National Pensions Framework

The National Pensions Framework (NPF) was issued yesterday, 3rd March 2010. The framework does not have any immediate effect on pension legislation. Instead it sets out the Government's intentions for changes in the pensions system over the coming 4 or 5 years, although in discussing the timeframe for changes the Government have said they will keep in mind the impact of changes on competitiveness, and will only introduce changes when they are confident the time is right.

The stated aim of the National Pensions Framework is to deliver security, equity, choice and clarity for the individual. It also aims to increase pension coverage, particularly among low to middle income groups and to ensure that State support for pensions is equitable and sustainable.

Summary of Key impacts:

1. All pensions, except DB, will be offered the "PRSA" type retirement options of ARF or annuity. This is expected by 2011, as such:
   - Clients no longer need to switch from company plans to PRSAs to avail of ARF options
   - Clients currently without ARF options may want to defer retirement if possible
2. Employee tax relief will change to 33% (plus PRSI / health levy relief), so:
   - For a 20% taxpayer it would be better to maximise the employee contribution (as long as the employer is paying proposed minimum of 2% of salary within earnings band)
   - For a 41% taxpayer it would be better to maximise the employer contribution (as long as the employee is paying proposed minimum of 4% of salary within earnings band)
3. With compulsion and ARF options open to all, there will be a massive increase in the post retirement advice market
4. The €200,000 cap on tax free lump sum has been restated, so clients with a potential tax free lump sum above this amount may decide to retire earlier before this is introduced
5. People may want to set up defined contribution schemes before 2014 to avoid compulsion and give themselves more choice / options (especially around funds)
6. Existing pensions cannot transfer into the new arrangements unless the fund is under €10,000
7. Customers should not hold off on pension planning until the new auto enrolled pensions arrive as this initiative may be delayed and customers will miss out on the tax relief (currently higher for 41% tax payers) and tax free growth over the coming years.

More Detailed analysis:

CURRENT COMPANY PENSION, PRSA AND PERSONAL PENSION STRUCTURES:

1. All Pensions

- There will be a matching State contribution equal to 33% tax relief, possibly from 2014.
- PRSI/Health Levy relief will also be available, though presumably this will be available for employees and not the self-employed which is the position currently.
- No change in tax free treatment of investment growth.
- Maximum Tax Free Lump Sum to be reduced to €200,000 in line with Commission on Taxation recommendations. That is pension lumps sums would be tax free up to €200,000. The balance of any lump sum above €200,000 would be subject to tax at the standard rate of income tax, which is currently 20%.
- No proposal to change the Standard Fund Threshold which is currently €5,418,085. The Commission on Taxation had included a recommendation to reduce this threshold to €3 million.

The move to a 33% tax relief rate will obviously be of benefit to those on a 20% tax rate, but will be a disadvantage to those currently receiving relief at 41%. The question is whether those on the 20% tax rate will be in a position to set money aside in a pension to take advantage of this.

Leaving the Standard Fund Threshold unchanged at €5.4m (in effect €10.8m for a couple) means there is still significant scope for clients to fund for pension benefits in a tax efficient way, particularly with the higher funding rates and tax efficient employer contribution options available using Company Pensions.

Employees/Directors

An important point is that for employees on the 41% tax rate, employer contributions to a company pension scheme will become more tax efficient than making contributions personally. So for such people it would make sense to maximise contributions by the company.

For employees on the 20% tax rate, employee contributions to a company pension scheme will become more tax efficient than making contributions by the employer. So for such people it would make sense to maximise personal contributions.

Self-Employed

The self-employed will be directly affected by the change in the tax relief rate. Self-employed clients may want to consider maximising their pension contributions from now to 2014 while relief is still available for higher tax rate payers at 41%.

After 2014, self-employed individuals paying income tax at 41% may wish to look at incorporation. Company pension planning currently offers advantages over personal pension planning in terms of maximum contributions, and if pension tax relief is changed to 33% it means that employer contributions to a Company Pension will be a more tax efficient form of pension planning than personal contributions by higher rate tax payers.

2. Defined Contribution Company Pensions

- No change in tax relief for employer contributions
- Access to Approved Retirement Funds will be provided for defined contribution scheme members from 2011.

Allowing employees to have access to ARF for their full fund will increase the attractiveness of Company Pensions. Although employees will have the ARF option, there is no proposal to change the tax free lump sum calculation for employees, which will remain at a maximum of 150% of final salary based on an employee with 20 years service to normal retirement age. Depending on each persons circumstances this tax free lump sum calculation may be more, or less, attractive than the 25% of fund that is available to a PRSA client. For example, clients with smaller funds may have the opportunity to largely take their pension as a tax free lump sum using the Company Pension route if they have sufficient service.

3. Defined Benefit Company Pensions

- A new DB model is proposed which schemes may wish to adopt in future.
- The funding standard will be kept under review.

There is a recognition that DB schemes are currently under pressure due to recent investment performance and increased longevity. The new DB model that is proposed consists of

- fixed contribution rates for members and employers, and
- flexible benefits in the event of investment losses or other adverse experience

Currently schemes with these features are called Defined Contribution! We will need further details to see if this proposal really offers something new for Defined Benefit schemes.

4. PRSAs

There are no specific changes proposed for PRSAs. However, the auto-enrolment scheme would seem to be aimed at the original target market of PRSAs, and is likely to impact on the number of people taking out PRSA products.

5. Personal Pensions and Buy-out Bonds

- It is proposed that both Personal Pensions and Buy-out Bonds would be withdrawn.

