MIND YOUR PENSION

A GUIDE FOR TEEU WORKPLACE REPRESENTATIVES

TECHNICAL ENGINEERING & ELECTRICAL UNION

FOREWORD

Colleagues,

As General Secretary of the TEEU I am pleased to be able to introduce you to this publication on the subject of Pensions.

Mind Your Pension – A Guide for TEEU Workplace Representatives is a timely publication and necessary resource for our union.

Pension schemes are constantly under review, mainly by employers, who quite often want to reduce their costs by transferring the risks to our members. We believe that all members are entitled to an adequate pension provision on retirement and the TEEU are committed to achieving this goal on behalf of all our members.

I'm sure this booklet will prove a useful tool and source of information to improve your understanding of pensions across the spectrum of the different types of schemes, and will be of particular benefit to our Shop Stewards, Branch Officers and Officials, who may find themselves engaged in discussions or negotiations regarding the provision or alteration of pension schemes.

Finally I would like to thank Paul Kenny, Pensions Ombudsman and Sean Heading Manager of ETOS for their assistance in producing this publication.

Owen Wills

Owen Wills
General Secretary / Treasurer

INTRODUCTION

The purpose of this booklet is to help TEEU Representatives to improve their knowledge of pension matters generally.

Pensions are an important element of pay – they represent earnings that are put aside during an employee's working lifetime, to be paid to him or her after retirement, or to make provision for dependants if the employee does not survive to pension age. They also may be the single most valuable asset that an employee has. Therefore, looking after pension rights has to be a high priority.

For TEEU Representatives, it is important to understand how pensions work. That understanding will help you to monitor the quality of the provision that is made for your members and assist you in the negotiation of better conditions.

In the current economic climate, pension schemes – particularly defined benefit pension schemes – are increasingly under threat. You may find employers, for various reasons, are no longer willing to bear all of the risks that such schemes involve. But the solution is not to transfer all of those risks to the pension scheme members, which is generally what happens if the defined benefit scheme is replaced by a defined contribution scheme.

Ideally, a solution should be found that is fair to both employers and the workers concerned. There is no "one shoe fits all" solution to these issues when they arise. It will require reasonable consideration and discussion between the company and the TEEU to find appropriate resolution for the consideration of the workforce.

This booklet is designed to assist TEEU Representatives in approaching the discussion of those issues with confidence and understanding.

CONTENTS

DIFFERENT KINDS OF PENSION

Various different kinds of pension exist in Ireland. Most trade union officials and workplace representatives will be concerned with Occupational Pension Schemes – those that are sponsored by employers, and usually involve contributions from both workers and employers. Most of this booklet is about these types of schemes. However, for the sake of completeness, and because you will occasionally come across other types of provision, this section will deal briefly with other types of pension.

The most common provision of all is what is now called the **State Pension** (formerly the State Retirement Pension or Old Age Pension). This is earned by contributions made by workers and employers to the PRSI (Pay Related Social Insurance) system. Most workers, with the exception of some in the Public Sector, plus self-employed people, qualify for these pensions, which are paid from age 65, or 66 in the case of the self-employed.

For those who don't qualify through their own contributions, a non-contributory pension is provided, but this is subject to a means test.

Another kind of pension is what is often called a **Personal Pension Plan (PPP)**, but is properly called a Retirement Annuity Contract. This is most commonly used by self-employed people, but is also used by those whose employment does not carry entitlement to a pension. They are normally provided by insurance companies. The contributions qualify for tax relief – the amount allowed depends on age. Retirement can take place from age 60 onwards, or any time if it's due to ill health. One quarter of the proceeds are paid as tax-free cash. The other three-quarters are paid either as an annuity (i.e., a pension), or can be placed in an Approved Retirement Fund **(ARF)** or an Approved Minimum Retirement Fund **(AMRF)**. These terms are explained below.

The third kind of pension scheme is called a Personal Retirement Savings Account **(PRSA)**. It is also available to both employed and self-employed people. It behaves very like a Personal Pension Plan, but the charges that can be applied to a "Standard" PRSA are controlled by the Pensions Board. In addition, it can be used by members of Occupational Pension Schemes (see below) for the purposes of extra retirement saving, in the form of Additional Voluntary Contributions **(AVCs)**.

The law now requires any employer whose employees will not qualify for membership of an Occupational Pension Scheme within six months of joining service, to offer them membership of a Standard PRSA. The employees must be allowed access to financial advice, and time off to obtain it, but the employer is not obliged to make any contribution.

For the sake of completeness, we need to deal with ARFs and AMRFs, which were mentioned above. They are not pension schemes, but personal investment accounts, into which the proceeds of certain pension arrangement (PPPs, PRSAs and Additional Voluntary Contributions) can be paid at retirement, and drawn down whenever they are needed – either as regular income, or as occasional lump sums. Most of the tax that is due on the capital invested and on any income it earns is deferred until the money is drawn down. ARFs are available to those under age 75 with a guaranteed pension income of more than €12,700 a year. Otherwise, the money may have to be invested in an AMRF, which locks in the original capital until age 75 – only the investment income can be withdrawn earlier.

