# Private pension schemes

## Their role in adequate and sustainable pensions

European Commission

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**European Commission**

Directorate-General for Employment, Social Affairs and Equal Opportunities

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# Introduction

To address the challenge of population ageing, the European Commission and the Social Protection Committee (SPC) are working with Member States to support, monitor and assess the impact of reforms to pension systems on the twin goals of developing adequate pensions and ensuring the long-term sustainability of pension systems. In the course of its work on achieving the commonly agreed objectives for pension provision, the SPC has examined most aspects of the policy challenges for statutory, publicly managed schemes that are financed on a pay-as-you-go basis. This squares well with the fact that the bulk of income provision for today's pensioners is delivered by schemes of this type. Indeed this is the case even in those few countries (e.g. Denmark, Ireland, the Netherlands and the United Kingdom) where, from the outset, private provision was given a significant, official role in total provision.

However, over the last decade a large number of Member States, as part of reforms to strengthen the sustainability of pension systems, have sought to engage the social partners and individual citizens more directly in pension provision by enlarging the future role for pre-funded, privately managed schemes.

With their growing economic importance, the pre-funding and tax expenditure aspects of these schemes have drawn increasing attention from authorities with responsibility for financial markets and services or for public budgets. For the SPC, by contrast, it is primarily relevant to take a closer look at the contribution of funded, privately managed schemes to the adequacy and sustainability of pensions and in particular to shed light on some key issues in funded and privately managed schemes, which must be mastered if they are to perform well as vehicles for social protection.

In April 2008 the SPC adopted a report with the results of its study entitled 'Privately managed funded pension schemes and their contribution to adequate and sustainable pensions'. Directed at Member States, this report sought to highlight some of the lessons learned about private, funded pensions.

Whereas the report tended to focus on the potential risks to full adequacy inherent in pre-funding, present concerns about private pensions are much wider and tend to centre on fundamental sustainability. The sudden reduction of the book value of pension fund assets by 15–35 % caused by the financial crisis in the last quarter of 2008 has underscored some of the basic vulnerabilities in pre-funding as a financing vehicle and seriously diminished public confidence in privately managed schemes.

Restoring schemes to solvency while avoiding the possibility that sponsors (employers, trade unions, members) pull out or subsidies are reduced (tax expenditure) have become key priorities as the very survival of schemes sometimes may be threatened. Obviously, economic recovery, including in financial markets, will determine much of the ability to re-establish solvency. But the strengthening of mechanisms that allow schemes to better absorb economic shocks by distributing the costs among all stakeholders will also be called for. Likewise changes to scheme design and investment strategies will often be necessary to reduce the risk exposure of pension savers.

This little booklet seeks to highlight some of the main issues which must be mastered if privately managed pre-funded schemes are to successfully fill the role of important contributors to adequate and sustainable pensions envisaged for them in many Member States.

## Adequate and sustainable pensions

The adequacy of pensions relates to their ability to prevent poverty and social exclusion in old age and to ensure a decent living standard for the retired, that allow them to share in the economic well-being of their country and to participate in public, social and cultural life. For pensions to be socially and politically sustainable they must be adequate and for pensions to remain adequate they must be financially sustainable, i.e. possible to finance without undermining the financing of other key aspects of sustainable societies. Adequate future pensions require pension systems to be financed sustainably in the face of rapidly ageing societies. The adequacy and sustainability aspects of pensions are thus inextricably linked.

# Private pension schemes

Pension systems vary extensively across Member States and there are significant differences not only in their structure but also in the terminology used. In broad terms, however, individuals can draw retirement income from:

(1) statutory social security schemes;

(2) occupational pension schemes that are linked to the employment contract and mostly based on collective agreement;

(3) individual pension savings' contracts with financial service providers, linked to voluntary, individual decisions.

In this brochure, the term 'private pension schemes' includes all pre-funded schemes that are privately managed. It incorporates both:

- all statutory (mandatory) fully-funded schemes — such as second tiers of statutory schemes, where social security contributions are diverted into individual accounts, which are privately managed;
- supplementary (voluntary) funded schemes — all occupational pensions including book reserve schemes as well as individual savings dedicated to a pension purpose, notably pension savings linked to annuities, but excluding other long-term savings products.

In other words, it does not cover reserve funds accumulated within the pay-as-you-go public schemes or individual long-term savings which do not have specific pension purposes.

## The role of private pension schemes is growing...

In most Member States, a dominant proportion of total pension provision is organised within the general government sector, with a noticeable impact on public finances. Until the early 1990s private schemes only played a significant role in the pension systems of Denmark, Ireland, the Netherlands, Sweden and the UK, where the initial limiting of pay-as-you-go public provision to basic, flat-rate pensions for everybody had spurred the growth of private provision, whether in the form of collective occupational pensions or individual pension insurance contracts. Yet, in the last decade of pension reforms in response to population ageing many more countries have expanded the role of existing private schemes or introduced new elements of pre-funded, privately managed pensions into their pension systems. This has typically happened in order either to improve the overall adequacy of pension provision by adding private components to the scope of public provision or to compensate for reductions in the future replacement rates of public schemes resulting from reforms. Other reasons cited by Member States

which have a significant proportion of — or are moving to greater reliance on — private funding in their systems include wishes to diversify provision, boost choice, improve transparency and foster greater individual responsibility. Traditionally, private pension provision has been discretionary and voluntary or optional in line with its character of remuneration (occupational schemes) or individual purchase and saving. Yet as private provision has been given greater official roles in provision, public regulation has increased and gradually reduced these original characteristics which made them particularly questionable as vehicles of social protection since they often resulted in fragmented coverage and unequal and insecure benefits.

