

Pensions 20-30: An essay exploring how this age group can be encouraged to make adequate provision for their retirement when holidays, socialising or even a first home may constitute more enticing “needs”

Emily King, trainee solicitor

Some men have less prudence than brutes, and will make no provision against age until it comes.¹

1. Introduction

Having spent life thus far living on student grants and part time jobs, is it any wonder that when they finally start earning money, young people want to enjoy it? When it comes to investing in the future, most would prioritise saving for a home over providing for their retirement. This may be short sighted, but it is undoubtedly the reality of life for those aged 20 to 30 and can perhaps be linked to the increasing commercialisation of our society. A new car, an exotic holiday or a night out offer immediate gratification – a pension does not. Unfortunately this will catch up with the young people of today, and also with their children, who will have to fund them in retirement through higher taxes and personal support. What can be done to make this reality hit home for those in their twenties? And how can saving for retirement be made the norm as opposed to the exception?

The man on the Clapham omnibus knows that pensions are the time bomb waiting to wreak havoc on European economies, but what can be done about it? The expenditure level for public pensions in most Western European countries is well above that of other highly industrial and post-industrial countries at a similar income level. While Ireland's bill is lower than that of its European neighbours, private pensions must be encouraged to ensure that in decades to come the economy is not crippled by pension payments. The average of public pension expenditures as a percentage of gross domestic product for the 15 EU countries in 2000 amounted to 10.4 percent. In Ireland the figure was significantly lower at 4.6 percent, but this will rise as the population grows older unless there are drastic changes in our pensions system².

2. More Enticing Needs

A reason often given for failure to contribute to a pension is a lack of available funds³. Yet according to research by Fidelity, the average household in the UK spends £769 on alcohol, £1,908 on restaurants, £1,180 on clothes and £3,542 servicing debt. There is little reason to suppose that the figures are very different across the Irish Sea. The same study found that a young man in the age bracket in question saves an average of just £60 in his company pension scheme every month. If no change is made to this thirty year old's pension contribution, he will have to survive on £5,841 annually in retirement. It is human nature that people will focus on immediate needs over future needs. Leaving the spending on leisure activities described above to one side, it stands to reason that young people are more concerned with getting on the property ladder than starting a pension fund, particularly given that a mortgage provides a tangible asset that can be used and traded at will.

¹ Daniel Defoe (1697), *An Essay on Projects*.

² *Pensions Reform Issues and Prospects for Non-Financial Defined Contribution Schemes*, Robert Holzmann, Director of Social Protection at the World Bank, and Professor Edward Palmer

³ *Hazards of Keeping Up With the Beckhams*, Pensions World, August 2007 p 6

Research by AEGON reveals that 9.6 million UK adults have no long term savings or a pension. Those surveyed believe they would need £15,000 to £20,000 (€19,730 to €26,307) per annum in retirement to live comfortably, but only 37% of these believe that they are investing enough to do so⁴. The survey related to adults in general, so it is safe to assume that a much smaller percentage of young adults in their twenties are investing sufficiently in their pensions. According to one expert, the reason young people are not saving for retirement is that “they do not like thinking about their own mortality”⁵. As will be seen below, this is far from the only reason there is a poor take up of pension products among those aged 20-30, but it is undoubtedly the case that a trip to Rio next summer is a more attractive prospect than a pension fund. The challenge is finding a way to persuade young adults that a pension fund is an attractive investment.

3. Pension Options

Before examining ways to encourage planning for retirement, a brief overview of the existing options will be set out.

3.1 State Retirement Pensions

On reaching the age of 66 a State Pension (Contributory) is payable to those who have made the required PRSI contributions⁶. Under current legislation, if you reach pension age on or after April 6 2012, you will need to have 520 paid social insurance contributions (10 years paid contributions), and you must have a yearly average of at least ten appropriate contributions paid from the year you first entered insurance to qualify for the full pension. The maximum rate of the State Pension (Contributory) is currently €223.30 per week⁷. A lesser, means tested, State Pension (Non-Contributory) is payable to those who do not qualify for the State Pension (Contributory).

Although the State may cover part of other expenses such as free travel, electricity, gas and a television licence, it is clear that most people will require another form of income in their retirement to maintain their standard of living. Although it is widely known that the State Retirement Pensions are not optimal, there is a strong argument to be made that if young adults were made aware through advertising of the hard cold figure of €223.30, it might bring the reality of failing to save for retirement home to them.

