If Carlsberg did pensions

"If Carlsberg did pensions" was the heading on one of the slides in a presentation I made to the Society of Actuaries in Ireland on February 7 last. The presentation set out proposals for slaying the triple-headed Hydra of (1) high charges, (2) low investment returns and (3) no security of income that bedevil retirees under group DC pensions. I reckoned that, if we could decapitate all three heads, it really would be the Carlsberg solution!

High charges are a consequence of members of Group DC schemes having to leave the scheme on retirement. They lose the bulk discounts that trustees have negotiated for active service members and incur extra costs by having to cash out of the group arrangement and enter into a new individual ARF. A 2016 report of the Pensions Council reckoned that charges on individual insurance-based ARFs were equivalent to a yield reduction of between 1.5% and 2% per annum.

Low investment returns are caused by risk aversion by both retirees and advisers. A working party of the Society of Actuaries in Ireland reported in November 2015 that over 40% of insured ARFs were 100% in cash. Risk aversion and the resultant low returns are understandable in the context of a stock market whose gyrations would frighten all but the bravest - or the foolhardiest. Over the last 32 years, share prices fell more frequently than one month in every three; they fell by more than 8% in a single month on 12 occasions, one of those being a fall of 26.5%. What adviser in their right mind would want to face the wrath of a customer who had experienced a fall of that magnitude shortly after being advised to invest in an equity-based ARF? Better to be safe than sorry.

But in taking the supposedly "safe" option, investors lose out badly in the long-term. Over that same 32-year period, a regular monthly investment in equities would have delivered an average return of 8.5% per annum, despite the occasional blip of a fall in values of 20% or more in less than a month.

It's easy, but wrong, to say that investors should be educated to accept short-term volatility for the greater good of higher long-term returns. It is part of the human condition to worry more about negative outcomes than to celebrate positive results. To find oneself 20% poorer in the space of a month is far more serious than "an occasional blip". Losses of that magnitude cannot be dismissed with a wave of the "it'll be alright in the long term" wand, especially when the clients are vulnerable senior citizens, some of whom are well into their 70s or 80s, or possibly even older. No. We must do better.

We face a conundrum. Short-term safety is the enemy of the long-term good. My proposed solution to the conundrum is to allow new money in and to pay money out to withdrawals based on smoothed investment returns.

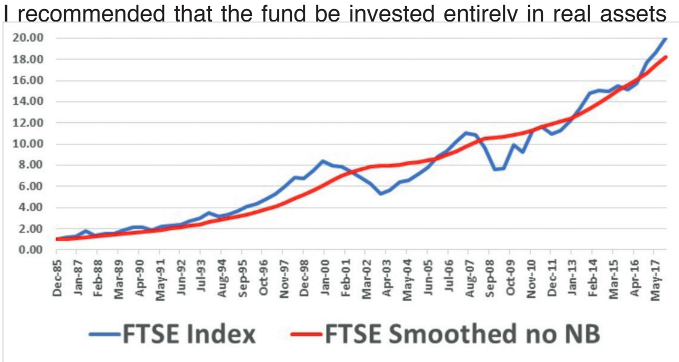
The smoothing formula I proposed, which is shown here in graphical form, transforms the pattern of monthly returns.

Whereas there were 12 occasions over the last 32 years in which market values fell by more than 8% in a month, now there were only two months over the same period when smoothed values fell, and on those two occasions the monthly fall was less than 0.1%. Assuming a steady flow of new money coming in and withdrawals ("pension payments") going out, and where all transactions take place at smoothed values, investors would still earn an average return of very close to 8.5% per annum.

It all looks too good to be true. There is a catch. Investors could play the system by joining when smoothed values were less than market value and cashing in when the opposite was true. In my presentation, I outlined steps that must be taken to mitigate this risk. They include insisting that new money be phased in gradually over a couple of years, that members can join only on retirement, and insisting on regular withdrawals: "it's a pension, not a piggybank".

I demonstrated that these mitigating actions would limit the cost of anti-selective behaviour to a reduction of less than 0.2% per annum in the average return over the entire 32-year period.

I recommended that the fund be invested entirely in real assets



such as property and equities, spread across several countries. One of my more controversial recommendations was that not even a cent should be invested in bonds. This contradicts conventional wisdom that retirees should invest their age in percentage terms in bonds: if you're 70, you invest 70% in bonds, if you're 80, 80% of your money should be in bonds, et cetera. That advice is utter rubbish, I said.

I concluded, but left it to others to prove, that a fund invested in this manner would have delivered durable and positive smoothed investment returns over the 147 years since 1871. I expect the same result for the next 147 years.

Dealing with longevity

We have now shown that allowing members to stay in the group scheme post retirement decapitates the Hydra's head of high charges; that the second Hydra's head of low returns can be severed by investing 100% in real assets such as property and equities and by smoothing investment returns over time. There only remains the third Hydra's head of no security of income. Our challenge is to design an axe to cut off this head, finally slaying the serpent.

One of the biggest worri˘es facing a DC pensioner is "How much can I withdraw each year so that I don't run out of money before

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Colm Fagan is a former President of The Society of Actuaries in Ireland. He founded the actuarial consulting firm Life Strategies (now Milliman Ireland). After retiring from Life Strategies in 2008, Colm became an Independent Non-Executive Director of a number of insurance and reinsurance companies. He is a Trustee of a Defined Benefit and a Group Defined Contribution pension scheme but emphasises that the proposed approach is being presented in a personal capacity.