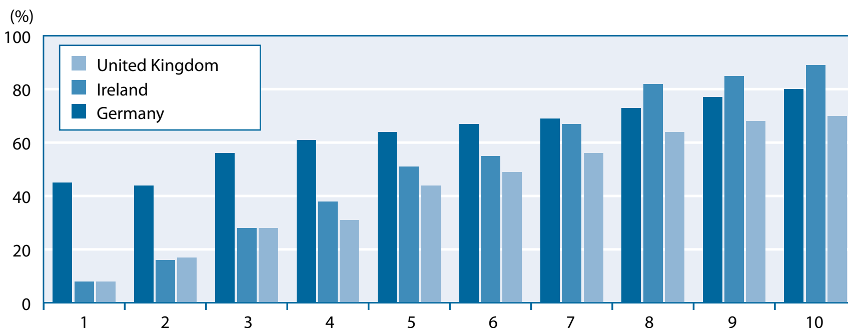
Indeed when a number of Member States (Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden) recently reshaped their statutory schemes by introducing a mandatory component of funded, privately managed pension schemes to complement the traditional statutory unfunded tier, they created an entirely new mix of public regulation and private management in European pensions, even though in most of these cases the transition is not yet complete and some important policy decisions remain to be taken.

## ... but varied

The current role of private pension schemes differs widely across Member States, not only regarding their contribution to the total income of retired people but also in terms of levels of coverage of active members, maturity of schemes and size of accumulated funds.

As shown in the table below, Member States broadly fall into four categories when it comes to how and the extent to which they use private pension schemes.

### Voluntary coverage rates by deciles of income




*Source:* OECD 'Coverage of funded pension plans' [DAF/AS/WD/PEN(2007)].

## Use of private pension schemes across the EU

| Member States fall in to four categories, i.e. those that | Examples |
|---|---|
| use little private funding and do not intend to change this even though there has been some marginal increase in private scheme coverage. | Spain, France, Luxembourg, Malta |
| have always based part of their pension promises on private, funded schemes but where the role of such schemes has increased and is still evolving. While pay-as-you-go schemes provide effective protection against pensioner poverty, they will not necessarily secure full pension adequacy in the sense of replacement income, therefore they are combined with private, funded schemes. | Denmark, Ireland, the Netherlands, Sweden (*), the United Kingdom |
| recently have reshaped their statutory systems to include a tier of mandatory funded, private pension schemes and financed these by shifting parts of the overall pension contribution away from the pay-as-you-go scheme. In most of these countries significant parts of the future adequacy of pensions is set to be based on these schemes which are expected to contribute to poverty avoidance as well as adequate income replacement. | Bulgaria, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia, Sweden (*) |
| have earnings-related pay-as-you-go social insurance pension schemes but are now shifting parts of their adequacy promise to an expansion of existing or newly created pre-funded, private pension schemes. | Belgium, Germany, Italy, Austria |

*(*) Sweden falls within two categories.*

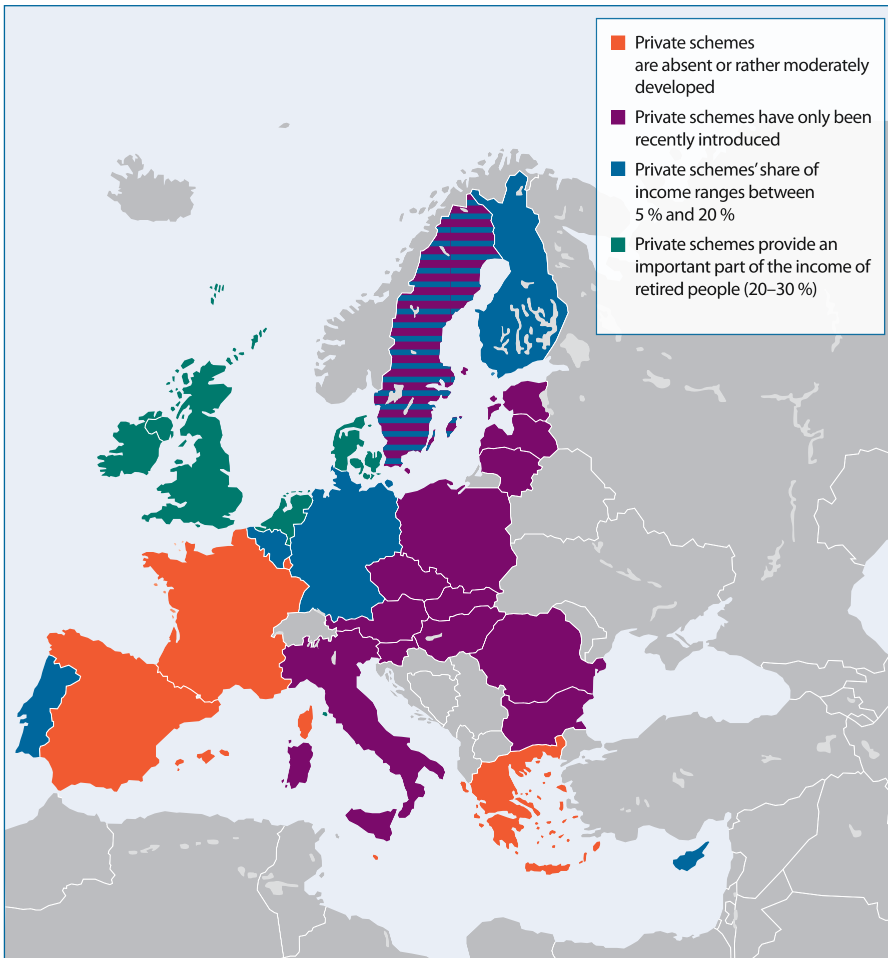
The current overall contribution of private pension schemes to the income of retired people varies greatly across the EU. Indeed a lack of agreed measures, combined with contrasting systems and the possibility of double counting (when coverage from various sources is added) means that at present there are no readily comparable international data sets in this field. It is therefore difficult to accurately determine coverage and contribution levels.