3.2 Occupational Pension Scheme

Occupational Pension Schemes, or Company Pension Schemes, are set up by employers to provide retirement and death benefits for their employees. It is important to note that there is no legal obligation on an employer to set up a company pension plan. These plans are generally set up under trust. There are two types of occupational pension scheme, Defined Benefit schemes provide a set level of pension at retirement, the amount of which depends on service and earnings at retirement. Defined Contribution schemes are where the employee's own contributions and the employer's contributions are both invested and the proceeds

⁴ *UK Adults Have a Rose Tinted Financial Outlook*, Pensions World, October 2007 p 6

⁵ www.aegon.co.uk Press release 30 August 2007

⁶ Social Welfare Law Reform and Pensions Act 2006

⁷ www.citizensinformation.ie

used to buy a pension at retirement. The level of the pension will depend on the amount invested, the return on the investments and the cost of the pension at retirement.

Defined Benefit schemes are an expensive commitment for employers, and one which many are no longer making. It is rare for a Defined Benefit scheme to be open to new employees and it is unlikely that many people aged 20-30 working in the private sector will get the benefit of such a scheme. A survey by Mercer in June 2006 revealed that 38% of Defined Benefit schemes were then closed to new employees with a further 22% of employers planning to close their Defined Benefit schemes to new employees within three years⁸.

One has to wonder whether young adults who see their parents retire on attractive Defined Benefit schemes are aware that this will not be the reality for them⁹. Again, it seems that promoting this message must be a priority for the Pensions Board.

3.3 Retirement Annuity Contracts

A Retirement Annuity Contract (“RAC”) is a personal pension. In short it is type of insurance contract approved by the Revenue. An RAC is a Defined Contribution pension plan in so far as the value of the fund depends on the level of contributions paid, the investment return achieved, and the cost of buying the benefits. RACs are open to those who have earnings from non-pensionable employment, for example those who are not part of a company pension plan and the self-employed.

3.4 Personal Retirement Savings Accounts

A Personal Retirement Savings Account (“PRSA”) is a contract between an individual and an authorised PRSA provider and is a form of investment account¹⁰. It is a Defined Contribution plan governed by contract law. Every adult under age 75 may take out a PRSA. An employer is obliged to provide mandatory access to at least one PRSA where the employer does not operate an Occupational Pension Scheme; or the employer operates an Occupational Pension Scheme but the eligibility for membership of the scheme does not cover all employees.

4. The Benefits of Saving

What is attractive about a pension? For young adults who do not like to dwell on their mortality and want to enjoy their money today, a pension is not a priority. It may be stating the obvious, but pensions are financially attractive investments. Money talks, so it is worth considering what makes a pension a smart investment and how to make this fact more widely known. The take up of Special Incentive Savings Accounts (“SSIAs”) in Ireland¹¹ proved beyond a doubt that young people can be incentivised to save for the future if they perceive it to be worth their while. In the EU as a whole the average income of pensioners relative to the average income of employees and the proportion of retirement income provided by the public

⁸ Mercer, 21 June 2006

⁹ How many people in their twenties know that British Airways has a £1.4 billion deficit in its Defined Benefit Scheme? Or that Diageo, owner of the Guinness brand, has a £653 million deficit?

¹⁰ PRSAs were introduced by the Pensions Amendment Act, 2002

¹¹ Available between 1 May 2001 and 31 April 2002

pension systems are expected to fall¹². The biggest losers from the reforms, but by no means the only losers, are likely to be women, the low paid, and part-time employees. Demographic changes mean that the young people of today cannot expect to be supported in their old age to the same extent as their grandparents were or that their parents will be. Personal financial planning will be crucial to ensure that standards of living are maintained.

Due to the voluntary nature of private pension provision and the increasing withdrawal of employers from Defined Benefit schemes it is likely that there will be greater income inequality in the future and increased poverty among the elderly. In 2007 a man aged 65 can expect to live another 16 years and a woman 19 years. By 2036 this will have increased to 21 and 24 years, and to 22 and 26 years by 2061. That translates into an increase of up to 40% over the period and this will be reflected in increased pension costs. Longer life expectancy poses challenges in terms of the sustainability and adequacy of the pensions system¹³. Starting a private pension early is therefore not only beneficial, but arguably necessary¹⁴.

5. The Barriers to Saving

A priority of the Pensions Board is to encourage young people to continue the saving habit begun with the SSIA's and it mounted a high profile campaign to that end¹⁵. The focus on pensions in the public domain has undoubtedly risen, and indeed pensions were a priority in partnership talks on Towards 2016¹⁶. While the public profile of pensions has risen however, this has not translated into an increase in saving for retirement among the young. According to the Department of Finance 20% of SSIA savers were under 40, and 45% of these did not have a pension¹⁷. The aim of the National Pensions Awareness Campaign last year was to encourage the conversion of awareness into positive action. This seems to be the stumbling block for young people when it comes to pension planning. A survey commissioned by the National Pensions Review reveals that 66% of those aged 25 to 34 consider that the "complexity of pension products" represents a barrier to increasing the coverage of pensions in Ireland¹⁸. The survey shows that 68% of that age group feel that "consumer understanding of pensions" and the "affordability of pensions" discourages pension saving¹⁹.

