Keynote Speech

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INTRODUCTION

Thank you for the opportunity to give a keynote address at this interesting conference.

EUROPEAN UNION's (EU's) ROLE

I should start by explaining the EU-level role in pensions. The design of pension schemes is largely the responsibility of Member States, and the organisation of social security is the prerogative of Member States. Unsurprisingly, pension systems, their structure and composition differ widely among Member States, reflecting national preferences and historical issues.

The EU regulatory framework is limited, and covers four points:

1. cross-border coordination to facilitate the free movement of workers and equal treatment of workers who change country; this involves rules on the co-ordination of social security

and a directive ensuring that people with supplementary pension rights who change country are treated no worse than those moving within a Member State;

2. minimum standards on investment and funding rules for funded occupational schemes, as well as solvency rules for insurance-based pensions, as discussed earlier with Mr Tertak;
3. minimum guarantees concerning occupational pensions and accrued rights in case of the insolvency of enterprises as sponsors; and
4. anti-discrimination rules applying to both statutory and private pension schemes.

But beyond this, Member States and the Commission consider it useful to cooperate on pension policy. This coordination process is called the Open Method of Coordination (OMC). It is used to facilitate and promote national reform, share best practice and set high-level objectives and indicators. At EU level, the agreed objectives for pension systems are that they are adequate and sustainable, as well as being modern and transparent.

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Our work with Member States on the OMC shows that funded pensions of one kind or another play an important role in trying to meet these aims in a significant number of Member States. And their role is growing. Faced with the challenge of demographic ageing, more funded pensions is one of the key policy responses we have seen, the other responses being encouraging more people to work more and longer and reducing the generosity of pension systems, all else being equal.

This greater emphasis on funding takes many forms. We have seen reserve funds backing Pay-As-You-Go schemes, mandatory statutory pension schemes and individual voluntary pension schemes, as well as workplace pensions. But it is important to note that, even with these reforms, Pay-As-You-Go pensions will still remain the most important element of overall pension provision for the average worker in Europe.

ROLE OF FUNDED OCCUPATIONAL PENSION SCHEMES

But in my speech today, I am going to concentrate on funded pensions in the workplace. So it is perhaps particularly appropriate that I'm giving this speech at this conference here in the United Kingdom, which has a long history of occupational pension provision.

Traditionally, occupational pension schemes play a significant role in some Member States, like the United Kingdom, covering substantial elements of the retirement income of a major group of workers. This reflects the social partner's decision to take responsibility for retirement incomes, as well as the responsibility of employers to consider retirement income as part of the remuneration package.

In general, occupational funded pensions are the most significant form of funded provision for people retiring today, particularly in the Netherlands, Ireland, Sweden, and, as I have mentioned, the United Kingdom. Belgium, Cyprus, Denmark and Germany also have pertinent occupational provision for those retiring today. Traditionally, these schemes have been, for these countries, Defined Benefit (DB). In the future, occupational pension schemes are

expected to be increasingly Defined Contribution (DC) and we can see this shift notably in the United Kingdom and Ireland. Also, we will perhaps see further growth of the so-called 'hybrid schemes' or 'collective DC schemes' – where at least some risks are shared between the sponsor, workers (future pensioners) and present pensioners.

But the 'Push to Funding' that we have seen as a key policy response to the demographic pressures facing pension systems has largely taken the form of the introduction of *statutory funded pensions*. Such pensions will gradually become more important, with Bulgaria, Estonia, Hungary, Italy, Latvia, Lithuania, Poland, Romania, Slovakia and Sweden all relying on statutory funded provision to some degree as an element of overall future pension income. These schemes are all DC.

Such funded pension provision intends to bring forward some of the pension costs that demographic change will bring and thus help with sustainability. But of course pre-funding statutory pensions means that over the next decade Pay-As-You-Go pensions need to continue to be paid while at the same time some social security pension contributions are also diverted into funded schemes. This can place strain on Members States' fiscal positions, as the current economic situation has made plain. For instance, Estonia and Latvia have had to reduce or halt the partial diversion of mandatory social security contributions to their funded statutory schemes. And Poland is also considering changes here.

Overall, *the reforms of statutory pension systems* (including mandatory funded schemes) will lead to a *considerable decline* in average replacement rates (of course a problematic term) from today to the end of the career of employees who have started working recently. For Poland, Portugal, Italy and Latvia this could reach 15–20 percentage points, and in Germany, France, Sweden, Belgium, Malta and Finland 10–15 percentage points. Of course, longer working careers can offset this. Indeed, these and other changes are designed to encourage more people to work more and longer, as a key way to

complete the circle of pensions that are both adequate and sustainable.