This was originally proposed when PRSAs were introduced in 2003. One reason why Buy-out Bonds were not withdrawn was because of the number of restrictions put in place for transfers from Company Pensions to PRSA, which in effect prevented people taking their preserved benefit with them when they left employment. The framework proposes that small DC pension funds, say less than €10,000, can transfer to the new auto-enrolment arrangement. But if Buy-out Bonds are withdrawn what will happen to the pots of money greater than €10,000 that people build up in different employments? Well, the framework document suggests that a tracing service will be put in place to facilitate the tracing of pension rights by former employees. It also suggests the establishment of a State managed fund into which untraceable accounts would be deposited! It is a pity that the framework has not suggested simplifying the rules for transfers from Company Pensions to PRSAs, so that employees could simply bring their pension fund with them throughout their working life.

6. ARFs/AMRFs

- Guaranteed pension income requirement to be increased from €12,700 to €18,000.
- People may have to meet guaranteed income requirement of €18,000 before availing of an ARF. There will be no alternative option of investing €63,500 in an AMRF.
- If an individual with an AMRF meets the guaranteed pension income requirement at a later date, then the AMRF can transfer to an ARF. Currently an individuals guaranteed pension income is only assessed at the point they take out an AMRF. Even if they meet the guaranteed income requirement at a later date, the AMRF will remain an AMRF

PROPOSED NEW STRUCTURE

Auto-enrolment from 2014

- People over age 22 will be automatically enrolled in a pension scheme when they enter employment or change jobs, unless they are already in a company pension scheme which meets the contribution requirements. The framework does not say that employees and employers currently contributing to a PRSA will be exempt from this requirement. This may be an oversight, or it may be because contributions to a PRSA are not compulsory.
- Contributions to the new scheme will be made within a band of earnings, with earnings below and above certain thresholds exempt.
- The total contribution will be 8 per cent (within a band of earnings) with 4 per cent being paid by the employee; 2 per cent being paid by the State and 2 per cent being paid by the employer. The State contribution will equal 33% tax relief, but PRSI/Health Levy relief will also be available in addition.
- There will be an opt-out mechanism for employees after 3 months, but they will then be re-enrolled every 2 years.
- Once a person remains in the scheme for six months, their contributions will be held in a pension account and no withdrawals will be allowed.
- The Government will not provide any guarantees on investment return.
- Benefit options on retirement will be similar to PRSA options, and will include access to Approved Retirement Funds.

The example bands given in the framework are that the entry level could be set at €352 per week/ €18,304 per annum, with people earning over that amount paying contributions on amounts over €127 pw / €6,604 pa (which is in line with employee PRSI limits) up to an upper limit of €995 pw / €51,740 pa.

It will be interesting to see if there is a move to set up company pensions schemes before the introduction of auto-enrolment in 2014. Employer's may prefer to be in control of their own company pension scheme, rather than being forced into an auto-enrolment scheme that they may have little control over.

There is no proposal to have auto-enrolment for the self-employed, even though this is an area where pension coverage can be low.

Social WelfarePensions

- State pension age will increase to 66 in 2014, 67 in 2021 and 68 in 2028.
- Mandatory social welfare pension coverage will continue.
- The Government will seek to maintain the rate at 35% of average weekly earnings.
- Arrangements will be put in place to allow people to postpone receipt of the State Pension and to make up contribution shortfalls.
- A total contribution requirement equivalent to 30 years PRSI contributions will be introduced in order to qualify for the maximum state pension from 2020.

The state pension (contributory) increased by 38% and state pension (non-contributory) by 42% between 2004 and 2009. In the same period average industrial earnings increased by 15% and the Consumer Price Index by 10%. These increases have had the welcome effect of reducing the percentage of elderly people regarded as being in poverty, or at risk of poverty. However, the demographic changes of an aging population will continue to put extra pressure on the state pension. To somewhat address this, the state pension age will increase for those not claiming the state pension at that time to 66 in 2014, 67 in 2021 and 68 in 2028. While not a popular message, increases in life expectancy made such increases in the state pension age unavoidable. Many other countries, from UK, Germany, USA and Japan have all had to announce in recent years that state pension ages will be increased.

Provisions were already in place to increase the minimum number of contributions required to qualify for the state pension. The number of contributions increased from 156 (equivalent to 3 years PRSI contributions) to 260 (5 years PRSI contributions) from April 2002. A further increase from 260 (5 years PRSI contributions) to 520 contributions (10 years PRSI contributions) was planned for those who reach 66 after 5th April 2012 and this change will proceed as planned.

The total contribution approach proposed for 2020 should simplify the qualification rules for the state pension. The proposal is that once you have made PRSI contributions for 10 years (i.e. 520 PRSI contributions in total) you will qualify for 10/30ths of the state pension. Each further year of PRSI contributions will then entitle you to a further 1/30th of the state pension, until after 30 years (1,560 PRSI contributions) you qualify for the full 30/30ths of state pension benefit.

Public Service Pensions

- A single new pension scheme will be introduced for all new entrants.

A new single scheme for all new entrants to the public service from 2010 onwards was announced in the Budget back in December. Some of the main provisions that were announced were as follows:

- Raising the minimum public service pension age to 66 years from 65 at present.
- Going forward the public service minimum pension age is to be linked with the State Pension age.
- The maximum retirement age will be set at 70.
- Pensions to be based on “career average” earnings rather than final salary as currently applies.

A specific "pension accrual rate" will be applied to pensionable pay so that each year public servants will earn a certain amount of pension payable on retirement. This calculation method lowers the pensions of people with high earnings increases, especially late in their career, with less impact on the pensions of lower paid public servants with relatively “flat” career earnings.

The Government is also to consider using the CPI as the basis for post-retirement increases for both existing and future pensioners. Other details of the new scheme are to be finalised following consultation between the Department of Finance and public service employers and unions.