I die?" It's no good telling them that they should plan for an average life expectancy of 26.4 years, or whatever. For someone in drawdown, all that matters is their personal life expectancy, not the average. That could be anywhere between zero and 40 years. There is a risk that they could draw down too much or too little.

The traditional solution to this dilemma is to buy an annuity, but this option carries a heavy cost: the money is invested in low-yielding bonds and most of it is lost on early death. My solution to the dilemma is what I call the "Lifetime Income Fund" (LIF). The LIF works as follows: on retirement (say at age 65) the member divides their retirement pot into 25 identical sub-pots. They cash one of the sub-pots every year for 25 years. Thus, at the end of 25 years, they will have cashed all their sub- pots and will have nothing left. In the meantime, though, they have been contributing 1% of their fund each year to a separate, pooled, LIF account, which is managed by the trustees. The yearly 1% contribution to the LIF is like an additional management charge. On surviving to the end of 25 years, i.e. to age 90, and having taken the last of their pension sub-pots, the Lifetime Income Fund rides to the rescue. It gives the member another sub-pot each year for the rest of their life. Take an example. Suppose Joe retires at age 65 with a pension pot of €250,000. His pot is divided into 25 identical sub-pots, each of €10,000. The first year, he cashes his first €10,000. The second year, he cashes his second €10,000 plus whatever smoothed return has accrued in the year, say €10,400 in total. The third year, he cashes his third sub-pot plus another year's smoothed return, say €10,700; and so on in each subsequent year. If Joe dies at the end of year two, after cashing his first two sub-pots, the other 23 sub-pots, i.e. €230,00, plus two years' interest, i.e. 107% of €230,000 in the above example, are paid to his estate. Suppose on the other hand that Joe is still alive at age 90. He has cashed a sub-pot every year, taking his final (i.e. his 25th) sub-pot in his 90th year. By that time, the starting €10,000 per annum in each sub- pot has increased to (say) €30,000 (assuming an average smoothed return of 4% per annum, net of the 1% per annum contribution to the LIF). The following year, when Joe is in his 91st year, the LIF pays him €30,000 plus another year's interest, and so on each year for the rest of his life. This assures him a sub- pot every year equal to 1/25th of his starting investment, plus interest, for as long as he lives. The biggest "losers" are the people who die shortly before reaching age 90; they have paid 1% each year to the LIF but get nothing in return, only the consolation of knowing that if they had survived for another few years, they too would be beneficiaries under the LIF.

The bottom line is that the combination of investment in real assets, smoothing of investment returns, and the Lifetime Income Fund mean that DC retirees can be assured of an income for life, starting at 4% of their original investment and most likely increasing each year at an average rate greater than the rate of inflation. On death before age 90, any undrawn balance is paid to the estate.

Approximate calculations indicate that someone who lives to 100 could expect under these proposals to get more than 2½ times what they would have got from an annuity. No wonder I have the zeal of a missionary for the idea to be taken up by the pensions industry.

If you would like to explore the proposals in greater detail, they can be found under the "Past Events" section of the Society of Actuaries in Ireland's website, www.actuaries.ie

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Jump in uninsured claims witnessed in 2016 sustained in 2017

The raised level of motor insurance claims relating to uninsured or untraced drivers witnessed in 2016 was sustained during 2017, according to new figures released by the Motor Insurers' Bureau of Ireland (MIBI). A total of 2,758 claims were received by the MIBI last year.

This represents a jump of 242 more claims than were received in 2015 when a total of 2,516 claims were submitted. There was a marginal 2% decrease in received claims between 2017 and 2016, when a total of 2,802 claims were made.

The largest number of claims came from Dublin with 1,140 claims arising in the capital. This accounted for 41% of all MIBI claims last year. The number of Dublin claims has also grown year to year, with 2017 seeing a 1% increase compared to the 1,129 received in 2016, while in 2015 a total of 1,074 Dublin claims were made.

Cork had the second highest number of claims, although the 212 received in 2017 was lower than both the 2016 figure (243) and the 2015 total (213). Limerick accounted for the third highest quantity with 156 claims submitted in 2017 (152 in 2016 and 155 in 2015).

While the national claim figures were broadly similar between 2016 and 2017, some significant regional variations did arise on a proportional basis. Leitrim had the highest percentage increase in the number of claims (70%), followed by Roscommon (60%), Carlow (43%) and Monaghan (42%). The largest percentage drop in claims came in Kilkenny (-39%), followed by Offaly (-34%) and then Wicklow (-33%).

The MIBI is a not for profit organisation which was established to compensate victims of road traffic accidents caused by uninsured and unidentified vehicles.

Speaking about the figures, David Fitzgerald, Chief Executive of the MIBI said, "In 2016 we witnessed a significant step up in the number of claims the MIBI receives and that level was sustained in 2017. When you compare the current level of claims to the approximately 2,400 to 2,500 claims range we experienced in the years up to and including 2015, you can see there has been a marked increase.

"There are a number of factors behind this change, including the number of uninsured drivers operating on Irish roads. As the MIBI outlined in late 2016, at that time there were over 151,000 uninsured private vehicles in the Republic of Ireland. We are continuing to work with the Gardaí, the State and the rest of the motor insurance industry to bring forward measures that will help combat this problem.

"The MIBI has also outlined our determination to tackle fraudulent claims. We estimate 1 in 8 of all claims we receive are suspicious. As we detailed in our Fighting Fraud strategy we are now making it much more difficult for claims of this type to succeed and we believe this more aggressive approach will lead to the decline in bogus claims over time, reducing the overall number of claims received in future," Mr. Fitzgerald concluded.