Reaction to the Auto Enrolment and "Tax Relief" Papers

Shane O'Farrell (Head of Products)

IRISH LIFE CORPORATE BUSINESS

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AGENDA

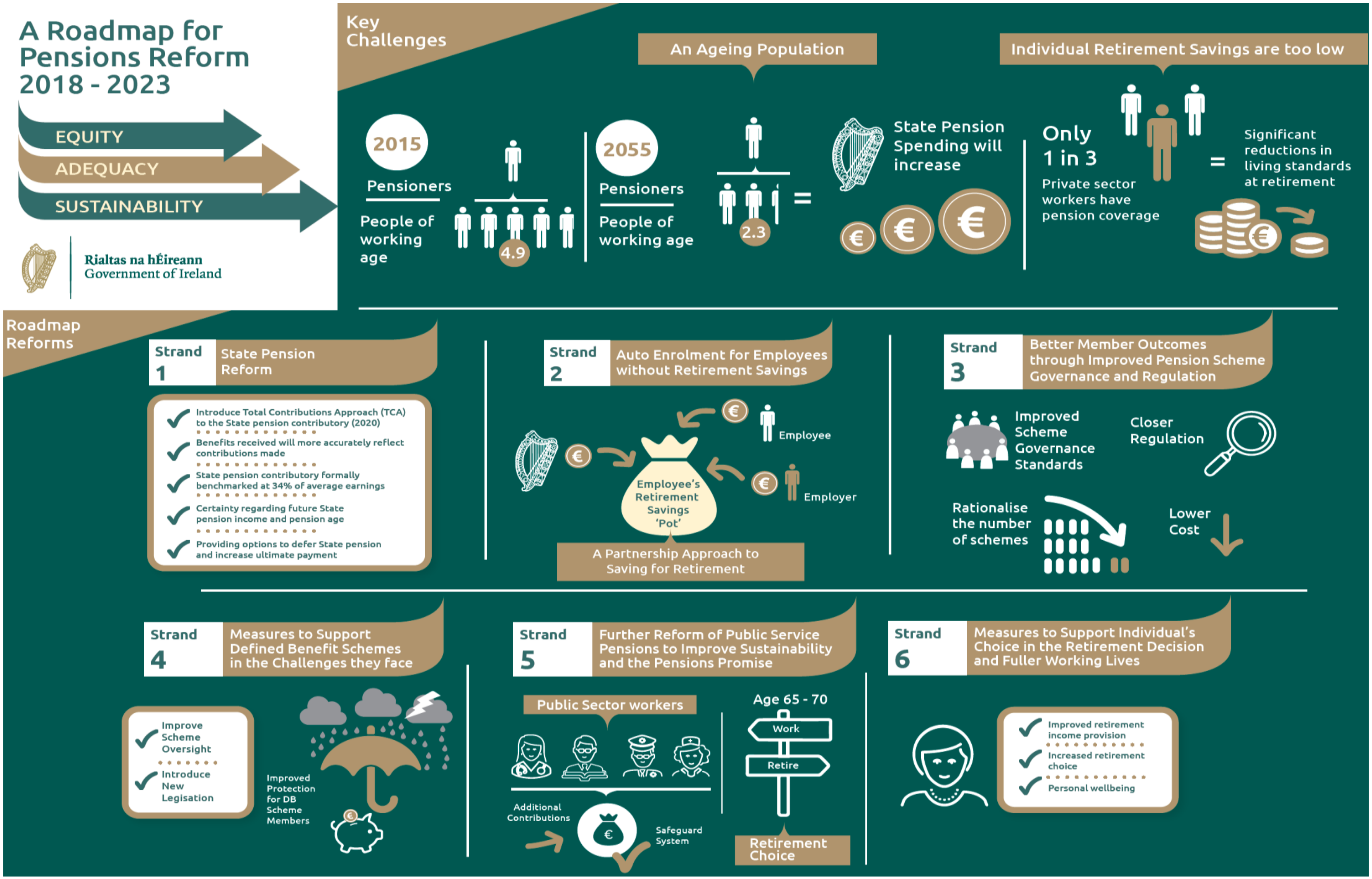
This paper will cover

- Responses from various parties to the “Strawman” on Auto Enrolment (AE)
- Thoughts on the tax relief from the Consultation on Supplementary Pensions Reform

These are the views of the presenter and not those of Irish Life or any other body

Roadmap for Pensions Reform

AE is Strand 2



GOVERNMENT CONSULTATION

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The AE Strawman was part of the RoadMap for Pensions Reform. After a long wait, there was a sudden a flurry of government Public Consultations (PCs) out for response in 2018. These are listed below by due date with focus here on the main AE paper and Tax Relief under Consultation on Supplementary Pension Reforms.

