Correspondence 3.4
Meeting – 15/12/2011

PAC-R-200

An Roinn Gnóthaí Sóisialacha

agus Teaghlaigh

Áras Mhic Dhiarmada

(01) 7043000

Department of Social

and Family Affairs

Áras Mhic Dhiarmada

Eimear Lavelle
Committee Secretariat
Committee of Public Accounts
Leinster House
Dublin 2

7th December 2011

Dear Eimear

I refer to your letter of the 23rd November following my appearance at the Committee on the 17th November 2011 during the course of the Committee's examination of:

The Pensions Board – Annual Report and Accounts 2010
The Pensions Ombudsman – Annual Report and Accounts 2010

In your letter, you requested the following:

1. Pensions Study

A copy of the preliminary results of the study currently being undertaken by the Department on the charges in all pension schemes to include details of the charges that reduce members contributions or investment returns (to be provided when the study is finalised).

This study will be sent to you when it is finalised.

2. Annuities

A note outlining the main findings of the annuities market study, which was carried out by the Department.

The study entitled Review of the Irish Annuities Market, was undertaken by the Partnership Pensions Review group and the group was chaired by the Department of the Taoiseach. ICTU, IBEC, the Department of Finance, the Department of Social Protection, the

Department of Enterprise, Trade and Innovation and the Pensions Board were also represented on the group.

The full study is available at http://www.nationalpensionsframework.ie/publications.html

With regard to the findings on the pricing of annuities, which was the focus of discussion at the Committee, I have included in Appendix 1 the conclusions of Chapter 5, Analysis of Annuity Pricing in the Irish Annuities Market. The findings in relation to the pricing and value of annuities were that market prices and the annuity prices modelled by the group corresponded closely, the value of annuities corresponded closely to those in the U.K. and that the reduction in yield (RIY), the measure of the cost associated with the purchase of annuities, also compared favourably with approved retirement funds (ARFs).

3. I also attach, at Appendix 2, a list of publications of the Pensions Board, which demonstrates the input of the Pensions Board into pension policy.

If you have any further queries please do not hesitate to contact me.

Yours sincerely

Dr Orlaigh Quinn
Assistant Secretary

Appendix 1 Review of the Irish Annuities Market (July 2007)

Extract from Chapter 5 – Analysis of Annuity Pricing in the Irish Market

5.8 Conclusions

In order to allow us to investigate the pricing of annuities in the Irish market, we constructed a model which allows us to produce our own annuity prices. The model, which is very flexible, allows us to vary all of the inputs to the calculation (both the age and sex of the annuitant, as well as the assumptions for mortality, investment returns, commission, expenses and cost of capital).

The results show the usual familiar pattern of annuity prices. In particular:

- The cost of an annuity falls the older one gets. For example, buying the level annuity is 12% cheaper for a 65 year-old than it is for a 60 year-old and it is 25% cheaper for a 70 year-old (compared to a 60 year-old).

- At any given age, an annuity on a female life costs more than a corresponding annuity on a male life (a female level pension is some 8% more expensive at age 60; 10% more expensive at age 65, and 13% more expensive at age 70 than for an equivalent male pension; the differentials for an escalating pension are even greater, reflecting the higher payments at older ages for an escalating pension).

- Escalating annuities cost more than level ones – the differentials are higher at younger ages (given that the longer payment term means that there is more time for the annuity payments to inflate), and are higher for females (for similar reasons).

We compared our calculated annuity prices with the actual prices being quoted by Irish annuity providers (as supplied to us by survey respondents) in order to investigate to what extent the actual market prices differed from our model prices (which were calculated based on our assessment of what we considered to be a reasonable set of pricing assumptions). In summary, as can be seen from the table above, the best available market prices were between 0.3% and 4.5% higher than our prices. The market median prices were between 3.9% and 7.5% higher than our prices. In summary, therefore, a comparison of market prices with the prices calculated by our model indicates that, on our central set of pricing assumptions, the market prices are somewhat higher than our model prices. However, if we change our pricing assumptions to take a more conservative view of future mortality improvements, we find that the market prices and the model prices agree quite closely.

In terms of the price of annuities relative to a defined benefit scheme's assessment of its pensioner liabilities, we find that annuity prices could be expected to be approximately 18% higher than a pension scheme's assessment of its corresponding liability. The cost of capital accounts for the biggest different, accounting for 6%, mortality differentials accounting for some 5%, a planned profit margin of over 3% and commission and expenses accounting for approximately 3%. Our findings in this area correspond quite closely with the views of the IAPF (who suggest a 15% differential for these factors)as well as the Society of Actuaries in Ireland.

A common approach to investigating the value of annuities is to use a measure called the money's worth. The money's worth (also sometimes referred to in the literature as the EPDV, or expected present discounted value) represents the value of the expected annuity payments that would be received if the annuity were purchased with €1. The MWR is a concept which has been used by other researchers in other markets and thus allows us to compare the money's worth of annuities in Ireland relative to those in other countries (particularly the UK). Our findings are that the MWRs for Irish annuities are very similar to those currently found in the UK, being in the region of 0.83 to 0.88 (compared to approximately 0.85 in the UK). In other words, some 12% to 17% is being absorbed in costs/loadings/expected profits. We believe that these returns are not excessive.