Occupational Pension Schemes, as mentioned above, involve active participation of the employer, who must make a meaningful contribution to them if they are to be approved by the Revenue Commissioners. Exempt Approved Schemes, as they are called, enjoy great advantages. Exempt approval means that contributions can be deducted from an employee's pay before it is taxed and that no tax is charged on investment income earned by the scheme. Revenue approval also means tax relief on contributions to the scheme, and that whatever the employer pays into the scheme is not treated as taxable pay of the employee.

Occupational pension schemes outside the Public Sector are almost always set up as trusts. The use of a trust helps security for benefits due to members. The scheme assets are legally separated from those of the employer – they become the property of the trustees, to be used for the benefit of members and their dependants. Trustees must invest the joint contributions of employees and employer in a prudent and balanced manner and hold and manage the accumulating assets for the benefit of those members and dependants. This responsibility has been reinforced by the Pensions Act, which has been amended to take account of EU requirements in this area.

The pension rights being built up year by year by members of occupational pension schemes are among their most valuable assets, sometimes more valuable than the house they live in. For those who have occupational pension cover, therefore, it is really important that they should understand how their scheme works and what their entitlements are, and keep a careful eye on how their rights are being protected.

The 1990 Pensions Act was introduced to improve and protect the rights of occupational pension scheme members and to ensure that schemes are properly controlled and administered. It has been extensively amended and strengthened over the years by Social Welfare and Pensions Acts.

An important feature of the Act is that it gives members the right to detailed information about their scheme and how it is run. Trustees must account to scheme members through giving them basic information about the scheme, about their personal entitlements and about how the scheme is being administered. It is important for people to know what their pension entitlements will be in retirement and what will be paid to their dependants after their death. This knowledge may help them, while time is still on their side, to decide if they have adequate cover and to take action to supplement what they have.

The Pensions Board, as the Regulator, is responsible for making sure that employers, schemes and trustees obey the Act. It has the power to prosecute those who breach the Act. The Board has also published a very useful set of booklets designed to explain many different aspects of pension schemes and of the rights of their members. They are available free of charge, either directly from the Board (see Useful Contacts, Page 26), or by downloading them from *www.pensionsboard.ie.*

HOW DO PENSION SCHEMES WORK?

A pension scheme is quite simply an arrangement that provides for payments to be made to a worker on retirement from paid work, or to his or her dependants on their death, either before or after retirement. *Occupational pension schemes* is the name given to employer-sponsored schemes for employees which are approved by the Revenue Commissioners under the Taxes Acts.

In the private sector, the benefits promised by pension schemes are funded in advance – that is, the money to pay benefits is put away while a person is at work, to be invested and paid out later in the form of benefits. So, an Occupational Pension Scheme is a formal framework that allows employers and their employees to put aside a part of total pay during the working lifetime of the members, in a tax-efficient manner, to provide an income for them in retirement, or benefits for their dependants in the event of death.

The Pensions Act, 1990 recognises two types of scheme:-

A Defined Benefit (DB) Scheme, in which the pensions and other benefits are clearly stated in the rules of the scheme and promised to members and their dependants. Since the benefits under these schemes are often related in some way to pay at or about the time of retirement, they are sometimes called Final Salary schemes.

A Defined Contribution (DC) Scheme (also known as a Money Purchase Scheme) is one where the benefits payable are decided solely by the contributions paid into the scheme and the investment return earned on those contributions - there is no specific promise or guarantee of particular benefit levels, except perhaps on death.

In practice, a range of names is used to define different sub-types of scheme – target benefits, hybrid, money purchase underpin, cash balance, career average, and so on. Each of these types is legally either DB or DC. Their titles give a clue as to their particular structure. *(see "Other kinds of Pension Scheme", Page 18)*

Funded Defined Benefit schemes are currently under a lot of pressure. This is partly due to the strict solvency requirements which they have to meet, at a time of low interest rates, poor investment returns and the increasingly long lives of pensioners. It is also partly due to the distortions created in employer balance sheets by local and international Accounting Standards. All this has resulted in higher contribution rates where these schemes are still in force; or in schemes being discontinued or wound up altogether, or quite often, being closed to new entrants. The biggest danger to members is the possibility that replacement schemes, which are often DC or "hybrid" in nature, might not produce an adequate income in retirement, as contributions to such arrangements are sometimes quite low. Many companies which have maintained their commitment to defined benefits have seen their contributions, and often those of the members as well, rise considerably.

It is important for members and their representatives to be clear what kind of scheme they participate in. It is worth noting that, even where the main pension scheme is a defined benefit scheme, a scheme or section of a scheme designed to accept additional voluntary contributions (AVCs) will often be set up on a defined contribution basis and is treated for member information purposes as if it was a separate DC scheme. **Personal Pension Plans** are always defined contribution schemes, although most Parts of the Pensions Act do not apply to them. **PRSAs** are also defined contribution arrangements.