Title	Scope	Timeline
Total Contribution Review (State Pension)	How the State pension works	Monday 3rd Sept
Mastertrust	Pensions Authority draft rules on new master trust regulations	Friday 5th Oct
Consultation on Supplementary Pension Reforms	Consists of 3 parts: 1. Simplification 2. Costs (i.e. cost of tax relief) 3. Review of ARFs	Friday 19th Oct
Auto Enrolment (AE) Strawman	All aspects of AE	Sunday 4th Nov

POSITIVES FROM THE PROPOSAL

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INITIAL REACTION

- Glass half full-many aspects as expected and sensible but lots more detail needed.

Positives from the Industry Point of View

1. Relatively generous contribution rates proposed building up over a short term giving good adequacy and not just coverage stats
2. The Central Processing Authority (CPA) will take significant cost out of the initial sign-up process of employer and employee on a large scale-most view this as essential for this cohort of lives
3. Seems the argument to re-use and re-cycle existing industry systems and expertise has largely won out (No full State solution-this was unlikely but was a possibility mooted early on (still looked for by ICTU))
4. Potentially a very large new market will develop as only 35% of Private Sector employees are currently in a pension-this is about 800,000. There is also the possibility of growth in existing Defined Contribution (DC) schemes that are not yet “AE compliant” eg: only 50% take-up and may be used as an alternative to formal AE.

NEGATIVES FROM THE PROPOSAL

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Negatives from the Industry Point of View

1. The bonus method possibly puts normal marginal tax relief under pressure as hard to see the two systems co-existing in long term
2. The bonus system will arguably cause confusion in the public mind and questions about best advice/outcome for lower/higher income tax payers may lead to opt-outs
3. The central CPA Hub is a large investment and risky for the State: will providers be expected to pay for it? Will it develop mission creep in years to come and compete with private sector? Will cost and projects overrun (like PPARS?)
4. The proposed maximum 0.5% Annual Management Charge is very challenging and may mean lower service standards or nobody interested in tendering?
5. It suggests all providers have (only?) 3 standard funds-Low/Moderate/Medium (note no high risk) with life-styling. The overall tone is a little concerning suggesting the typical mix here will be very low risk/low return in profile (to member's longer term detriment?) and the central agency wants to be involved in assessing fund suitability
6. No mention of fully digital or paperless special status to cut costs

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Summary of Reaction from the Insurance Ireland, Society of Actuaries, IBEC and ICTU

All these bodies broadly welcomed the papers but with differing emphasis on the detail.

All agree some form of AE is needed in Ireland to tackle the widespread under pensioned population. However, widely differed in the detail of how to do this and who bears the cost.

There was strong general agreement of the need to maintain the current tax relief incentives. Most wanted the current tax relief to operate for AE. ICTU requested an equivalent bonus rate.

ICTU position was confused. Suggested wanted same tax relief as at present but then called for €1 for €2.50 (29% relief-not 40%)

Contribution rates - Workers will contribute a minimum 6% gross earnings. - Employers will match workers' contribution. - State will contribute €1 for every €3 a worker saves. Contributions to be phased in 2022 – 2027.	- Workers contribution graduated from 1% to 4% on first €20,000. A flat 5% contribution on remaining earnings. - Employers contribute a flat 7% on all earnings. - State contributes €1 for every €2.50 a worker saves.

ICTU and IBEC both took hard opening negotiations position in relation to Employee and Employer payments. The Strawman suggested 1 and 1 going to 6 and 6 (with 2 from State). ICTU suggested Employees graduated from 1% to 5% and employers 7% flat. IBEC suggested 1% growing to 3% for Employee and Employer with the Employer contribution ceasing at 5 years once habit is developed.

Society of Actuaries welcomed it. Concerns centred on:

- Arbitrage on the bonus proposal versus tax relief
- The low risk/low return nature of the default funds on offer
- No age limits between 23 and 60: all should be included

TAX RELIEF V BONUS METHOD

Tax Relief v Bonus

There are actually 2 different consultations here interlinked. The AE Strawman proposed a State €1 for Employee €3 bonus system (i.e. implicit 25% tax relief). The Interdepartmental Pensions Reform and Taxation Group (IDPRTG) set out to consider the whole tax agenda.

