ireland. The principal regulatory step of the Act was to establish a Pensions Board with responsibility for overseeing the operation and regulation of all occupational pension schemes. It also introduced provisions with regard to minimum funding standards for defined benefit schemes and the preservation of benefits for members leaving schemes. The Act provides detailed guidance to trustees in relation to their obligations under pension’s legislation and trust law in particular the requirement to provide information to members and potential members of the scheme.

The pensions (Amendment) Act 1996, in addition to updating the original 1990 Act, introduced compulsory and voluntary reporting to the Pensions Board in relation to the mis-appropriation of scheme assets or mis-management of a scheme. Compulsory reporting applies to the auditor, actuary, trustee and insurance intermediaries involved with a scheme where a material misappropriation or fraudulent conversion of a scheme’s assets has occurred. A voluntary report of material mis-appropriations, fraudulent conversions, and mal-administration of a scheme or breaches of the Pensions Acts may be made by any person.

The Pensions (Amendment) Act 2002 provided for the creation of the Office of Pensions Ombudsman to investigate complaints on behalf of beneficiaries and to adjudicate on disputes of fact or law in relation to pension arrangements. The Act also improved the position of those who leave Occupational Pension schemes before retirement by reducing the minimum vesting period from 5 to 2 years (after two years, employer contributions on behalf of the employee vest with the employee’s fund even if the employee subsequently leaves the employment) and by extending benefit preservation to benefits accrued prior to 1991.
APPENDIX 2

Occupational Pension Schemes - The Tax Subsidy.

One of the key catalysts in the growth of pension schemes has been the tax benefits attaching to such schemes. The full range of tax benefits only apply to schemes which are "approved" by the Irish tax Authorities (the Revenue Commissioners), as coming within the framework of the applicable legislation (Chapter 1, pt30, TCA97.)

Where a scheme complies with certain specified criteria outlined in the legislation (Chapter 1, pt30, TCA97) the Revenue Commissioners are obliged to grant the scheme approval. These criteria include:

1. That the scheme is established on bona fide grounds, for the sole purpose of providing relevant benefits in respect of service as an employee, to the employee himself or to his widow, children, dependants or personal representatives.

2. That the scheme is recognised by the employer and employees to whom it relates in that every employee who is or has a right to be a member of the scheme has been given written particulars of all essential features of the scheme which concern him/her.

3. That there is a person resident in the State who will be responsible for the administration of the scheme.

4. That the employer is a contributor to the scheme.

5. That the scheme is established in connection with some trade or business carried on in the State by a person resident in the State.

6. That employees are not entitled to a refund of contributions made by them, whether during the subsistence of the scheme or later.

7. That the maximum benefit payable to an employee will not exceed 1/60\(^{th}\) of the employee's final remuneration for each year of service up to a maximum of 40 such years.
8. That (subject to 12 below), the benefit for an employee is a pension on retirement at a specified age not earlier than age 60 and not later than age 70. Approval for schemes which facilitate early retirement is at the discretion of the Revenue Authorities (see below).

9. That the maximum pension payable to a spouse where the employee dies before retirement is 100% per cent of the pension that could have been payable to the employee if that employee had retired at normal retirement date.

10. That any lump sum benefit payable to the spouse, children dependants or personal representatives of an employee who dies before retirement should not exceed in the aggregate 4 times the employee’s final remuneration.

11. That any benefit for a spouse on death after retirement should consist of a pension and that pension should not exceed 100% per cent of the pension payable to the employee.

12. That no pension can be surrendered for a cash sum or assigned except in the case of commutation of a lump sum which does not exceed 3/80ths of final remuneration for each year of service up to a maximum of 40 years. (exceptions can apply for 5% per cent directors)

13. That no other benefits are payable under the scheme.

The legislation does however give the Revenue Commissioners discretion to grant approved status to schemes, which do not satisfy all of the prescribed conditions. In particular, they have discretion in relation to:

- Improving benefits for individuals with less than 40 years service.
- Approving the payment of benefits in early retirement situations.
- Providing for refunds of contributions in certain circumstances and the payment of interest on those contributions.
- Granting approval where the trade or business is carried on only partly in the State and by a person not resident in the State.