The most popular type of hybrid arrangement to emerge from the winding-down of pure defined benefit commitments is a scheme whose basic provision is on a defined benefit basis. Typically, employees will be covered on this basis up to a defined salary limit (which would be revalued over time) or perhaps pinned to the pay of a particular grade of employee. When salaries exceed that limit, the employer's commitment to the excess is on a defined contribution basis. Legally, if the DB and DC components of a hybrid scheme are governed by a single trust, the scheme must be registered with the Pensions Board as a DB scheme.

HOW DOES A DEFINED BENEFIT SCHEME WORK?

An employer setting up a defined benefits scheme intends to promise the scheme members a specific amount of benefit to be paid on their retirement. Many years ago, this benefit might have been a fixed amount of annual or weekly pension, or perhaps a set amount of pension for every year spent in the service of the employer. Later, the promised pension began to be defined as something based on pay and service combined, so the pattern of defined benefits that we see today emerged. Modern defined benefit promises are usually expressed as a fraction or percentage of pay taken at or near retirement age, and multiplied by the completed service of the member.

A common formula nowadays would promise 1/60th of final pensionable pay for each year of pensionable service. This is usually intended to fix the maximum pension promised at 40/60, or two-thirds, of salary.

Because the benefit to be paid is fixed in this way, and because it is not possible to predict what the amount of final salary is going to be, it follows that we cannot know in advance what the promised benefit is going to cost.

ADVANCE FUNDING

Employees are not happy with the idea that their security in retirement is going to depend on the employer being (a) still in existence and (b) making enough profit to pay their pensions, so employers must arrange to fund these benefits during their employees' working lives, to provide a fund from which the promised benefits can be paid in the future. Part of the money may be contributed by the members themselves. In that case, their rate of contribution is usually also defined. The employer then pays the balance of the cost. The recommended rate of payment is decided by an actuary, who makes various assumptions as to what will happen in the future to the members (how long they will live, survival by dependants and so on), their future rates of pay and the investment returns that the fund will be able to earn, among other things. These assumptions are reviewed at least every three years in the light of what actually happens within the scheme and a new rate of contribution is recommended, if appropriate.

TAX TREATMENT

Funding in advance for pensions is encouraged by the government, which gives favourable tax treatment to pension funds. This applies, not just to defined benefit schemes, but to defined contribution schemes as well. Both employers and scheme members receive tax relief – and relief from PRSI - on their contributions as they pay them. In addition, what the employer pays is not treated as employee earnings for tax purposes. Most important of all, the pension fund pays no tax on the investment income that it makes in the shape of dividend income and capital gains. In return, except for some limited benefits paid in cash on retirement or death, most of what is paid out as benefits from pension schemes is taxed under the PAYE system.

To qualify for this tax treatment, a scheme must be approved by the Revenue Commissioners, who police the maximum benefits that can be provided. Employee contributions are allowed, at the same rates as those mentioned below in the context of defined contribution schemes. It is usual for employees' compulsory contributions to be fixed as a percentage of their pensionable pay. The employer then pays the "balance of cost" – the difference between the employees' total contributions and the contribution needed to maintain the benefit promise.

OTHER FEATURES

Apart from retirement pensions, defined benefit schemes usually include the option for the retiring employee to exchange some of his or her pension for a lump sum. Lump sum benefits for dependants on death in service are common features. Many schemes also provide pensions payable to spouses and/or other dependants, on death in service or in retirement.

SOLVENCY

The biggest threat to the security of members and their dependants is the possibility that the scheme's assets might not be enough to cover its liabilities – i.e., that it is insolvent. Threats to solvency can take many different shapes – inadequate contributions, unrealised actuarial assumptions, outside influences such as large pay increases or long-term falls in interest rates.

Insolvency of schemes can have consequences that were not foreseen some years ago – for example, members who left with preserved benefits and who thought – or were told – that these could be turned into early retirement benefits at any time after age 50, now find, when they come back to look for these benefits, that the trustees refuse to allow this, because the scheme has become technically insolvent in the meantime.

HOW DOES A DEFINED CONTRIBUTION SCHEME WORK?

Unlike the defined benefit scheme, the defined contribution scheme promises only that a certain level of contribution will be paid and the pensions to come from the scheme are not defined or promised – they are whatever can be bought with the contributions paid in and the investment income earned on those contributions.

HOW IS THE CONTRIBUTION FIXED?

Generally, the employer's contribution is decided in advance by the employer, and agreed with the relevant trade unions. Employee contributions will be in addition to the employer's fixed rate of contribution.