In the vast majority of Member States, pay-as-you-go statutory publicly managed pension schemes provide the dominant proportion of pensioners' incomes. As private schemes provide complements of income to pensioners, their importance to a certain extent reflects the scale of the public pay-as-you-go provision. But where they are not simply mandated factors such as the magnitude of tax expenditure and other subventions and the character of the industrial relations system (crucial for the spread of occupational schemes) also influence their prevalence in major ways.

As many pre-funded schemes have only been introduced in the last decade and they take 30 to 40 years (i.e. the length of a work career) to mature, it is hardly surprising that in most Member States, the contribution of private pension schemes to the incomes of present pensioners remains rather limited. Even in those countries where

such schemes are most developed they presently contribute at most a third of the total income of retired people. This is because they only cover a limited part of today's pensioners and because most schemes are only still maturing. The map below demonstrates that their role is modest or almost negligible but will grow in a number of countries as a result of recent reforms.

## Contribution of private pension schemes varies across the EU



# Securing adequacy in funded, privately managed schemes

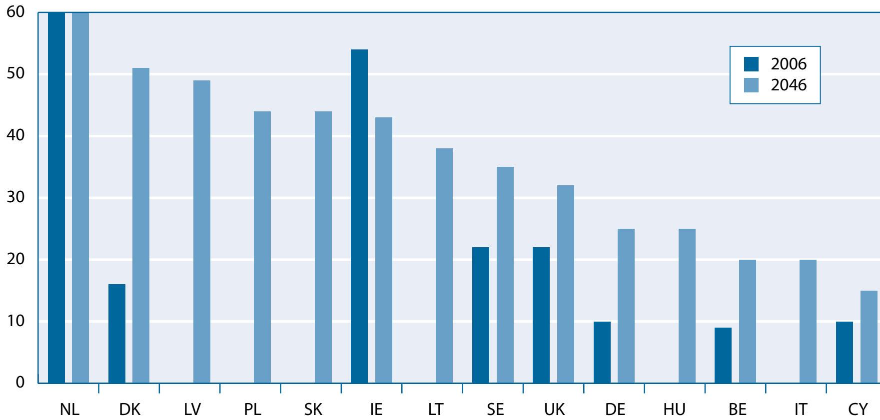
When governments assign a considerable role in pension provision to pre-funded, privately managed schemes they need to take account of the key social protection vulnerabilities in scheme design. These include aspects such as coverage and contribution levels, the management of the multiple risks associated with the accumulation and pay-out phases, the impact of charges and the need for information, financial education and monitoring of scheme performance. These are all issues which need to be tackled to make private schemes into fully dependable contributors to the adequacy of the overall pension package.

# Coverage and contribution levels

The overall contribution of private pension schemes to the income of retired people reflects the level of contributions, the coverage of such schemes, their maturity (i.e. the proportion of pensioners with a full career covered by the scheme) and their weight in the pension system.

Coverage and contribution levels of private schemes should reflect their intended role in the overall pension system. If they are meant to be or become an essential component of retirement income for the whole population, coverage and contribution levels need to be high. If they are a top-up to other universal retirement provision to ensure similar replacement rates for all, then coverage may only need to be targeted at certain segments of the population. If coverage is optional for sponsors and voluntary for members, young and low-paid workers are least likely to be covered and most likely to have breaks in contributions.