The tax subsidy extends to the tax liability of scheme members during their working lives as well as their entitlements on retirement, the employers tax position and the tax position of the scheme itself.
Under current Irish law, members are entitled to a tax deduction at their marginal tax rate and a PRSI (social security) deduction for contributions made to Revenue approved occupational pension schemes up to the following maximum level of contribution:

Allowable limits for tax deduction purposes.

<table>
<thead>
<tr>
<th>Age (at any time during year of assessment)</th>
<th>per cent of net relevant earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 30</td>
<td>15 per cent</td>
</tr>
<tr>
<td>30 - 39</td>
<td>20 per cent</td>
</tr>
<tr>
<td>40 - 49</td>
<td>25 per cent</td>
</tr>
<tr>
<td>50 - 54</td>
<td>30 per cent</td>
</tr>
<tr>
<td>55 - 59</td>
<td>35 per cent</td>
</tr>
<tr>
<td>60 or over</td>
<td>40 per cent</td>
</tr>
</tbody>
</table>

In addition, subject to Revenue agreement, where a once off AVC type payment brings the level of contribution in a particular year outside the allowable limits, the excess can be offset against income in the preceding year, and so on for a period of ten preceding years, subject to the overall constraint that in no year can the allowable limits be breached.

Individuals who are engaged in specified occupations and professions — primarily sports professionals, qualify for a minimum 30 per cent deduction irrespective of age.

In 2006, a cap of €250,000 was put on the amount of net relevant earnings in respect of which a tax deduction could be claimed. This has been increased annually since then in line with an earnings index declared by the Government. Earnings in excess of the cap are not taken into account in calculating the allowable contribution.
For Irish taxpayers at the top tax rate, the tax incentives reduce the cost of qualifying contributions almost by 50 per cent when the impact on social insurance contributions is also taken into account.

At retirement age, members can take part of their entitlement in the form of a tax free lump sum. The maximum entitlement is one and a half times final salary. Thereafter, pension receipts are taxable as income. Growth within the fund itself is allowed to roll up tax free providing the scheme meets certain very broad objectives with regard to investment.

Employer companies are entitled to a tax deduction for any costs incurred in establishing and running an approved pension scheme and for contributions made to the scheme. Tax relief for contributions is given on a paid rather than an accruals basis. This gives some scope to companies to time pension fund contributions so as to maximise the tax advantage. Any recovery by a company of contributions (e.g. pension fund surpluses) is taxable on the company as trading income. For this reason, many companies rather than taking surpluses out of schemes instead take a contribution holiday.

Similar tax incentive arrangements exist across Europe and the US.

**Addition Voluntary Contributions (AVC) Arrangements:**

These are arrangements attached to the main employer scheme which allow employees to make additional contributions (subject to overall tax allowable limits as outlined above) and thereby fund additional benefits again subject to overall allowable limits. In effect AVC schemes are designed to compensate for the shortfall in benefits between those provided under the main scheme and the maximum allowed by tax legislation.
APPENDIX 3

The Funding Standard

The Funding Standard (introduced under the provisions of the Pensions Act 1990 and effective from June 1, 2002) sets out the minimum assets that a defined benefit scheme must hold and what steps must be taken if the assets of the scheme fall below this minimum. It requires defined benefit schemes to submit to the Pensions Board actuarial funding certificates at three yearly intervals. The purpose of the actuarial funding certificate is that the scheme actuary can certify whether, if the scheme had been wound up on the effective date of the certificate, its assets would have been sufficient to meet its liabilities. Before 2000 very few schemes failed the funding standard however Pension Board estimates as at December 2008 (Pensions Board (2009)) state that number of schemes failing to meet the funding standard was as high as 75 per cent at that date. A certificate must be submitted to the Pensions Board no later than nine months after its effective date. If the scheme could not have met its liabilities a funding proposal must be submitted to the Board.