There are many variations on the way an employer's contribution may be established and the following are all examples taken from schemes actually in operation:

- a fixed pension contribution, with the cost of death benefits and possibly also disability benefits paid in addition;
- a fixed overall contribution rate, with death and disability costs charged as a first charge against that contribution, the balance going to pension provision. This design has given rise to numerous problems. The cost of "risk" benefits such as death in service lump sums, can increase rapidly as people get older, and this will often erode pension expectations. *Under no circumstances can pension benefits be surrendered to pay the cost of disability insurance.*

- different rates of contribution at different starting ages - the older the employee when the scheme starts, the higher the contribution made by the employer. There are variations on this also – contributions that increase in line with the member's age, or with service completed.

Contributions can be at any suitable level but there are some conditions attaching to them:-

- The employer must make a "substantial" contribution to the cost. This Revenue requirement can be satisfied if the employer pays the running costs and about 10% of the benefit costs.
- The benefits likely to be generated by both employer and employee contributions combined will not exceed the maximum limits which the Revenue impose on an employee by reference to salary and completed service at retirement.
- Employee contributions themselves are limited to an overall maximum percentage of gross pay, including any contributions required by the rules of the scheme. The maximum allowable employee contribution, which was originally 15% of gross pay for all, is now age related: 15% for those under age 30; 20% between 30 and 39; 25% for those aged 40-49; 30% for those aged 50-54; 35% for those aged 55-59; and 40% for those aged 60 and over. Employer contributions are made in addition, as long as the overall benefit limits are not breached.
- There is a maximum earnings figure that can be taken into account for contribution purposes, and a maximum overall fund value, but these do not affect most ordinary working people.

WHAT HAPPENS WHEN THE CONTRIBUTIONS ARE PAID IN?

Once contributions are received by the pension scheme trustees, they are invested through an insurance company or other investment manager. They are usually invested separately for each individual member in collective investments such as unitised or "managed" funds, and the member's share of the fund can be easily tracked.

Exactly how they are invested depends on a number of things, including how close the member may be to retirement age. For example, if the member was within a few years of retirement, suitable investment would be in assets whose value was not likely to reduce. A younger member might invest in more unpredictable assets, in the hope of making substantial capital gains before he or she needs to "consolidate" in the run-up to retirement. The assets of pension funds build up without any tax being paid on investment income or capital gains. Under normal circumstances, therefore, they should grow faster than an investment fund that has to pay tax.

WHAT HAPPENS ON RETIREMENT?

When a member retires, the total fund accumulated in their name becomes available to the trustees to provide benefits. The maximum benefits that can be provided are dictated by the Revenue Commissioners' rules. For those retiring at normal pension date, having completed at least 20 years' service, the maximum tax free lump sum is 1½ times "final remuneration", and the balance of the fund available for the individual has to be applied to purchase pensions for the scheme member (and also perhaps for his/her dependants). The amount of pension available after the lump sum has been taken will be dictated by (a) the value of the accumulated fund and (b) the state of annuity rates at the time of retirement. Neither of these can be predicted in advance. The best that can be done in the case of someone who is years away from retirement age is to make a reasonable estimate of what might be available. Such an estimate would be based on assumptions regarding future fund performance and annuity rates. It is important to review these regularly, to measure actual performance against the assumptions. That way, changes can be made to the rate of contribution if needed. People who neglect to review their provisions regularly can be taken by surprise when their benefits matured, particularly at times of low interest rates, which directly affect the cost of annuities.

WHAT HAPPENS ON DEATH IN SERVICE?

The fund that has accumulated for pension provision will form part of the overall death benefit provided by the scheme - how that is calculated will be determined by the rules of the scheme itself. Death benefits may be paid as tax-free lump sums within certain limits, with any balance going to purchase pensions.

WHAT HAPPENS ON DEATH AFTER RETIREMENT?

That will depend on the choices made at the point of retirement to provide for dependants. Some people set up a pension only on their own lives, which dies with them. Others ensure that part of the capital available at retirement age is used to buy an extra pension which will be paid to a spouse or other dependant on the death of the member after retirement. The available capital can be used to tailor the benefits to fit individual circumstances.

ADVANTAGES AND DISADVANTAGES

Each type of scheme has its own advantage and disadvantages. What appears to be an advantage to an employer may often be a corresponding disadvantage to the scheme member, and vice-versa.

In defined benefit schemes, the employee knows what pension to expect, the employer is taking all the risks of funding the scheme, and it is the best way of catering for long-stay and lower-paid employees. The employer finds these schemes a useful tool in attracting and retaining employees, they make manpower planning easier – but the costs and the risks involved in maintaining such schemes may be very heavy, and certainly won't be known in advance.

In a DC scheme, on the other hand, the employer's cost is known and fixed. The risks pass to the scheme member. But it could be costly if there is high turnover of staff, and it is not a useful tool in manpower planning. For the employee, there is a lot more flexibility to design benefits around one's own needs. Members may be able to influence the way their money is invested. Early retirement won't be blocked by insolvency of the fund. But the member is taking all the risks (see the next Section of this booklet), the eventual benefit can only be guessed at, and there is a danger that benefits will not be adequate in the long run, if contributions aren't high enough.

