Press Release 30 April 2024

A Better Way of Investing Auto-Enrolment Pension Contributions Will Double Workers' Pensions

Colm Fagan, a leading actuary and Past President of the Society of Actuaries in Ireland, has welcomed the introduction of Auto-Enrolment; however, he qualified his welcome, saying:

"Workers' pensions can be doubled by replacing the outdated investment approach proposed in the Bill with one designed especially for Auto-Enrolment." and adding: ***"The Bill envisages separate investment strategies and separate risk management profiles for each individual[i]. This is grossly inefficient; it is suboptimal in investment terms[ii] and will be difficult to administer[iii] as UK experience with a similar approach[iv] introduced over a decade ago has shown."***

Deputy Richard Bruton, speaking in the recent Dáil debate on the Second Stage of the Bill, made much the same point[v].

The approach in the Bill takes no account of the fact that the scheme's assets will continue to grow for decades to come. Fagan's alternative proposal, which was awarded first place in the Institute and Faculty of Actuaries' Frank Redington Prize competition, takes a radically different approach, which Fagan claims can be introduced much quicker and with less risk[vi].

"My approach sees Auto-Enrolment as a form of National Wealth Fund. Contributions will be invested to earn the highest possible long term returns for members. It will be like a high interest savings account paying an average interest rate about 4% a year more than normal savings accounts."[vii],

The savings-account-like stability of returns under Fagan's proposal contrasts with the volatility of investment returns under the approach proposed in the Bill.

"Under the approach proposed in the Bill, fund values will fall almost as often as they rise and could fall by more than 10% in a month about once every two years." said Fagan.

The Pensions Council, which advises the Minister of Social Protection on pensions policy, commissioned an independent expert[viii] to check out Fagan's claim. The expert calculated that pensions under the alternative approach would be even higher than claimed by Fagan[ix]. He also said that any technical challenges could be overcome. Despite this advice, the Pensions Council advised the Minister to reject Fagan's approach.

"The rejection advice was based on an understandable fear of doing something that has never been done before""[x] said Fagan.

"A decision of such magnitude, to reject a proposal that could be worth €2 billion a year to the nation in the form of higher benefits or lower contributions[xi]***, should be based on more than Council's subjective opinion, without any independent expert support***[xii]***"*** said Fagan.

He concluded: "***At the very least, the ESRI should be asked to complete a detailed evaluation of all aspects of my proposal before proceeding with the flawed design currently before the Oireachtas"*****.**

Papers, reports, and letters (for reference):

- *"A New Approach to Auto-Enrolled Pensions" Entry for Frank Redington Prize, by Colm Fagan*
- *"Out with the old, in with the New" presentation to TASC seminar, March 2023*
- *Summary and Conclusions of Paragon Research Report for Pensions Council*
- *Pension Council's letter to Minister Humphreys, recommending rejection of my proposed approach*
- *Government press release on publication of Auto-Enrolment Retirement Savings System 2024*
- *"Higher pensions for half the cost", My 2021 paper to Society of Actuaries in Ireland*

Notes expanding on statements in press release:

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[i] " --. **separate investment strategies and separate risk management profiles for each individual…"**
Under the Bill, workers must decide on joining between low-risk, medium-risk and high-risk unit-linked funds. There is a default option, where contributions are invested in higher risk funds at young ages. Contributions and accumulated funds are shifted to lower-risk funds as retirement approaches. At retirement, members leave the scheme and must buy individual insurance products if they want a pension for life.

[ii] "**….suboptimal in investment terms"**
Shifting to lower risk investments in the lead-in towards retirement means significantly lower investment returns on average. Other things being equal, the investment return in a single year close to retirement could exceed total investment returns in the first ten years of membership. Post-retirement, the normal advice (especially for retirees of limited means) is to invest in "safe" assets, which earn low investment returns on average. Members are also exposed to higher charges when they leave the group arrangement at retirement. Under my proposal, they will remain in the scheme post-retirement, and will continue to enjoy the lower costs and higher investment returns.

[iii] "…**difficult to administer"**
Separate unit-linked funds will be required for members choosing the low-risk, medium-risk or high-risk option. Provision must also be made for members choosing the default option for accumulated funds to be transferred and contributions to be applied to different risk-rated funds once they reach a specified age, irrespective of their personal retirement plans. Each fund must be valued daily or weekly and contributions applied (possibly weekly for weekly-paid employees) at prices ruling on date of receipt. Under my proposal, there is just one fund, which operates like a deposit account on which an interest rate is calculated once a month.

[iv] **as UK experience with a similar approach .. has shown."**
The UK's biggest auto-enrolment scheme, NEST, started well over a decade ago. Its trustees decided a few years ago to change Third Party Administrator from TCS, possibly due to dissatisfaction with

quality or cost. Its efforts to build a relationship with a new supplier were unsuccessful, and it had to return to TCS, having taken an impairment charge of close to €70 million in 2022/23. NEST had an accumulated deficit of well over €1 billion at 31 March 2023, and was still making losses, despite charging more in the early years than the Irish scheme had proposed initially and despite also having around ten times as many members as the Irish scheme expects. If NEST cannot wash its face charging 0.5% of assets under management, what chance does the Irish scheme have of ever breaking even? Interestingly, the Department of Social Protection and the Department of Public Expenditure and Reform do not yet seem to have agreed the charge to be levied against scheme assets.