The funding proposal must be designed to put the scheme in the position that it could meet its liabilities no later than a specified date (originally, the effective date of the next actuarial funding certificate – within three years). The funding proposal must be agreed and signed by the scheme actuary, the sponsoring employer and the scheme trustees.

The rationale behind the funding standard is that pension promises should be backed by sufficient assets to ensure delivery (Green paper 2007a). There is a divergence of
views about the standard: one view is that the standard is too high and this is the reason why such large numbers of schemes are failing it. The alternate view, held in particular by the Society of actuaries is that the standard is appropriate or even too low and that schemes failure to meet the standard is a result of increases in longevity and lower actual and expected future yields. The standard has been subject to many reviews since its inception. In early 2004 the Pensions Board undertook a review of the standard and a consultation document was published which identified a number of alternatives to the current standard and the Boards preferred response. As a result of the consultative process, legislation and changes to actuarial guidance was introduced in 2005. The funding standard was substantially unchanged but the facility to restore funding over periods longer than three years (up to 10 years) which had been available on a case by case basis was formalised and the grounds on which these longer periods were available were widened. Subsequent developments in 2006/2007 and 2009 has led to further flexibility in terms of the length of time over which the Pensions Board will allow schemes to restore funding (see chapter 7).
APPENDIX 4

IAS 19

The objective of IAS 19 is to prescribe the accounting and disclosure for employee benefits (all forms of consideration given by an enterprise in exchange for service rendered by employees). The principle underlying the detailed requirements of the Standard is that the cost of providing employee benefits should be recognised in the period in which the benefit is earned by the employee, rather than when it is paid or payable.

Pension benefits is just one of the various types of benefit provided to employees by way of remuneration. Other benefits include wages and salaries, bonuses, paid vacation and sick leave, profit sharing plans, medical and life assurance benefits (during and post employment), housing benefits, free or subsidised goods or services, long leave or sabbatical leave, jubilee benefits, deferred compensation programmes and termination benefits.

IAS 19 as it applies to pension benefits.

The accounting treatment for pension benefits is dependant on whether the pension scheme is a defined contribution or a defined benefit scheme.

➢ Under a defined contribution scheme, the sponsoring employer pays fixed contributions into the scheme but has no legal or constructive obligation to make further payments if for instance the scheme does not have sufficient assets to pay all the employees' pension expectations.
A defined benefit scheme is defined by IAS 19 as a pension scheme other than a defined contribution scheme, where the sponsoring employer has a constructive obligation to the employees outside of the fixed contribution rate.

For defined contribution plans, the cost to be recognised in the financial statements of the sponsoring company for a particular period, is the contribution payable in exchange for service rendered by employees during the period. The actuarial risk that benefits will be less than expected and the investment risk that assets invested will be insufficient to meet expected benefits falls on the employees and not the employer. Assets or liabilities may exist for the pension contributions if the company has not paid or overpaid the amount due for the period. Disclosure is required, by way of a note to the financial statements of the actual contribution charge (as opposed to paid) for the accounting period in question.

Accounting by an entity for defined benefit plans involves;

(e) using actuarial techniques to make a reliable estimate of the amount of benefits employees have earned in return for their services in the current and prior periods. This requires an entity to determine how much benefit is attributable to the current and prior periods and to make estimates and assumptions about demographic variables and financial variables that will influence the cost of the benefit,

(f) discounting that benefit in order to determine the present value of the defined benefit obligation and the current service cost.

(g) Determining the fair value of any plan assets.
(h) Where a plan has been introduced or changed, determining the resulting past service cost, and

(i) Where a plan has been curtailed or settled, determining the resulting gain or loss.