A defined contribution scheme places a great many things firmly under the control of the member. Benefits do not have to be taken in any prescribed pattern, though the maximum levels of benefit are laid down by the Revenue Commissioners. Thus, the scheme member can decide on the distribution of benefits, between personal pension, lump sum, dependants' pensions and cost-of-living increases.

As well as this flexibility, defined contribution schemes have the great benefit of allowing an individual to trace the buildup of his fund, so that he knows its exact capital value as it accumulates over the years. However, he will not be able to estimate with any accuracy how that fund will translate into a pension until he is quite close to retirement age.

RISKS AND RISK SHARING

There are risks involved in both types of scheme. In a DB scheme, as already mentioned, the employer is the one who bears them, if the scheme is funded in a way which requires him to pay the "balance of cost" – that is, the recommended funding rate as estimated by the scheme actuary, less a fixed contribution rate paid by the members.

The main risks are these:

- People are living longer, so it costs more to "buy" a unit of pension.
- If pay increases by a large amount when people are close to retirement, the extra pension that this gives them has to be paid for in a very short time.
- The cost of buying pensions by means of annuities is high when interest rates are low
- Investment returns earned by the fund may be lower than expected.
- Keeping the fund solvent and meeting the Funding Standard under the Pensions Act can require huge (though possibly temporary) increases in contributions.

There are a good many other, less obvious risks as well, but all will be borne by the employer, whose contributions will have to rise if things go wrong.

By contrast, in a DC plan the member is taking the investment risk - i.e., the possibility that the returns on money invested could be poor. These cannot be guaranteed in advance in most circumstances. If poor investment returns are experienced, it follows that the capital available at retirement age would be less than a person might expect or wish for.

Secondly, there is the risk involved in annuity rates. While the money available to buy a pension can be taken to the open annuity market to get the best value available in annuity rates, if long-term interest rates are low at the time of retirement, they will affect all annuity rates and so the annual pension available for a given amount of capital is likely to be poor. Annuity rates are also going to be affected by longer life expectation.

The biggest risk of all is that the contribution being paid into the scheme will be low – this is the case in a great many DC schemes

SHARING THE RISKS

In the recent past in Ireland and elsewhere, things began to go wrong for defined benefit pension schemes. Interest rates were low, life expectancy was getting higher, investment returns were extremely poor, and many DB schemes were technically insolvent. The reaction was often a tendency to panic. Schemes were closed to new entrants, or frozen completely and, in some cases, wound up and replaced with defined contribution schemes.

A more measured reaction on the part of some employers was to try to find ways of lowering the risks, and of sharing them and the costs more fairly between employer and scheme members.

This sometimes took the form of changing the nature of the scheme. Various "hybrid" models appeared, which were neither pure DB nor pure DC. Rates of accrual of benefits were altered.

Increases in contribution rates were shared between employer and members on an agreed basis. Sometimes, some of the more expensive features of a scheme could be cut back. Retirement ages have been raised where it was appropriate to do this, or items such as cost-of-living increases after retirement were no longer guaranteed, but became discretionary or linked to the fund's ability to pay. The next Section of this booklet will describe briefly some of the "hybrid" schemes that have resulted from these changes.

THE OTHER KINDS OF PENSION SCHEME

The traditional defined benefit scheme has been a "final salary" type of arrangement, with benefits being based on pay at, or close to, retirement age. This exposes the employer to the maximum risk.

A scaled-down version of this is a **"Career Average"** scheme. It is a defined benefit scheme still, but the benefit is based on average earnings over a member's whole career. Earlier earnings may be "revalued" over the years in line with an index, for example, the Consumer Price Index. This cuts down on the risk posed by high pay increases close to retirement age.

Fixed Benefit schemes are somewhat similar, except that they give a certain amount of benefit for each year in service, which may also be revalued. They are not very common.

A **Combination Hybrid** is a scheme that has some element of Defined Benefits, and some of Defined Contribution. Legally, these are DB schemes. They would typically give benefits on a DB basis on earnings up to a specified maximum. Any earnings in excess of that ceiling would be pensioned on a DC basis. Again, this cuts down on the risk posed by late pay increases, and shares the risks between employer and members, but it also has the great advantage that the lowest-paid members will always be pensioned fully on a DB basis, and so do not share much of the risk.

A **Final Salary Lump Sum** scheme promises a lump sum of a multiple of final pay, or a fraction or percentage of final pay for each year of service. This is available to the member at the point of retirement to buy a pension. In this case, the employer takes the pre-retirement risks – investment, late pay increases, and so on. However, at retirement, the risk passes to the member, who now faces the uncertainty of what annuity rates will be when the pension is being bought.

Self-Annuitising DC schemes are ordinary DC schemes up to the point of retirement – the member takes the investment risks and so on. However, when he gets to retirement age, instead of having to buy an annuity on the open market, he can benefit from guaranteed terms for converting his cash to pension. In this way, the employer takes the annuity risk, rather than the member.