But Member States are also looking for other ways to close the adequacy gap resulting from these cuts, and to give people opportunities to save more for their retirement. This is where we come back to occupational pensions on the one hand and to *voluntary individual pension* provision on the other. The latter are a minor element today, except in the Czech Republic and Germany, and to a lesser extent the United Kingdom and Ireland. Germany is one of the few Member States anticipating significant strengthening of the individual voluntary type of provision with the *Riester* pensions. The *Riester* pension is an interesting case, as the authorities are making huge efforts to ensure that this type of pension savings is also used by lower-income groups through the use of not just tax credits, but also additional direct payments to incentivise participation for everyone.

The voluntary nature of both types of schemes raises problems – both tend to better cover people with better education and higher incomes. OMC work has shown a strong socio-economic gradient in private pension coverage. For instance, in the United Kingdom the poorest decile has coverage of just 8 per cent, whereas coverage reaches 70 per cent in the top earning decile.¹

Interestingly, Germany is also the country where a *new role for the workplace* emerges with regard to individual savings through a comparatively recent scheme called ‘*Entgeltumwandlung*’. A worker can place up to 4 per cent of earnings in collectively organised savings schemes of a DC nature. Denmark will also increase substantially the use of occupational schemes, while the UK intends to organise the new personal account programme at the workplace level. This should lead to occupational pensions becoming widespread among low earners at least in the Netherlands, Denmark, Sweden and the United Kingdom – while Germany might be the only country in which both types of non-statutory schemes will expand.

With these recent experiences, the advantage of involving the workplace has become more

visible: collective schemes have lower administrative and management costs. Such schemes do not need to make profits themselves, and can have a higher degree of independence from direct interests of financial market players. They do not lead to better coverage of lower-income groups *per se*, but in a workplace-based scheme can be more easily reached or at a lower cost. That said, one should be realistic as to how far one can go without some element of obligation. Innovative approaches such as the automatic enrolment planned for the United Kingdom’s personal accounts may be one way to improve coverage, short of full compulsion.

We observe a certain interest in occupational schemes in the new Member States as the future adequacy gap for low- and middle-income workers becomes visible, although there is as yet little movement in countries other than those where they play a traditional role.

Would there not be a role for occupational schemes and their representative bodies to share best practice with those who have little tradition and experience and even face scepticism because of the role of state enterprises as a key social policy tool in the (communist) past?

Through the OMC process we are also looking at ways to share best practice on occupational pension schemes. In particular, we hope to hold a peer review around how such schemes can best cope with shocks, notably learning from the events of the financial and economic crisis.

Although not the topic I am speaking on today, I should still emphasise that all these measures will not be sufficient if both the volume of employment and the length of the working life do not increase, and if – for many countries – labour market participation does not increase further. This is a major challenge against the current economic backdrop, but it is one that needs to be met.

THE FINANCIAL CRISIS – A SIGNAL THAT MORE PROGRESS IS NEEDED

The impact of the financial and economic crisis has proved an important wake-up call for pension

systems of all kinds around the world. In the short term, European systems have proved relatively robust, particularly for those already retired or nearing retirement. This is perhaps to be expected given that the long-term nature of pensions offers some natural protection from shocks. But for the future there are key lessons for all kinds of pension systems and all types of pension schemes. For funded pensions it is clear that a greater reliance on these schemes – and in particular DC funding – leaves people more vulnerable in the future if steps are not taken to try to mitigate investment and other risks.

For funded occupational pension schemes specifically I think there are two types of lesson from the crisis. First, there may be things that could be looked at to make such schemes more resilient for the long term. But second, I think occupational pension schemes also provide some useful lessons to other kinds of funded provision that proved more vulnerable in the crisis.

For the first type of lesson we need to look at DB and DC separately.

DB occupational schemes provide scheme members with some important protection from investment risk. But we have seen that employers are less and less willing to face this risk alone. In the United Kingdom in 2008, only around a quarter of DB schemes were open to new members, and we can expect this to have dropped further, given events.² It is a similar story of declining DB provision in Ireland.

In contrast in the Netherlands, where scheme members share the risk with employers, we have not seen anywhere near as strong a trend toward DB schemes closures. When funding levels fall in Dutch schemes, adjustment mechanisms via lower or zero indexation and/or increases in employee and employer contributions kick in. These mechanisms have been stretched to the limit by the crisis, and there may need to be some more fundamental changes, notably around pension ages, to cope with underlying structural issues exposed by the crisis. But in general, the mechanisms have been effective in sharing risk and re-balancing the pension schemes in a way that does not lead to wholesale scheme closures.