### Estimated contributions of statutory funded, occupational and voluntary pension schemes to pensioners' income in 2006 and 2046 (% of theoretical replacement rates)




*Source:* 2008 SPC study 'Privately managed funded pension provision and their contribution to adequate and sustainable pensions', table 7

# Pension levels: a risky business

The adequacy of pension benefits in contributory pre-funded schemes is subject to a number of uncertainties and risks. Those covered may experience a break in their pension contribution records as a result of work career interruptions due to social events such as unemployment, sickness, maternity or caring duties (social risk). They may 'outlive' their capital (longevity risk), inflation may erode future pensions (inflation risk) and returns may become unexpectedly low or turn negative (financial risk). Furthermore, the combined effect of these risks is greater than the sum.

# Tackling career break risk

Most pension schemes were traditionally designed for men working long full-time careers as family 'breadwinners'. Women's pension needs were met through their husbands' contributions or, after his death, through widows' pensions complemented with child allowances. This approach is still reflected in the basic principles of many pension schemes, although Member States are progressively adapting their systems in accordance with existing Community law and in the light of higher labour market participation of women and aspirations to greater gender equality.

In schemes where benefits are closely related to contributions, career breaks with interruptions or substantial lowering of pension contributions raise concern about the future adequacy of pensions. Groups that tend to have more career breaks due to family duties, unemployment or sickness will be particularly affected. Women, the low-skilled and the low-paid may be at special risk.

### Defined benefit versus defined contribution schemes

The risks for beneficiaries in a funded, privately managed pension scheme differ markedly depending on whether it is designed as a 'defined benefit' (DB) or a 'defined contribution' (DC) scheme. In a DB pension scheme the financial and longevity risks are borne by the scheme sponsor. Benefits to members are typically based on a formula linked to members' wages and length of employment. By contrast, benefits to members in DC schemes are solely a function of the amount contributed by the member and the sponsor and any return on that investment. Thus in DC schemes it is members that have to bear the financial and longevity risks.

DB designs were typically used in older occupational schemes to emulate the benefit formula in civil servants' schemes. But the number of such schemes has been falling for years. Nearly all schemes established in the last 20 years are of the DC design. This goes for occupational as well as for statutory schemes. Thus where Member States have shifted part of their social security pension provision into privately managed funds with mandatory participation they have all used the DC design.

Career breaks generally have stronger effects on pension benefits in DC than in DB schemes. This is because the calculation of benefits in the latter are not necessarily as closely related to the contribution record of the beneficiary as in a DC scheme.

Thus DC schemes provide higher benefits for those that have longer working careers and smoother wages over their working life. Those who find themselves unemployed for long periods of their working lives or have broken work records for other reasons will be less well off in retirement. In Member States where funded pensions are expected to play a significantly higher role in the future, this could result in a greater incidence of pensioner poverty among vulnerable groups with poorer work and income records.

Depending on the exact role supplementary pensions are playing in any particular Member States' pension system, it may be important to pay contributions at a certain level or credit career breaks (in particular, unemployment, sickness/disability, maternity and parental breaks) to ensure the adequacy of final pension income. Some countries have introduced 'solidarity elements' into their statutory funded schemes. Others have also done so in occupational schemes, for example by compensating for certain periods outside active employment (e.g. with the state paying contributions during periods of childcare or unemployment). The costs of such rules may, however, be quite significant and also affect work incentives.

In Member States which rely more heavily on private provision, the link with minimum or means-tested universal income in retirement needs to be carefully designed. The provision of a means-tested retirement income may discourage saving for some, since additional income from savings could lead to a reduction in their entitlement for means-tested benefits. The UK, for example, has sought to tackle this issue using 'savings credit', a decreasing supplementary benefit which rewards savings by those who are eligible for means-tested benefits. Yet, tapering off assistance in this way is more expensive due to increased coverage. While encouraging take-up, the UK is therefore also reforming pension credit as part of its wider pension reform package to ensure that it remains appropriately targeted and cost-effective.

# Longevity risk: the pay-out phase

The organisation of the pay-out phase in private schemes impacts on the adequacy of benefits. Scheme design should offer sufficient protection against inflation and survivor risks and for longevity.

There are three broad groups of pay-out products.

> **Annuities** are most commonly used as pay-out products in mandatory or semi-mandatory DC pension schemes. They provide periodical payments to beneficiaries with insurance against biometric risks such as longevity and there is the possibility of survivors' protection in the event of death, based on the use of life expectancy tables.

> **Lump sums** provide a single payment to beneficiaries, leaving it to them to ensure that this provides a sufficient pool of income during retirement. In a significant proportion of countries, citizens may opt to take the whole or substantial proportion of retirement savings as lump sums.

> **Phased withdrawals** provide periodic payments, but without any insurance against the longevity risk, progressively diminishing the capital available.

Member States vary greatly as to whether scheme members can choose between annuities, phased withdrawals and lump-sum payments. In most countries where private, funded schemes are mandatory, annuities are compulsory (e.g. Estonia and Romania). There are also requirements to take up an annuity in some occupational pensions (e.g. the Netherlands), but elsewhere pension savings can be taken as lump sums under certain conditions (e.g. the UK).