Underpin arrangements usually involve alternatives – DB and DC – with the member getting the better of the two options on eventual retirement or leaving service. They can be complicated to administer and may not be any less expensive than a traditional DB scheme. They are not common.

Cash Balance schemes commit the employer to a specified contribution each year, which is then increased by a specified rate of interest, up to retirement age. Then the employee must convert this to a pension. In this way, it is similar to a final salary lump sum scheme – the employer takes the investment risk up to retirement age, and the member takes the annuity risk at that point.

The various types of hybrid mentioned above could be combined in various ways, and there is no doubt that new variations are likely to appear in the future.

Further information on hybrid schemes can be obtained from the Pensions Board, which has published a useful booklet on the subject (see Useful Contacts, below, or download from ***www.pensionsboard.ie***).

PITFALLS AND POOR DESIGN

Pension schemes which are badly designed or which do not fulfill the needs of members can be a problem. A few examples of poor design are given below.

RISK AS A FIRST CHARGE

One of the areas of poor design is where defined contribution schemes are set up in a way in which there is a defined contribution from employer and employee, but where the “risk” benefits – death-in-service benefits, and sometimes even disability benefits – are set off against the contribution as a first charge – these are paid for before any money is invested or, worse still, they may be paid for by cashing in units of investment already purchased.

When the member is young, risk benefits are fairly cheap, so there is still a substantial amount going to purchase pension. But as the member gets older, the risk benefits cost more, and less of the money goes to pension. Finally, the risk cost can absorb the whole contribution and, in extreme cases, start to eat into the accumulated fund.

These schemes should be avoided if possible, but if they can’t be altered, they need to be regularly monitored.

“TARGET BENEFIT” SCHEMES

These are defined contribution schemes schemes that can look like defined benefit schemes. The employer does not promise a benefit, but instead sets a “target” which he will aim for. No guarantees are given that the target will be reached. These scheme are based on a number of assumptions, about the future behaviour of pay, investment markets, and so on. If the assumptions are not met in practice, the target won’t be met. Therefore it is important that these schemes be reviewed regularly.

DEFINED BENEFITS – AVERAGING OF SALARIES, INTEGRATION WITH STATE BENEFITS

In defined benefit schemes, final pensionable pay may be expressed as an average of, say, pay in the three years prior to retirement. Sometimes schemes will take contributions in the run-up to retirement, based on each year's current pay but, when the average is computed at retirement, benefits may be based on a lower figure than the one the contributions were based on. This is particularly likely if retirement is not scheduled – for example, if a member takes early retirement. This sort of thing is just bad design and can be avoided.

The same is true, where pensionable pay is calculated by deducting a sum to account for Social Welfare (State) pensions. If State pensions are increased by a large amount, as in recent years, it is likely that the pay increases, at least of the lower-paid, part-timers, etc., will be less than the increase in the State pension "offset", and the new pensionable pay will be lower than the amount the previous year's contributions were based on. This again is a case of bad design, which can be avoided.

CONTRIBUTING TOO MUCH?

Members of defined benefit scheme often complain that they will be contributing members for more than 40 years, but only 40 years are taken into account in calculating their benefits. This is a very difficult problem, and there seems to be no solution that is fair to these members without affecting other members in one way or another.

This list of pitfalls is not comprehensive and, if you have doubts about any particular feature of a pension scheme, you should take advice.

ADDITIONAL VOLUNTARY CONTRIBUTIONS (AVCs)

WHAT ARE AVCs?

Voluntary contributions are made by employees in addition to any compulsory contributions which they make. AVCs are used to improve the benefits of members, over and above those provided by the scheme rules. Scheme rules must make provision for AVCs if scheme members wish to make them. If your scheme rules do not allow them at present, you would have to get your employer's consent to change the rules in order to permit voluntary contributions. Alternatively, a separate scheme can be set up to accommodate AVCs. If there is no AVC provision in the scheme, the employer must offer access to at least one Standard PRSA, to be used for AVC purposes. Comments about AVCs apply equally to AVC PRSAs.

WHY MAKE VOLUNTARY CONTRIBUTIONS?

AVCs can be used, within the limits imposed by the Revenue Commissioners, to:-

- Increase basic pension or provide benefits based on non-pensionable pay.
- Increase tax free lump sum, if possible.
- Provide or increase dependants' provisions on death in retirement.
- Provide or increase cost of living provision on all benefits.
- Increase death in service provision.
- Provide additional security on early retirement.
- The proceeds of AVCs may, if the member wishes, be transferred at retirement, to an Approved Retirement Fund (ARF), subject to conditions; or to an Approved Minimum Retirement Fund (AMRF) if those conditions have not been met.

In considering whether AVCs are appropriate, the questions to be answered are

- Is all pay pensioned?
- Is the main pension scheme integrated with social welfare? If it is, there is room for more benefits
- Is pensionable service short? Is all service pensionable?
- Has the employee got dependants and if so are there adequate dependants' benefits in the scheme?
- Is there provision for cost of living increases?