The charge/expense in the employer financial statements (Statement of Comprehensive Income/Profit and Loss Account) for any particular year is effectively the net movement in the employer company’s liability to the pension scheme during the year. The scheme surplus or deficit overall will be reflected as an asset or liability in the employer company’s Statement of Financial Position (Balance Sheet). Where an entity has more than one defined benefit plan, the entity applies these procedures for each material plan separately. IAS 19 requires more elaborate disclosures for D.B. schemes including:

(a) The accounting policy
(b) A description of the plan
(c) A reconciliation of the assets and liabilities including the present value of the obligations, the market value of the assets, the actuarial gains and losses and the past service costs.
(d) A reconciliation of the movement during the period in the net liability.
(e) The total expense in the Statement of Comprehensive Income (Profit and Loss Account) broken down into its constituent parts.
(f) The actual return on plan assets.
(g) The principal actuarial assumptions used as at the period end date.
This standard applies where an actuary is preparing an actuarial report for a DB pension scheme established in the Republic of Ireland where the report is being prepared:

- in order to satisfy legal requirements, including those imposed by the scheme’s governing documents,
- because a formal actuarial valuation report on the funding of the scheme is requested by the client, or
- to give funding advice when the scheme is initially established.

The main purpose of the standard is to ensure that reports contain sufficient information to enable the expected future course of a scheme’s contribution rates to be understood and also to enable the current solvency level of a scheme to be understood. The standard is therefore intended to ensure that the methods and assumptions used are properly explained and that variations between the assumptions chosen and the actual experience are analysed in the report.

The standard is not intended to restrict the actuary’s freedom of judgement in choosing the method of valuation and the underlying assumptions employed.

The standard requires that the actuarial report must make it clear to whom it is addressed and the purpose of the valuation. It must include a statement of the benefits
which have been valued. If assets and corresponding liabilities in respect of certain benefits such as AVC's and pensions secured by annuities, are included in the valuation, this must be disclosed.

The report must include a summary of the investment strategy being pursued by the trustees, a statement of the market value of the assets at the valuation date and a summary of the investments held, subdivided between the main asset classes. Reference must also be made to any insurance arrangements in place for the benefit of the scheme. Expert advice may be required for the valuation of contingent assets.

The report must state the funding objectives of the scheme. It must include a statement of the rates or amounts of contributions recommended in the previous valuation report and paid during the inter-valuation period. The report must also include a commentary on any material developments affecting the scheme during the period and on any significant variations in experience from the assumptions made at the previous valuation.

The report must contain a summary of the demographic and economic assumptions made explicitly and implicitly in the valuation exercise. It must also identify the mortality tables used in sufficient detail that another actuary could replicate the calculations.

Attention must be drawn in the report to assumptions to which the valuation results are particularly sensitive. The actuary must describe how the valuation results will
differ if these assumptions are not borne out so that the reader can understand the sensitivity of the results to the assumptions chosen.

The report must confirm the compatibility of the basis of valuing the assets with that of valuing the liabilities or target benefits. It must state the value of assets, accrued liabilities and the funding level on the basis being used for the current valuation. It must also include an analysis of the actuarial surplus or funding level compared with the position disclosed by the previous valuation. The analysis must be sufficient to identify the relative significance of the material items of actuarial gain or loss including changes in the valuation method and the valuation assumptions.

The report must recommend contributions consistent with the funding objectives for the period until the next formal actuarial valuation.

In the case of a scheme subject to the statutory minimum funding standard, the report must state the amount of the statutory liabilities valued in accordance with ASP PEN 3 and the funding level – i.e. the proportion of the liabilities covered by the assets of the scheme. If the funding level is less than 100 per cent, the actuary must provide an indication of the implications for the funding level over the period to the next actuarial valuation, of anticipated changes in the statutory liabilities.

The report must include analysis of the scheme’s exposure to investment risk and the sensitivity of funding position to future investment market changes.

Specifically, the actuary must:
describe in broad terms, the form and incidence of the scheme’s liabilities and the likely pattern of future cash flows

indicate the contribution rate which would be required and the relative level of variability in the contribution rate and the funding level, if the assets were invested in a mixture of fixed interest and index linked bonds rated at least AA and the liabilities were valued accordingly.