This has been one area of general wide agreement in terms of responses from the main industry groups and the "social partners". Concern arise from:

- The paper suggest that a €1 State bonus contribution should be paid for every €3 of employee contribution. This is designed to be easier to understand than tax relief and fairer to lower rate tax payers. Whilst the system is simple and arguably most appropriate for this cohort, does it lead to potential for full tax relief to be undermined? It works well here as many low earners (and some-a very small %-pay no tax). We guesstimate about 70% of the in scope people are standard rate tax payers.
- But it creates inconsistency and arbitrage issues into the future between AE and the standard occupational DC model. For mid and high earners (single people earning over €34,550), they could end up paying a higher tax rate in retirement than the 25% relief implicit on their contributions. Can the two systems exist side by side with such significant arbitrage options?
- There are real question of fairness between State Superannuation members and (Private) DC members if there is any change. The tax incentives here include not just relief on employee contributions but no BIK rules on employers. Any change would have very significant impacts on the State employees if the very high implicit rate of employer contribution was properly accounted for.

TAX RELIEF V BONUS METHOD

<u>Tax Relief v Bonus</u>

Other anomalies pointed out:

<u>Advice/Best outcomes</u>: Some employees would be best advised to alternate between AE and DC year by year as they get higher/lower bonus/commission or as they progress up the salary scale (moving into higher tax net); who is going to take the burden of advice on?

<u>Greater take home pay hit</u>: The bonus system actually means a 6% deduction means more than 6% in terms of net take home pay. It could be over 8% in reduction in take–home pay as the full amount is reduced from net pay with no relief. Is the alternative method more affordable?

<u>Post retirement treatment:</u> The whole draw-down and point of retirement treatment is unclear. There is certainly risk of arbitrage if it differs from the current systems and transfer are allowed. But if it doesn't differ is it right a higher earner could get 25% relief in AE and then pay higher rate tax at 40% on that income in retirement? They would be best advised to cease contributions.

The risk is that having 2 systems with winners and losers creates a general sense of concern and may put people off the whole concept. They may opt out if they are unsure what's best for them. Any form of confusion or noise on this is very unhelpful.

MAX CHARGES

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➢ <u>Max charges</u>

Max charges of a 0.5% Annual Management Charges are proposed. This is very challenging for the low average annual premium with no initial fund; there seems to be no option for a policy fee or % of contribution fee. There is further mention that this could expand to cover any ARF rolling over from an AE policy.

1. Will 50bp become new target for pensions generally?
2. Will it be too low to attract in enough credible players to the tender?
3. How much economy will the Central Processing Agency (CPA) (discussed below) bring to providers that makes this viable?
4. Do some believe some of the costs of the CPA be funded from this further reducing the net margin?
5. Many responses from within the industry have raised concerns on this and suggested a zone of 75-100bp is more credible (assuming the CPA does initial sign-up).
6. Is there a need for Advice at retirement (or during accumulation) and how paid if 50bps is the max ARF rate?

IBEC OTHER POINTS

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- <u>IBEC</u>

Should be staging by employer size-largest first

Revenue to have a role with the CPA (but private providers doing ultimate admin and investment)

Employees who have access to a DC plan should be excluded (even if not actually a member)

Scheme should be paused/flexible depending upon economic circumstances

€50k max salary limit with age limits 23 to 60 and optimal for self-employed

ICTU OTHER POINTS

- ICTU
- From age 16 to a higher than 60 upper limit
- No lower salary limit
- Employer and State continue to contribute during Employee contribution holiday
- Revenue do all collection (like PRSI) and remit to a State Fund. One provider (eg NTMA) which could out-source.
- The 50bps fee is excessive.
- State provide annuities on retirement linked to the amount of contributions made

WHAT’S LEFT OUT

Important items left out of the Strawman includes:

Product type

The report is open to the offering of Master Trust based products or Contract based. Presumably the AE regime will operate on one or the other (not a variety) and that has to be determined. The DEASP have hinted at elements of both but would a third hybrid cause more confusion and complexity? Can insurance companies and non-insurance companies compete?

Details of AE compatibility of existing DC schemes

It’s unclear the exact rules that mean an existing DC scheme would qualify as meeting the AE compliance for an employer. It’s expected the scheme has to be default opted-in but will things like a max charge of 0.5% apply? Will Employer and Employees rates have to be 6% in 6 years? What if policy fees and commission deductions apply for service and advice? These schemes operate without the CPA and may have higher advice/service levels that are desired.

This is demanding and a big impact on existing schemes.

Funding, cost and regulation and ownership of the CPA

None of this is set out. Will a reduction in tax relief help pay for this cost and the general (tax payer) State bonus top ups? The initial capital costs could be very high. The on-going cost could also be large.

CONCLUSION

AE is potentially an enormous change to our industry. There is likely to be a very welcome growth in the coverage rate for pensions across the wider population. We'd expect the success in the UK to be repeated here if the right approach is taken.

But there are risk and challenges and it's critical the decision taken do not do damage to the existing wider pension system in a negative way.

All in the industry as experts in this complex area have an opportunity to ensure the decisions taken are the right ones.