## Only annuities protect against longevity risk

Annuities guarantee an income for life regardless of its eventual length and, as such, are the most secure means of providing an income in retirement. They are common in many countries (and for some, they constitute the only option available), but where voluntary they are not as prevalent as might be hoped. This is because people can be somewhat short-sighted regarding their financial future; in particular they tend to underestimate their life expectancy and often opt for phased withdrawals as this enables them to bequeath any remaining money. With annuities, the remaining stream of payments can only be inherited during a guaranteed period (if that option is chosen) and so can seem to be less attractive. As benefits from private schemes often complement life-time benefits from public schemes people may be tempted to take in their private pensions as lump sums in order to raise their short-term consumption. While this at times may make sense the envisaged contribution to pension adequacy from private schemes will hereafter be missing from their pension package. Although phased withdrawals or lump sums can sometimes be converted into annuities, this is rarely undertaken without compulsion. Since the risk that the beneficiary will outlive the money available is growing with rising longevity only annuities are fully suited to ensure adequacy.

# Balancing the financial risk

Rates of returns — i.e. the ratio of money gained or lost on an investment relative to the amount of money invested — tend to fluctuate significantly over time, posing significant risks for pension adequacy. If rates of return are lower, pension savers need to stay in the labour market for more years to contribute longer and ensure the same level of benefits. Thus, to provide people with adequate information on their expected pension level on retirement, to take decisions regarding further labour market participation, assumptions about projected long-term rates of return need to be made with a reasonable level of accuracy. In this context, well-functioning financial supervisory bodies and effective financial regulatory frameworks are essential.

Future benefits depend both on net returns during the 'accumulation phase' and on the actuarial calculations that determine benefits in the 'pay-out phase'. Both of these phases are equally important and thus require careful design and supervision.

While legislators in most of the Member States have introduced measures to mitigate investment risks, few have brought in a direct mechanism of guarantees against investment risks in the accumulation phase. Regarding guarantees in the pay-out phase, there are increasing calls for financial service providers to have reinsurance to cover their liabilities if they should fail.

## Balancing risk, security and affordability

Measures to protect against financial risk have costs. Tight regulations aimed at short-term financial stability can become counterproductive if large and rapid increases in the levels of contributions are required to restore financial reserves after an economic downturn. Particularly since this may increase the cost of labour and reduce spending during a financial crisis, as was the case at the start of the last decade in the Netherlands.

Achieving an appropriate balance between the short-term security of pension schemes and the overall long-term robustness of the pension system remains a challenging task for policymakers and regulators. In the last decades, regulations have been loosened in many Member States to allow pension funds to seek greater returns by investing a larger share of funds in more risky assets. Losses in the present crisis have raised calls for tighter regulation of pension fund investments.

Minimum returns can be used to protect savings against investment risks, but such guarantees imply costs. These may be both direct — payment of an insurance premium in the case of a capital guarantee — and indirect — through lower overall returns because the provider opts for a conservative investment strategy aimed merely at meeting the target set by the minimum return.

## Protecting benefit levels

Benefit levels may also obtain important protection against investment risk by altering individual portfolio structures when people are approaching retirement. It is thus advised to develop a lifecycle approach towards investments: with such a strategy, younger citizens choose riskier products with a higher chance of earning more over one's life; in contrast, people close to retirement select fixed interest products to avoid the risk of large drops in asset values before turning pension savings into annuities.

As prices of annuities will vary, the exact month in which assets are 'annuitised' may significantly affect the sum of benefits received. It is therefore important that regulators allow for some flexibility in the time frame within which assets have to be turned into annuities.

# The impact of charges and costs

Administrative charges levied by pension funds can represent significant costs and as such significantly reduce pension levels. This may be particularly serious for low-income earners, who may have difficulty accruing adequate benefit levels. For private, funded pension schemes, administrative costs are a key variable to consider. Differences in costs add up to huge differences in pension benefits in the long run: for instance a yearly charge of 1 % of assets will, over 40 years, consume as much as 20 % of total contributions [1]. Thus governments have a clear role in keeping costs low and facilitating accumulations of adequate levels of future pension benefits. The challenge is how to regulate the fee structure so as to maintain a proper incentive design for fund participants as well as for fund managers. Policies used by Member States vary from soft to strict regulation of charges.

## Setting caps on charges

In a context of low transparency, customer choice and information disclosure is unlikely to deliver low costs by itself. Specific regulation, in particular through caps on charges, is therefore likely to be needed. Thus, some Member States have set cost caps on management fees, or in terms of the synthetic cost indicators, for instance in the UK. In other countries, limits are put on the cost structure. In Italy, for example, the duplication of management fees is not allowed: this discourages pension scheme asset managers from investing in mutual funds managed by other fund management companies.

There are, however, also downsides to cost caps. For example, they may have ambiguous information content: while they may prevent products with excessive costs being offered in the market, they may also limit competition by signalling as 'acceptable' a particular level of cost that is not necessarily optimal.

(1) If a person saves 100 currency units per year for 40 years, that would make 4 000 currency units by the end of his or her career (for simplification, inflation and the real rate of return equal zero). If administrative charges amount to 1 % of assets per year, the accumulated charges after 40 years amount to about 720 currency units. This means that the level of charges as a percentage of total contributions made would amount to around 18 %.