Of course this has meant some pain for pension scheme members, but clearly the outcome is better than outright scheme closure and a pure DC scheme. Indeed, this trade off is recognised in the United Kingdom, where on occasion there have been some *ad hoc* adjustments made to pension schemes via negotiation among the social partners. This ensures that schemes can remain open, although in exchange for less generous benefits, higher contributions from employees and later retirements.

This is part of a wider trend to develop more ‘hybrid’-type schemes, and the occupational pension universe is no longer a bi-polar one of pure DB or DC. Instead, they represent two extremes with intermediate options such as DB with conditional indexation, hybrid schemes and collective DC sitting between them.

So, to have a long-term future, DB schemes need to consider options to share and manage risk among all the partners in a fair and sustainable way. As I mentioned, we hope to use the OMC process to contribute to this thinking via a peer review.

Concerns have also been raised in DB schemes about the timing of calls for extra funding requirements and the timing of other recovery measures such as no indexation being put in place. Clearly both types of measures display a pro-cyclical nature, so looking at ways to smooth these impacts while not reducing the necessary funding rigour could be worthwhile.

Turning to lessons for DC occupational schemes, such schemes of course place the onus on the individual. Clearly moving to a more hybrid design that shares the risk would be optimal from the pension scheme member’s viewpoint. But failing that, the crisis has shown there are still things that can be done to protect scheme members. For instance, so-called ‘lifestyling’ investment options, which gradually and automatically reduce investment risk as a scheme member approaches retirement age, can help shield people from big falls in investments close to retirement. Although quite common in UK occupational DC schemes, lifestyling is by no means universal. Other options include nominal guarantees as seen in German schemes. At the

payout phase, annuities can provide investment and longevity protection, but again annuities are not universal in DC occupational schemes in Europe.

This brings me neatly on to the second type of lesson – those that other types of funded schemes can learn from occupational schemes. At a high level, one thing to consider may be developing occupational pension schemes to help support overall pension provision in countries that don't have such schemes at the moment. And as I mentioned, there may be a role for representative bodies in encouraging thinking in this area.

But, that aside, existing funded schemes that are not occupational schemes – typically mandatory statutory DC schemes – can often lag behind the best practices seen in the best DC occupational schemes. On investment practices I've noted that DC occupational schemes can use lifestyle investment approaches or nominal guarantees to mitigate some of the investment risk for scheme members. This is something other forms of DC provision can learn from. And there is evidence of renewed thinking on this in some Member States with statutory funded DC provision.

I think the other key point is around the payout phase. Rather surprisingly, payout phase design does not always seem to have been fully considered when mandatory DC schemes have been introduced. Indeed, in one country there is not yet even a settled policy on how such pensions will be paid out, even though they were introduced 10 years ago. Converting pension funds into annuities, as is the case with many occupational DC schemes, ensures that pensioners do not face investment and longevity risk once retired. So this is something other kinds of DC-funded pensions should seriously consider, although the timing of conversion into an annuity may need to be flexible.

Beyond these two key issues, there are a number of other areas where occupational schemes' best practice could be beneficial, such as good information for scheme members and low charges. Clearly some of this is aided by the

partnership and collective approach of occupational schemes. But it ought to still be possible to improve these areas in other kinds of schemes.

Indeed, we have seen action on this in Poland, where the Government has reduced the charge caps on the privately managed statutory funded schemes. On information, some peer review work we carried out as part of the OMC process made clear that many people in mandatory funded schemes did not fully understand or appreciate the risks they were running. So the crisis was a rude awakening for these people, and we need to ensure not only that the systems themselves are improved, but also that people are better informed.

CONCLUSIONS

Let me summarise.

In response to the demographic challenge, more people working more and longer is key to meeting the aim of having adequate and sustainable pension systems. However, funded pensions are also playing an important and growing role, though most of this growth is not in the occupational funded pensions sector. And existing occupational pensions are under pressure as perhaps never before. But if EU Member States are able to learn from each other's experiences, good occupational schemes can and should still have a strong future. And they can also inspire beneficial changes in other kinds of funded pension provision, notably funded statutory schemes.

Thank you again for this opportunity to speak and for your attention. I'll be happy to answer any questions in the time we have left.

REFERENCES AND NOTES

- 1 Table 6, page 16 of Joint Commission and SPC report 'Privately managed funded pension provision and their contribution to Adequate and sustainable pensions', http://ec.europa.eu/employment_social/spsi/docs/social_protection_committee/final_050608_en.pdf.
- 2 Purple Book (2008), Table 3.2, page 27 (published jointly by UK's Pension Regulator and Pension Protection Fund), http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/purple_book_dec_2008.pdf.