Finally, we also investigated the Internal Rate of Return (IRR) and, by extension, the Reduction In Yield (RIY) on annuities in the Irish market. We found that the IRR varied from 2.76% p.a. to 3.23% p.a. depending on the annuity in question. Given that short-term interest rates at the date in question were just under 4% and long-term rates were approximately 4.2%, these IRRs translate into RIYs of approximately 0.9% to 1.25% p.a. depending on the particular annuity in question. We note that these RIYs – which are a measure of the costs associated with the purchase of an annuity – compare favourably with typical RIYs on ARFs (which are typically in excess of 1.5% **5.8**

Conclusions

In order to allow us to investigate the pricing of annuities in the Irish market, we constructed a model which allows us to produce our own annuity prices. The model, which is very flexible, allows us to vary all of the inputs to the calculation (both the age and sex of the annuitant, as well as the assumptions for mortality, investment returns, commission, expenses and cost of capital). The results show the usual familiar pattern of annuity prices. In particular:

- The cost of an annuity falls the older one gets. For example, buying the level annuity is 12% cheaper for a 65 year-old than it is for a 60 year-old and it is 25% cheaper for a 70 year-old (compared to a 60 year-old).

- At any given age, an annuity on a female life costs more than a corresponding annuity on a male life (a female level pension is some 8% more expensive at age 60; 10% more expensive at age 65, and 13% more expensive at age 70 than for an equivalent male pension; the differentials for an escalating pension are even greater, reflecting the higher payments at older ages for an escalating pension).

- Escalating annuities cost more than level ones – the differentials are higher at younger ages (given that the longer payment term means that there is more time for the annuity payments to inflate), and are higher for females (for similar reasons).

We compared our calculated annuity prices with the actual prices being quoted by Irish annuity providers (as supplied to us by survey respondents) in order to investigate to what extent the actual market prices differed from our model prices (which were calculated based on our assessment of what we considered to be a reasonable set of pricing assumptions). In summary, as can be seen from the table above, the best available market prices were between 0.3% and 4.5% higher than our prices. The market median prices were between 3.9% and 7.5% higher than our prices. In summary, therefore, a comparison of market prices with the prices calculated by our model indicates that, on our central set of pricing assumptions, the market prices are somewhat higher than our model prices. However, if we change our pricing assumptions to take a more conservative view of future mortality improvements, we find that the market prices and the model prices agree quite closely.

In terms of the price of annuities relative to a defined benefit scheme's assessment of its pensioner liabilities, we find that annuity prices could be expected to be approximately 18% higher than a pension scheme's assessment of its corresponding liability. The cost of capital accounts for the biggest different, accounting for 6%, mortality differentials accounting for some 5%, a planned profit margin of over 3% and commission and expenses accounting for approximately 3%. Our findings in this area correspond quite closely with the views of the IAPF (who suggest a 15% differential for these factors) as well as the Society of Actuaries in Ireland.

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Appendix 2

Index of Pensions Board Research Publications [1]

Name of report	Date
Developing the National Pension System – Final report of the National Pensions Board	December 1993
Ringfencing of Additional Voluntary Contributions (AVCs) on Wind-Up in Defined Benefit Schemes	January 1997
Report on the Extension of Social Insurance to the Self-Employed – National Pensions Board	January 1998
Securing Retirement Income - National Pensions Policy Initiative (NPPI) Report	May 1998
Proposals on Surpluses in Occupational Pension Schemes	December 1998
Proposals to give effect to Equal Treatment in the Gender and non-Gender areas in respect of Occupational Pension Schemes	December 1998
Report of the Working Group on Pre-Funding of Social Welfare Pensions (jointly with DSP, DoF, DETE and Pensions Board)	February 1999
Indexation in Occupational Pension Schemes	November 1999
Pensions Compensation Scheme	March 2000
Pensions Ombudsman	March 2000
Protection of Accrued Rights	April 2000
Review of the Treatment of Umbrella Schemes under Pensions Act, 1990	May 2000
Treatment of Commissions in Occupational Pension Schemes	June 2000
Disclosure and Other Issues in relation to Defined Contribution Schemes	June 2000
Review of Minimum Funding Standard	July 2000
Pensionable Pay	October 2000
Review of Self-investment by Occupational Pension Schemes in the Financial Sector	December 2000
Impact on Calculation of Pensionable Salary of Increases in Social Welfare Pensions	October 2001
Enron – Pension Issues – Could this happen in Ireland?	February 2002
Recommendations for a National Pensions Awareness Campaign	July 2002
Review of the provisions in the Pensions Acts governing the priorities which apply to the distribution to members of the assets of a defined benefit pension scheme in the event of its being wound-up (letter to Minister)	December 2003
Review of the Funding Standard	December 2004

[1] Some Pensions Board letters are also included in this index.

Name of report	Date
Review of Potential Options to Encourage Increased Pension Coverage (carried out by Indecon on behalf of the Pensions Board)	March 2005
National Pensions Review – Progress Report	June 2005
National Pensions Review – Final Report	November 2005
Review of Construction Federation Operatives Pension Scheme (carried out by Mercer on behalf of the Pensions Board and DETE)	September 2005
Background to FRS17 – Accounting for Pension costs (carried out by PwC on behalf of the Pensions Board)	2006
Special Savings for Retirement – Report on mandatory pension system	July 2006
Report on Trusteeship	November 2006
Review of Irish Annuities Market (carried out by Indecon for the Partnership Pensions Review Group by Department of Taoiseach – Pensions Board participant in this group)	July 2007
Pensions Board Operational Review	November 2007
Funding standard for defined benefit schemes (letter to Minister regarding recommendations)	November 2007
Defined benefit occupational pension schemes (letter to Minister)	December 2008
Recommendations for changes to the wind-up priority order for occupational pension schemes (letter to Minister)	December 2008
Defined benefit occupational pension schemes (further letter to Minister)	January 2009
Report of Special Group on Public Service Numbers and Expenditure Programmes – Board views (letter to Minister)	November 2009
Reducing aggregate tax expenditure on pensions savings (letter to Minister)	April 2011
Pension levy (letter to Minister)	May 2011
Review of Pension Taxation Options	October 2011