# Better financial education is needed

With the introduction of funded, privately managed schemes, pension systems have become far more complex. People may be asked to choose between various pension scheme providers and they are presented with options concerning the investment of their contributions. For incentives in scheme design to work and for pension markets to function, people increasingly need to make informed decisions about pension products, their savings and about the length of their working life and the timing of their retirement. As scheme members are asked to take more responsibility for their pension they need to better understand financial issues in order to make informed choices. Indeed, those who are less 'financially literate' are less likely to benefit from more complex financial arrangements and therefore less likely to save for retirement. Without financial education, those who are confronted with a wide choice or complexity will tend towards inactivity. This underlines the necessity to use automatic enrolment and default options for workers who may not be motivated to make informed choices.

## Promoting financial education

Education differs from information as the former combines the latter with skill building and motivation to change behaviour. Both have been found to be successful: for example, an awareness campaign was undertaken in Ireland to promote understanding of how the pension system worked. The action saw a simultaneous increase in take-up of personal retirement accounts, particularly among its target age bracket of 25–35 year-olds. As such, awareness in combination with financial literacy may not only improve the situation of the specific customer, but also boost the financial services market by making it more competitive.

Two studies on Member State initiatives to provide financial education have found that information is provided by a range of sources from financial supervisory authorities, adult literacy agencies, debt advice clinics, social workers, financial industry federations, microfinance organisations, consumer representatives, education authorities, individual financial firms and housing authorities [2]. Above all, though, national authorities were identified as the main drivers of such initiatives.

The European Commission's recent communication outlining the basic principles for the provision of high-quality financial education schemes shows its support for such actions [3]. It has also established the 'Dolceta' website offering consumer education on each national market in Community languages.

(2) Observatoire du Crédit et de l'Endettement et al., FES (2007), 'Better access to financial services and financial education', Report of the survey on financial education, April 2007, and Evers and Jung (2007), 'Survey on financial literacy schemes in the EU-27', November 2007.

(3) http://ec.europa.eu/internal_market/finservices-retail/docs/capability/communication_en.pdf

## Enhanced information

While guidance and regulation differs greatly between countries, there are certain discernible trends — not least towards greater simplicity. In particular, the need to use simpler language to avoid confusing citizens has been highlighted (in Ireland and Spain, for example).

Information should be tailored according to people's needs and their circumstances. General guidance is not appropriate for all individuals and, in attempting to offer clear and simple information, there is a danger that it may be made so generic that it becomes meaningless. This has led to calls for personalised advice although this may be expensive and difficult to implement.

Any sort of information, particularly personalised, also raises the issue of liability. Whoever supplies the information may also be seen as liable for its quality and use. As such, suppliers can be reluctant to provide any form of information that might be construed as advice beyond the generic through fear of being held responsible for any unforeseen results.

# The impact of tax policy

The ultimate goal of tax relief to funded, privately managed pension schemes is to reward private saving in order to ensure a higher standard of living in retirement, both by encouraging more private saving and by contributing to the final sum. The efficiency and cost of these tools clearly depend on whether additional savings are made. There are many differing factors that can influence peoples' pension saving such as advice from financial advisers and encouragement from employers.

Within this framework, a number of Member States consider that tax relief plays an important role as an incentive for individuals to join and participate in pension schemes. Providing such tax relief can be expensive. The Organisation for Economic Cooperation and Development (OECD) projections suggest that, while demographic changes will mean an increase in revenues from taxation of pension income from funded schemes, the costs of tax relief will continue to outweigh revenues collected ([4]).

([4]) Pablo Antolin, Alain de Serres and Christine de la Maisonneuve (2004), 'Long-term budgetary implications of tax-favoured retirement plans', Economics Department Working Papers No 393, OECD.

## Benefits of tax incentives are uncertain

Furthermore, there is a lack of clear evidence for the efficacy of using tax relief to encourage citizens to invest more in pensions. For instance, it is not clear that tax subventions actually create additional savings rather than simply diverting existing savings. If savings are merely diverted, tax relief will be both expensive and inefficient as it rewards savings that would have taken place without it.

Another issue regarding tax relief is who benefits both in terms of greater incentives and greater savings. Evidence from the US 401(k) pension plans shows that middle and lower earners are more likely to respond to saving incentives with 'saving creation', and higher earners with 'saving displacement' [5]. However, while this might suggest that tax relief is better targeted at those with lower to middle incomes, evidence from the USA, UK and Canada also suggests that the take-up is higher among higher earners (in terms of participation and contribution levels) [6]. The design of certain tax relief systems seems thus to favour higher earners, while the complicated nature of tax relief can result in confusion. What is more, it is often only those on higher incomes who have access to independent financial advice to take full advantage of tax relief.

In some Member States, there are additional advantages for individual pension savings through direct state support (e.g. Germany and Austria). Matching contributions or significant pension contribution subsidies allow the targeting of lower earners who need to save more, and would offer much better value for money for smaller savers. It is also much easier to understand and so would better target those without financial advice.

Given the lack of clear evidence regarding the fiscal incentives of tax relief and the substantial costs to public budgets, there is scope for Member States to look at tax relief options, particularly regarding the effects on adequacy and sustainability.