Unless the funding level of the scheme is 100 per cent the actuary must explain the scope for variability in the statutory minimum funding level, having regard to possible investment market changes and to the relationship between the assets held and the form and incidence of the statutory liabilities. Scenario analysis would normally include the estimation of the statutory minimum funding level based on one or more scenarios each involving a substantive shift in investment market conditions, with at least one scenario involving adverse changes in investment market conditions.

Attention must also be drawn to specific risks that are relevant to the scheme, in particular currency mismatching, concentration of assets and self investment.

The report must contain sufficient analysis to convey a reasonable understanding of the nature and extent of the investment risk. The actuary is not however required to give investment advice.
APPENDIX 6

The Society of Actuaries in Ireland.

Actuarial Standard of Practice PEN –3

This ASP is the “applicable professional guidance” issued by the Society of Actuaries in Ireland and required by legislation (S. 42(4) of the pension’ Act 1990) to be applied where an actuary is certifying whether the scheme meets the minimum funding standard required by S.44 of the Act.

➢ The responsibility for signing the certificate is that of the scheme actuary alone. The scheme actuary is in a special position in that, in addition to the normal responsibilities to his employer or client, when signing a certificate he has statutory obligations laid on him by the Act and Regulations.

➢ The Scheme actuary is required to state if, in his opinion, the resources of the scheme at the effective date are/are not sufficient etc, and based on this opinion to certify that the scheme does/does not satisfy the funding standard.

➢ For the purposes of the funding Standard the liabilities of the scheme at the effective date must be valued as follows;

(a) the cost of pensions in payment should be arrived at by obtaining annuity quotations either on an individual or bulk basis or fitting an actuarial basis to sample market rates bearing in mind the age profile of the pensioners.

(b) Deferred pension entitlements should be valued at the transfer value to which each member would be entitled in accordance with standard transfer value rules prescribed elsewhere (ASP – PEN 2).

(c) Allowance must be made for the estimated expenses of administering the winding up of the scheme. Such allowance would normally not be less
than the greater of 2per cent of the sum of the liabilities under (a) and (b) above and €5,000.

➢ In valuing the assets of the scheme, the following points are relevant;

(b) Assets must be valued at their realisable value with allowance being made for expenses of sale while pooled assets should be valued at bid price.

(c) The actuary must have regard to any concentration of investments or self investments by a directly invested scheme.

(d) If the assets take the form of insurance policies the actuary needs to consider the cost of terminating the policies – in effect the realisable value of the policies.

(e) If part of the assets of the scheme are contingent assets extra care and where appropriate expert advice needs to be taken in determining the value to be placed on such assets.

➢ The trustees annual report must contain a copy of the most recent funding certificate and a statement as to whether the scheme actuary is reasonably satisfied that the scheme would satisfy the funding standard with an effective date of the end of the period to which the trustees report relates.

➢ Where in the most recent actuarial funding certificate, the scheme actuary has certified that the scheme did not satisfy the funding standard, the trustees' annual report should include an actuarial
statement to the effect that the scheme actuary is reasonably confident that on foot of the scheme’s funding proposals, the scheme will satisfy the funding standard at the effective date of the next actuarial funding certificate.

Where a scheme actuary signing the Actuarial Funding certificate is also a trustee or a director of a company acting as trustee, that status must be disclosed to the regulatory authority, (The Pensions Board).
APPENDIX 7
Main Research Findings.

1. The majority of respondents (87 per cent) were trustees of defined benefit schemes.
2. One in every three trustees had a degree level education or above.
3. The majority of trustees had no qualifications in finance/investment. Of the trustees who did have a relevant qualification, accountancy was the most common.
4. The range of years of experience among trustees varied considerably. Of the trustees interviewed, 15 per cent had fewer than three years experience while 31 per cent had 10 years or more.
5. In the first 12 months of trusteeship, 26 per cent of trustees received less than one's day's training and 43 per cent of trustees received one or two days training.
6. Of the training courses on offer, the most popular course for trustees in their first 12 months was the basic trustee course, followed by courses provided by consultants.
7. Further training beyond the initial 12 month period was limited and appeared to focus on conferences and seminars. 46 per cent of trustees interviewed reported to have received no training beyond the first twelve months.
8. The majority of trustees (79 per cent) held full time jobs.
9. 49 per cent of trustees spent three hours or less preparing for pension investment matters.
10. Indexed and scheme specific benchmarks were referenced by the majority of funds.