¹² *Reforming Pensions in Europe: Evolution of Pension Financing and Sources of Retirement Income*, edited by Gerard Hughes of The Economic and Social Research Institute and Jim Stewart of Trinity College Dublin

¹³ Speech by the Minister for Social and Family Affairs, Martin Cullen TD at the Launch of the Government Green Paper on Pensions, Government Press Centre, 17 October 2007

¹⁴ According to research by the ESRI in countries (such as Ireland) which rely heavily on private pension provision the costs to the State can be substantial. The research indicates that implementing pensions policy through the tax system is likely to increase income inequality in old age. *Private Pensions and Equity in Ireland and the UK*, Gerard Hughes, Economic and Social Research Institute.

¹⁵ National Pensions Action Week in March 2007 involved intensive advertising and promotion of pensions to key age targets of 25 – 39 and included on-the-street promotional activity, outdoor, ambient and online advertising, national print advertising, regional and national radio and TV advertising.

¹⁶ See footnote 12

¹⁷ Pension Board Press Release 13 March 2007

¹⁸ *National Pensions Review*, Report of the Pensions Board 2005. Indecon commissioned TNS mrbi survey.

¹⁹ Similarly, 60% of the same age group agreed that the "taxation treatment of pensions" represents a barrier to increasing the coverage of pensions in Ireland.

6. Options for Reform

The Pensions Review published in 2006 set out the options for reform of the pensions system in Ireland. Five alternatives were examined:

- Flat rate State provision but at a significantly increased level;
- Mandatory earnings related State provision linked to earnings or to earnings related contributions;
- Mandatory private pension;
- Incentivised voluntary private provision (this is the current system); and
- Neutral voluntary private provision – i.e. no incentive for supplementary provision.

An option which the review group considered merited further investigation was the automatic deduction of 5% from the earnings of employees who do not join a pension scheme. This money would be invested in a PRSA type product with the employee having the right to opt out of the scheme. The Minister for Social Affairs in 2006, Seamus Brennan, stated that he thought there was merit in mandatory pensions, particularly “soft” mandatory pensions as recommended by the Turner Report in the UK²⁰. The Minister favoured this approach because of the very low pensions coverage in certain sections of society, including younger workers²¹.

This enthusiasm is not shared by other stakeholders such as IBEC²², the Irish Congress of Trade Unions, or the Irish Association of Pension Funds (“IAPF”)²³. According to IAPF Chairman Joe Byrne, not all employees are in a position to save or want the Government dictating what should be done with their money. Mr Byrne suggested that “workers are better positioned to save for their retirement where there are clear and simple incentives”. In a study commissioned by the IAPF, Dr Shane Whelan suggested that the Government incentivise workers to save for retirement by simplifying eligibility rules and rationalising the existing State pension system. With these recommendations in mind, it is interesting to examine what other countries have done to tackle the pensions problem and encourage saving amongst the young.

7. Mandatory Pensions – the Antipodean experience

Several countries have compulsory private pension provision and one that is often discussed is the Australian model²⁴. Introduced in the mid 1980s, the scheme became compulsory in 1992 for employees earning over approximately €290 per month. Employers contribute 9%

²⁰ UK Department for Work and Pensions, *Security in Retirement: towards a new pensions system*, May 2006 (also known as the Turner Report). The Turner Report proposed a National Pensions Savings Scheme, in which employees would be automatically enrolled into a pension when they start a new job, but also be given an opt out.

²¹ *Could Mandatory Pensions Work Here?* Irish Pensions Magazine, Vol 2, Spring 2006

²² Irish Business and Employers Confederation

²³ see footnote 19

²⁴ see footnote 21

of salary and employees contribute 3%, although tax incentives encourage contributions of up to a further 3% by employees. Compulsion has meant that 95% of full time employees and 75% of part time employees have a pension. Although this is undoubtedly a welcome achievement, the IAPF and others argue that compulsion has a knock on effect on other savings and that solving the coverage issue does not automatically solve the adequacy issue.

The pension system in New Zealand has provided the model for reform in the UK outlined in the Turner Report. From April 2007, the KiwiSaver scheme required that all workers taking up employment be automatically enrolled²⁵. Employees then have eight weeks in which to opt out. Employees pay 4% of their salary into KiwiSaver. From 1st April 2008 the employer must contribute 1% of salary, rising by 1% annually to reach a maximum of 4% in 2011²⁶. Employers can claim a tax credit of up to NZ\$20 per member per week if it contributes to KiwiSaver schemes or complying funds on behalf of its employees. The employee can choose their own fund provider or be allocated to a default provider by their employer or Inland Revenue. If an employee does not opt out of KiwiSaver within the eight week timeframe there are only very limited circumstances in which he/she can opt out. The self-employed and those not in employment are also free to join KiwiSaver.