(5) Sheena S. Iyengar, Wei Jiang and Gur Huberman, 'How much choice is too much?: Contributions to 401(k) retirement plans'.

(6) Pablo Antolin, Alain de Serres and Christine de la Maisonneuve (2004), 'Long-term budgetary implications of tax-favoured retirement plans', Economics Department Working Papers No 393, OECD, June.

# Better monitoring needed

There is a growing trend to shift the risk away from the state towards private institutions and individuals. Such a strategy may look financially sound but, if adequacy problems arise, the responsibility for guaranteeing it may again fall on the state. As such, the development of funded pensions and their potential effects on adequacy needs to be monitored and more comparable information is required from Member States.

Indeed, with the growing importance of private pensions, major improvements of the tools to monitor them are called for. In some Member States data are broken down by different criteria but in others data gathering and data breakdown is far more limited — particularly those where private schemes have recently been introduced. Extensive information is required to understand the full impact of a greater reliance on private pension saving — particularly to gauge future incomes in retirement and identify those groups who are not saving and so may experience lower incomes in retirement.

Currently the relative impacts of different policies in Member States cannot accurately be compared. Their relative merits therefore remain somewhat obscured. Countries would benefit from more extensive and comparable information to better understand the impacts of their policies and to better evaluate them once implemented.

Further efforts are needed to enhance the framework of funded pensions (in particular statutory ones). There is a clear need to enhance the monitoring of the development of funded pensions and their potential effects on adequacy. Tools need to be developed to monitor future advances as well as to better assess the current situation; in particular, cross-country comparability and reliability of national data need to be ensured (for example, solving the issue of coverage and double counting of individuals participating in private pension schemes). Independent sources of data are in development, however, in particular from Eurostat and the OECD (see box).

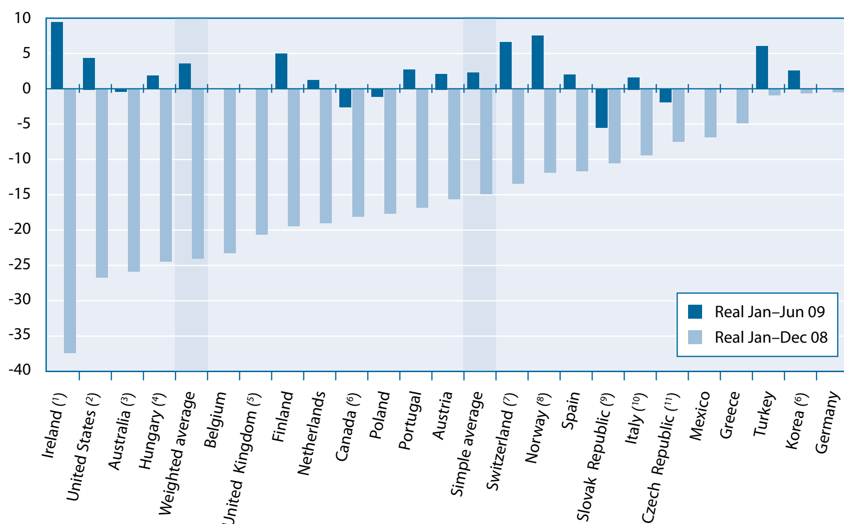
## Sources of harmonised data remain in development

| Source | Data available |
|---|---|
| **Eurostat — European system of integrated social protection statistics (ESSPROS)** | Pension expenditure is broken down on the basis of types of benefits paid out, contributions depending on the type of contribution (employer, government, employees).<br>http://epp.eurostat.ec.europa.eu/portal/page/portal/living_conditions_and_social_protection/introduction/social_protection |
| **Eurostat — Structural business statistics (SBS)** | Occupational schemes (with the exception of Spain and Portugal where the statistical data include both occupational schemes and individual schemes) broken down by variables on the number of members, pension fund demographic and variables on accounting, internationalisation and employment.<br>http://epp.eurostat.ec.europa.eu/portal/page/portal/european_business/data/database |
| **Eurostat — EU statistics on income and living conditions (SILC)** | Breakdowns of disposable income (including all types of pension and survivor benefits) and variables on individual private pensions.<br>http://epp.eurostat.ec.europa.eu/portal/page/portal/living_conditions_and_social_protection/introduction/income_social_inclusion_living_conditions |
| **OECD — Global pension statistics (GPS)** | For funded pension schemes, including funded and book reserved pension schemes, as well as pension insurance contracts that are workplace-based or accessed directly in retail markets (personal pension schemes). Mandatory and voluntary arrangements are included. Data include schemes where benefits are paid by a private sector entity (classified as private pension schemes by the OECD) as well as those paid by a public sector entity.<br>www.oecd.org/daf/pensions/gps |
| **OECD — EU 2007 Survey** | It provides elements on the distribution of membership by status (active, deferred members and retirees) and by earnings brackets (e.g. less than average wage, from average wage to two average wages, more than two average wages), age brackets and gender for some Member States.<br>http://www.oecd.org/document/8/0,3343,en_2649_34111_38958856_1_1_1_1,00.html#contents |

# The impact of the crisis

At the time of the adoption of the report (April 2008) on which this booklet is based the increased importance of pre-funded schemes in the overall pension package envisaged by Member States can be illustrated in the figure below. It depicts the trajectories in coverage and share of pensioner income which pre-funded schemes were expected to take in various Member States until 2050.