[v] "**Deputy Richard Bruton, speaking in the Dáil on the Second Stage of the Bill, made much the same point"**

"The question of whether it makes sense to have the pension fund split into individual pension accounts with their own risk management profiles and investment strategies has been raised. I am quite persuaded by the argument that, for a fund like that proposed, which is to be managed centrally by the auto-enrolment board, there is a strong case for a policy to maximise the return to the fund in which people would own units"

[vi] " …**can be introduced much quicker and with far less risk"**

Under my proposal, there will be just a single account to which interest will be applied monthly. It will be much easier to introduce and administer than the plethora of unit-linked funds required under the Bill. Under the approach proposed in the Bill, systems must also be designed and implemented to value the assets of each of the unit-linked funds and to calculate unit prices daily or weekly. Devising investment strategies for each of the funds will also be challenging. Under my alternative proposal, contributions will be invested in a passive world equity fund from the start. After a few years, when assets under management are significant, more sophisticated investment strategies can be considered.

[vii] " … **average interest rate about 4% a year higher than normal savings accounts"**

In current circumstances, the starting interest rate will be around 6% a year (0.5% per month)

[viii] " …. **commissioned an independent expert** .."

Paragon Research. See link to Paragon Research's report at the end of the Press Release.

ix " **...pensions under alternative approach would be even higher than claimed by Fagan**"

Table 3 below from Paragon Research's report shows a pension under the alternative approach equal to 239% of that under the DSP's approach (for a 25-year old joiner).

Table 3 – Projected benefits from the Alternative AE Proposal versus lifestyling

Projected (real) pensions and lump sum (25% of fund) benefits at age 65 of worker earning €20k						
	Pension			Lump Sum		
Age at joining	Lifestyling	Proposed	Alt/LS	Lifestyling	Proposed	Alt/LS
25	4,468	10,695	239%	42,916.81	61,807.23	144%
35	2,672	5,901	221%	25,665.53	34,100.84	133%
45	1,372	2,806	205%	13,173.97	16,217.19	123%
55	427	809	189%	4,102.04	4,673.82	114%

x " **…. understandable fear of doing something that has never been done before"**

The Pension Council wrote that one of its five areas of assessment, which led to the rejection recommendation, was that it could not find any precedents for a similar investment approach elsewhere.

xi **" ….. a proposal that could be worth €2 billion to the nation .."**

Basis for €2 billion estimate for annual saving is as follows:

DSP estimates the required contribution for an "adequate" pension at 14% of earnings. Cost under the alternative proposal is estimated at half that, or 7% of earnings. Therefore, annual savings of: 7% of (say) €36,000 average earnings for 800,000 workers, equals €2 billion.

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xii **" …. Council's subjective opinion, which lacks independent expert support"**
Council cited five areas on which its rejection recommendation was based.

a) One was technical feasibility, but Council noted Paragon Research's conclusion that the proposal was technically feasible. Under this heading, it cast doubt on the equity risk premium (ERP), which is unquestioned by serious economists. There are no professional economists on Council, and no indication that it sought economic advice when questioning the ERP.
b) A second area was practical feasibility. The Council wrote that the scheme's viability would be placed at risk if significant numbers ceased contributing whenever smoothed value exceeded market value. I addressed this issue in my award-winning paper for the Institute and Faculty of Actuaries. The jury for that competition apparently found no problem with my explanation. Again, the Pensions Council did not cite any evidence or analysis (independent or otherwise) to support its assertion.
c) The third was that the Council didn't find any precedents for the investment approach in my proposal. I have dealt with that under (xi) above.
d) The fourth area was appropriateness for the provision of AE. The main objection under this heading was that my proposal restricted choice for consumers. Consumers prefer value over choice every time. My proposal offers double the pension that workers would get under the proposal in the Bill. In the UK, close to 99% of NEST members eschew choice and opt for the default fund. The Council also raised intergenerational fairness under this heading, but without explaining the problem. Again, I covered this issue comprehensively in my paper.
e) The fifth area covered in the Pension Council's letter was "Other matters." Under this heading, Council questioned if there were implicit guarantees under my proposal. My paper for the Institute and Faculty of Actuaries explained why there are no such guarantees. Council did not explain why it disagreed. Also under "Other matters", Council suggested that efforts should be made post-launch 'to identify a product that could capture the benefits that Mr Fagan has identified while addressing the risks that the Pensions Council's analysis has outlined.' This would be a gross waste of resources: the unit-linked approach proposed in the Bill requires heavy IT investment at the start; that money will be wasted if the deposit-account-based approach I'm proposing is eventually adopted. Far better to address the risks as perceived by the Pensions Council now, while progressing other aspects, and then to slot in the straightforward saving-account systems required under my approach, assuming (as I expect) that independent analysis shows Council's concerns to be unfounded.