11. The majority of funds did not have a separate investment committee or in-house professionals.

12. Almost two thirds of trustees had one investment consultant to work with – very few funds had more than one available.

13. Trustees had however limited contact with investment managers – 54per cent spoke with their investment managers less than once every three months. 61per cent spent time with managers less often than three months.

14. A quarter of trustees reported that their boards had questioned advice within the previous month, however when asked the same question, only 12per cent of scheme administrators agreed that this level of questioning had taken place.

15. Almost all trustees reported to question the advice given by consultants, although most usually followed the advice given.

16. The degree to which trustees felt they had influence over strategic allocation differed depending on whether the influence was at a collective or personal level. Collectively, trustees clearly felt their influence was strong, whilst individually they felt they have some influence.

17. Trustees were involved in a number of tasks relating to pension funds with the most common being the review of the scheme performance, and ensuring compliance with statutory regulations. When asked to prioritise the importance they placed on these tasks, it was clear that performance review was seen as the most important task, whereas compliance with regulations, and asset allocation, were somewhat secondary.
18. Most investment consulting and management contracts appeared to have been last tendered more than three years previously.

19. Trustees held a range of opinions relating to investment strategies;
APPENDIX 8

Pensions Board Trustee Checklist

The following checklist was issued by the Irish regulatory Authority – The Pensions Board as an aide memoire for trustees to ensure that they do not contravene the specified provisions of the Pensions Act, 1990 relating to trustees.

1. Is your scheme registered with the pensions Board? Are your scheme details up to date? Have you paid your scheme’s annual fees to the Pensions Board?

2. In relation to your scheme, can you comply with the disclosure of information requirements applicable to the
   ➢ governing documents,
   ➢ trustee annual report,
   ➢ audited accounts,
   ➢ actuarial valuation report,
   ➢ members explanatory booklet,
   ➢ relevant individuals
     i. during relevant employment (benefit statement)
     ii. on leaving service
     iii. on retirement and death
     iv. where a scheme winds up
     v. where a pension adjustment order has been made in respect of a members benefits?
3. Have you responded to any requests for information about your scheme that you may have received from any of the following:

- the Pensions Board
- your scheme auditor
- your scheme actuary
- any employer to whom your scheme relates?

4. If your scheme is defined contribution, have you arranged for the annual valuation of its assets and liabilities?

5. If your scheme rules provide for you to invest the resources of the scheme in accordance with the members’ directions, are you providing those members with information to enable them to make informed decisions with regard to the giving of their directions?

6. If your scheme is defined benefit, have you submitted an actuarial funding certificate to the Pensions Board within 9 months of the effective date of the actuarial valuation or where the AFC is due because of a negative inter-valuation statement in your annual report, within 12 months of the last day of the period to which the annual report relates?

7. Have you procedures in place within your scheme for paying or accepting transfer payments where a member has requested same? Are you providing benefit statements to any members of your scheme who are transferring funds to a personal retirement savings account (PRSA)?

8. Have you a current Statement of Investment Policy Principles (SIPP) in place for your scheme. (Not required for small schemes)?
9. Do you comply with the Provisions of the Act when calculating a pension increase involving a State pension offset?
### APPENDIX 9