## Pension fund's real return on investment in selected OECD countries



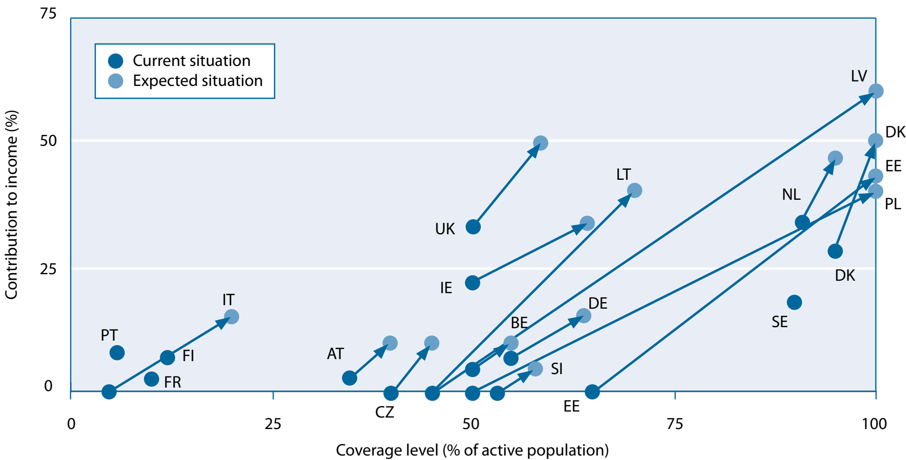

(1) 'Jan–Jun 2009' investment rate of return is an OECD estimate.
(2) Estimate including IRAs.
(3) Data refer to APRA-regulated entities with more than four members and at least AU$50m in total assets. Return on assets is net earnings after tax divided by the average assets for the period.
(4) Data refer to mandatory pension funds. Nominal return data for voluntary pension funds are 4.63 % (-10.67 % for 2008).
(5) 'Jan–Dec 2008' investment rate of return is an OECD estimate.
(6) Data refer to the period January–March 2009.
(7) Data refer to January–August 2009.
(8) Data relates to a selection consisting of the largest private and municipal pension funds, accounting for about 80 % of aggregate total assets.
(9) Data refer to the second pillar pension funds. Nominal return data for third pillar pension funds are -0.16 % (-1.93 % for 2008).
(10) Data refer to contractual pension funds. Nominal return data for open pension funds are 3.0 % (-14.0 % for 2008).
(11) Estimated data. The net return for investors equals 0.34 % for 2008, after extra funding by the fund managers.

*Source:* OECD Global Pension Statistics and OECD estimates.

Yet with the sudden onset in the early autumn of 2008 of a financial crisis of unprecedented scope and the subsequent deep economic downturn, funded pension schemes have suffered a major reduction in the book value of their assets from which they still have to recover. As illustrated in the OECD figure above, pension funds across Europe had by November 2008 already experienced a negative real return on their investments in the magnitude of 15 to 35 %.

The subsequent steep economic downturn and rapidly rising unemployment has made it difficult to sustain the hopeful expectations that rapid growth would allow active wage earners to build up extra funded pensions for themselves at the same time as they financed pensions for their parents and grandparents. Indeed a number of the more ambitious countries have had to revisit their plans and temporarily shift part of the contribution for the funded scheme back to the financing of the pay-as-you-go scheme and thus extend the timeframe for the build-up of pension funds.

## Future trajectories in coverage and share of pensioner income from funded schemes; stylised illustration



# Conclusions

The expansion of pre-funded private pensions as supplement to pay-as-you-go statutory schemes has innovated and potentially strengthened the ability of many Member States to deliver adequate and sustainable pensions. As scheme designs in several Member States often are neither finished nor fully optimal there is great scope for improving the overall performance of pension funds as vehicles of social protection. Moreover, the crisis has revealed the vulnerability of funded schemes to volatility in financial markets and highlighted the need for policymakers, regulators and supervisors to promote more prudent management of people's retirement savings. With a wide range in the losses incurred and with even greater variety in capacities to absorb the shock, differences in pension fund designs and investment strategies clearly matter. From the variance in impacts across the Union important lessons can be drawn about how funded schemes can be improved and a better balance between risk, security and affordability for pension savers achieved. Accordingly in several Member States a new agenda is emerging for necessary changes to funded designs and for speedy completion of the unfinished parts of the new mandatory schemes — for example, concerning more secure default options, life-styling, charge capping, rules for annuitisation, the pay-out phase and capacity for shock absorption. Fulfilling this will be an important part of rebuilding and maintaining public confidence in funded, privately managed pensions. The crisis has furthermore underlined how pension funds as significant operators will have to be included in measures to stabilise financial markets. In this as in the other areas the need for better regulation may also have a European dimension.

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