REVENUE RULES:

- Total member contributions may not exceed 15 - 40% (depending on age) of gross pay in any tax year, including any contributions already required by the scheme rules.
- AVCs made annually should usually be deducted on a "net pay" basis. This gives immmediate tax relief at the point of payment.
- Revenue approval is needed for "special" contributions, i.e. those not being made on a regular basis.
- When the benefits secured by AVCs are added to the main scheme benefits, the maximum Revenue limits on benefits must not be exceeded.

ADVANTAGES OF AVCs

- Full and immediate relief from income tax, and PRSI.
- The fund in which the contributions are invested does not attract tax.
- AVCs give the member some control over benefit levels.
- At present, the AVC fund can be paid as an additional tax-free lump sum on death.

DISADVANTAGES OF AVCs

- Contributions are locked in until death, retirement or leaving service, unless the member is less than two years in any scheme of the employer on leaving - in that case, they can be refunded, less tax.

- AVCs are not short term savings. While it is possible for a member to stop contributing, no refund of contributions is generally possible.
- If a refund of contribution is taken on leaving service, this would usually exclude the possibility of any other benefit from the company pension scheme.

FORM OF AVC INVESTMENT

In the private sector, AVCs mostly take the form of *defined contributions*. It is quite unusual for benefits secured by AVCs to be set up on a *defined benefit* basis. For this reason, the investment considerations in AVC schemes are generally the same as those for defined contribution schemes.

AVCs AND THE MAIN PENSION SCHEME

Obviously, it is important for every member considering the question of Additional Voluntary Contributions to get proper advice. This advice should take into account the benefits being provided under the main pension scheme, as well as the member's personal circumstances and considerations such as tax relief and possible investment return. It is also very important that the trustees of the main company pension scheme should be aware that people are making voluntary contributions. It is the responsibility of the trustees to monitor the Revenue limits imposed on members' benefits and it is impossible for them to do so if they do not know that members are making voluntary contributions alongside the main scheme. If scheme members are using PRSAs to make AVCs, there is also a duty on the PRSA provider to make sure that Revenue limits are not exceeded.

INVESTMENT MATTERS!

In occupational pension schemes, the trustee is always legally responsible for the investment of the pension scheme assets. The Pensions Act and Regulations made under the Act impose particular obligations on trustees, and also place some restrictions on the form that pension scheme investment must take. In practice most trustees pass on the investment of their funds to professional investment managers (banks, insurance companies, etc). Most pension scheme documents give the trustees power to delegate the conduct of the investment to an investment manager and the choice of manager will depend on the nature and size of the scheme concerned.

WHY IS INVESTMENT SO IMPORTANT?

In a defined benefit scheme, the employer has promised a given level of benefit. If the investments do not perform well, the money to meet these benefits has to be made up somehow, and this usually takes the form in an increased contribution from the employer. Therefore, the employer is particularly interested in the success of the pension scheme's investment policy.

Defined benefit schemes include most of the biggest schemes in terms of membership. Trustees must decide how they wish to invest the money in conjunction with their appointed investment manager and the scheme actuary, taking into account the nature and duration of the liabilities which are being funded. Trustees of all schemes (including defined contribution schemes) with more than 100 members (active and deferred) are required to make, and review regularly, a Statement of Investment Policy Principles (SIPP), which must be published in the Scheme Annual Report.

The benefits to be provided under a defined contribution scheme depend solely on the amount of money available when a person comes to retire, leaves service, or dies. If the investment policy followed by the trustees is not successful, this will mean that the member gets less by way of benefits than he might have hoped or expected. In this kind of scheme, therefore, the member is vitally interested in the performance of the investments. Most smaller schemes are defined contribution schemes. So are most of the arrangements designed to accept additional voluntary contributions (AVCs).

Since the trustees are legally responsible for the investment of the funds, the individual scheme member may have little or no say in how his money is invested. Sometimes the trustees will allow members a choice between a limited number of investment options - at times including a choice of different investment managers. The contributions made for and by individual members must be "tracked" so that each receives a fair return on his investment. Trustees can pass the legal responsibility for investment to the scheme member, provided they fulfil certain conditions laid down in Regulations made under the Pensions Act and enables individuals to take direct control of the way their money is invested.

POOLED FUNDS

The majority of insurance contracts used for pension scheme investments are now pooled funds, though it is possible to invest in more "traditional" with-profits insurance contracts.

Shared investment vehicles include the wide variety of managed funds offered by insurance companies and unit trusts offered by the investment banks and specialist fund managers. They are similar to the funds used for individual investment. The main advantage of pooled investment vehicles is that they offer even smaller pension schemes an opportunity to spread their investments over a wide range of assets. A scheme that could never consider buying a property, for example, can still benefit from property investment by buying units in a managed property fund.