**Fund Account of Scheme E for the Year Ended 31 December 2002**

<table>
<thead>
<tr>
<th>Contributions and benefits</th>
<th>Actual 2002 '000</th>
<th>Restated to show costs of 2.20 per cent 2002 '000</th>
<th>Restated to show costs of 0.30 per cent 2002 '000</th>
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<td>Contrib. and benefits</td>
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<td>0</td>
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<tr>
<td>Company contributions: Normal</td>
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<td>6.3</td>
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<tr>
<td>Members contributions: Normal</td>
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<td>0</td>
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<tr>
<td>Transfers from AVC scheme</td>
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<td>4.7</td>
<td>4.7</td>
</tr>
<tr>
<td>Transfers from other funds</td>
<td>11.0</td>
<td>11.0</td>
<td>11.0</td>
</tr>
</tbody>
</table>

| Pensions                    | 50.2             | 50.2                                          | 50.2                                          |
| Commutations                | 17.0             | 17.0                                          | 17.0                                          |
| Death in service benefits   | 0.4              | .4                                            | .4                                            |
| Refund to members leaving service | 0          | 0                                             | 0                                             |
| Transfers to other funds    | 1.8              | 1.8                                           | 1.8                                           |
| Insurance premium           | 0                | 26                                            | 26                                            |
| Administration expenses     | 0.9              | 0                                             | 0                                             |
|                            | 70.3             | 69.4                                          | 69.4                                          |

Net deductions from dealing with members

-59.3

Return on Investments

| Investment income           | 77.7             |
| Foreign exchange losses     | 0                |
| Overseas tax                | 0                |
| (Loss)/profit on sale of investments | 65.5        |
| Unrealised losses on investments | 0           |
| Investment manager and custodial fees | -3.2        |
| Net return on investments   | 140              | 199.8                                         | 199.8                                         |

Total costs and fees

-60.7

Net increase in fund during period.

80.7

Net assets of the scheme:

- At beginning of period 2762.6
- At end of period 2843.3

Costs as disclosed:

- 4.1
- 60.7

Potential saving

52.5
### Fund Account of Scheme F for the Year Ended 31 December 2002

<table>
<thead>
<tr>
<th>Contributions and benefits</th>
<th>Actual 2002 (000's)</th>
<th>Restated to show costs of 2.20 per cent 2002 (000's)</th>
<th>Restated to show costs of 0.30 per cent 2002 (000's)</th>
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</thead>
<tbody>
<tr>
<td>Company contributions: Normal</td>
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<td>Members contributions: Normal</td>
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<td>Transfers from AVC scheme</td>
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<td>Transfers from other funds</td>
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<td>Refund to members leaving service</td>
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<td>Transfers to other funds</td>
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<td>Insurance premium</td>
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<td>Administration expenses</td>
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<td></td>
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<tr>
<td>Net deductions from dealing with members</td>
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<td>-22942</td>
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<tr>
<td>Return on Investments</td>
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<tr>
<td>Investment income</td>
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<tr>
<td>Foreign exchange losses</td>
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<tr>
<td>Overseas tax</td>
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<tr>
<td>(Loss)/profit on sale of investments</td>
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<td>Unrealised losses on investments</td>
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<tr>
<td>Investment manager and custodial fees</td>
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<tr>
<td>Net return on investments</td>
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<td>-425797</td>
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<tr>
<td>Total costs and fees</td>
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<td>Net decrease in fund during period</td>
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<td>-495098</td>
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<td>Net assets of the scheme:</td>
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<tr>
<td>At beginning of period</td>
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<td>2107219</td>
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<tr>
<td>At end of period</td>
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<td>Costs as disclosed:</td>
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<td>46,359</td>
<td>6321</td>
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<tr>
<td>Potential saving</td>
<td></td>
<td></td>
<td>40038</td>
</tr>
</tbody>
</table>
Dear,

I am currently doing a Phd. on Irish occupational pension schemes at School of Business, Trinity College Dublin. I am focussing in particular on the Governance structures, levels of costs incurred and the role and profile of trustees. For this purpose, I am compiling a data base of information taken from the audited accounts of as many pension schemes as possible. The information will be treated confidentially and any output results will be on an overall basis without reference to any specific scheme.

It would be extremely helpful if I could have copies of the accounts of group scheme for the years or indeed any other document/s which might give me the above information. I would be happy to let you have a copy of the results of my work in due course if you so wish.

I look forward to hearing from you.

Bridget Mc Nally