These accounts are of great interest because of the manner in which they provide flexibility for young people, in particular with regard to buying a first home. After three years, or in cases of financial hardship, funds can be accessed for a deposit on a first home. The funds that can be accessed for a deposit on a first home are both the employee's and the employer's contributions to KiwiSaver. The Government makes an upfront contribution of NZ\$1,000 per person into each KiwiSaver account. An additional contribution by the Government is a first home deposit subsidy of NZ\$1,000 per year of membership up to a maximum of NZ\$5,000. A couple therefore can claim a maximum of NZ\$10,000. To further ease the burden of home ownership, up to 50% of KiwiSaver contributions can be diverted towards mortgage repayments. It is also possible to request a "contributions holiday" for three months to five years. This is an attractive package for young people which promotes saving for retirement but crucially also leaves open an SSIA type window where part of the money saved can be used to buy a home and contribution breaks can be taken if necessary because of childcare or other costs.

8. Conclusion - The PaddySaver Account

The name may not catch on, but a system based on New Zealand's KiwiSaver scheme has a great deal to recommend it. It is a facilitative rather than a mandatory scheme and thus leaves the decision as to whether or not to take part to the employee. While the final decision remains with the employee, the onus is on him/her to take steps to opt out. In short, a flexible savings scheme to which the employer contributes is the default, but employees are free to withdraw or to choose their own scheme provider. Such a system addresses many of the problems identified above regarding the alternative means of saving for retirement. It also bears many of the hallmarks of the SSIA scheme which proved so popular with the target age group and as such could be marketed to young people as a new improved SSIA for retirement package.

²⁵ The principal legislation governing this scheme is the KiwiSaver Act 2006.

²⁶ See the excellent *KiwiSaver Employer Guide* <http://www.ird.govt.nz/resources/file/eb75d44d2532e3e/ks4.pdf> Contributions made to an existing superannuation scheme count as compulsory employer contributions if the scheme was registered prior to 17 May 2007.

The New Zealand Government has done an excellent job in explaining and rolling out the KiwiSaver scheme as a consumer friendly, easy to use financial product²⁷. This is precisely the approach that is required in Ireland where young people know they should save for retirement but perceive this as a prospect so far into the future as to be irrelevant. Not only is retirement seen as too remote, but the complicated array of financial products available render the prospect of choosing pension provision daunting. The KiwiSaver scheme offers not only an easy way to save for retirement, but an easy way to save in the medium term. The option of using part of the funds saved as a deposit on a home and towards mortgage repayments, together with the knowledge that contribution holidays can be taken, would go a long way towards convincing young people that pension planning need not be a matter merely for the middle aged.

The adequacy issue raised with regard to the compulsory Australian pension scheme remains to be addressed. It is suggested that by making saving for retirement the norm and facilitating people in building up funds, a competitive market for those funds will develop in much the same way as a competitive market for people's SSIA funds developed. In New Zealand six default providers have been appointed by the Government for those who do not choose their own scheme provider²⁸. It is to be hoped that by facilitating pension planning an interest in the options available, and indeed a desire to improve on what is offered, will be awakened in people who may not have considered pensions before. Even though this will not be the case for all savers, a strong argument can be made that some level of personal saving is to be preferred over the current system where it is estimated that pension coverage is only at 50%²⁹.

The argument that the State should not interfere with people's finances and that pension provision above a basic level is a matter of personal choice undoubtedly carries much weight. People should be free to make their own financial decisions and plan, or indeed fail to plan, for retirement as they see fit. However, pension planning is not merely a matter of personal choice as ultimately it is society that must either make up the shortfall or deal with the consequences where the elderly have insufficient means to live decently. It is beyond argument that as populations age, the strain of supporting pensioners on society could have far reaching consequences on many western economies. It is for this reason that young people must be encouraged to save for retirement. Experience in Ireland has shown that where the product is right, young people are enthusiastic savers and are perfectly willing to forego holidays and socialising to do so. While they may not be prepared to forego their first home, the scheme proposed not only does not require this sacrifice, it facilitates home ownership. For this reason it is posited that serious consideration be given to a scheme similar to that adopted in New Zealand.

²⁷ See the comprehensive and user-friendly www.kiwisaver.govt.nz

²⁸ AMP Services (NZ) Limited, ASB Group Investments Limited, AXA New Zealand (National Mutual Corporate Superannuation Services Limited), ING (NZ) Limited, Mercer Human Resource Consulting Limited, Tower Employee Benefits Limited

²⁹ *Double the Challenge for Tiernan O'Mahony* Irish Pensions Magazine, Vol 3, Autumn 2006