DIRECT INVESTMENT

When the value of a scheme's assets reaches a certain size, trustees often feel that they can add value by moving away from shared investment arrangements and asking their investment manager to invest in stocks, shares and other assets that are owned directly by the trustees. Because a scheme is investing directly, it may follow an investment strategy that is closely designed for its particular needs. Even these schemes, however, may not hold direct property investments, but purchase property fund units instead.

INFORMATION ON SCHEME INVESTMENTS

The annual report of the trustees of each pension scheme will contain information on how the assets are invested, the name of the investment manager and how the manager is paid. It will also include information on the investment policies followed by the trustees during the scheme year and on any changes made to those policies. The report should give details of any significant financial developments (such as large movements of money in or out of the scheme) and comment on the performance of the investments during the year. Other information that must be given, if it applies, is whether there is what is called a concentration of investment - that is, whether more than 5% of the assets - are invested in a particular asset or asset type. “Self investment” (this means investment in employer-related assets or property) must also be reported. Regulations require that more than half of the investments must be in “regulated” markets, and that they must be diversified.

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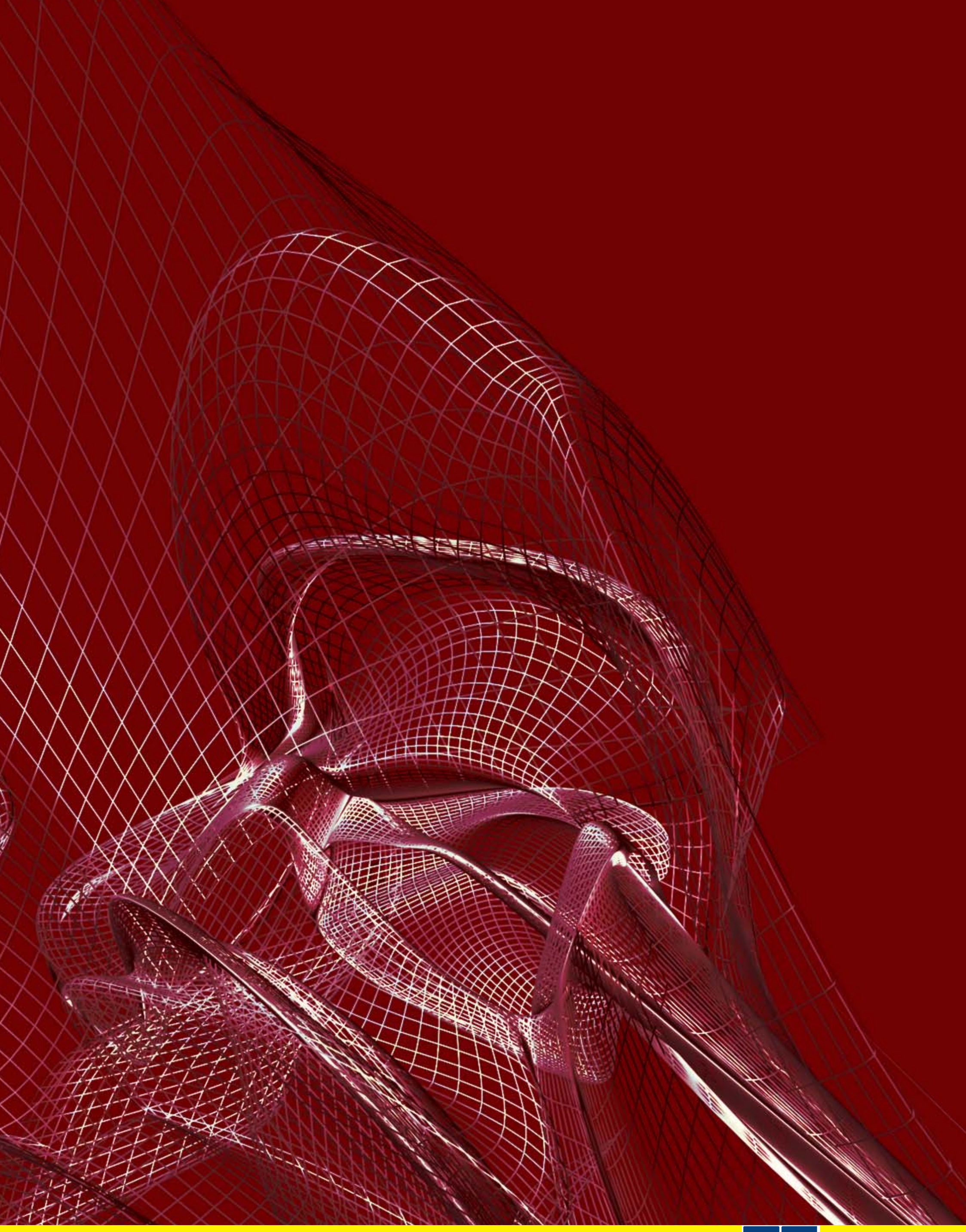

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