Original Article

European pension reform: A way forward

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ABSTRACT This article discusses the main challenges facing earnings-related pension systems in Europe and explores the roles of the financial sector, employers, national governments and the EU in addressing these challenges. The internal market and a deeper European capital market can help create a richer set of building blocks to build greater retirement security for European citizens. Governments should facilitate intergenerational risk sharing by issuing wage-indexed and longevity bonds. The financial sector must provide better retirement products. In particular, during the accumulation phase, interest rate and inflation risks should be managed with the pay-out phase already in mind. During the pay-out phase, annuity, health and care insurance should be optimized, using various securities supplied by governments. Employers can provide a valuable platform for transforming human capital in financial capital during the accumulation phase. They can also help to treasure the human capital of workers and to reinvent the retirement process.

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Earnings-related retirement systems in Europe are in deep crisis as a result of the toxic mixture of aging, the financial crisis and poorly functioning labor markets. Large pay-as-you-go (PAYG) schemes are vulnerable to low fertility rates, increased longevity and low retirement ages. Addressing these problems is all the more urgent now that the financial crisis has weakened the public finances. The financial turmoil and the associated low interest rates have also accelerated the demise of employer-provided defined-benefit plans. These plans are not sustainable in the face of aging because the associated lack of sufficient

collateral exposes the retirees to substantial macro-economic and firm-specific risks.

With governments and corporations retreating as risk sponsors, traditional DB plans are rapidly being replaced by DC plans in which households bear the risks. Unfortunately, the DC plans currently offered by the financial industry are poorly designed as earnings-related pensions for the middle class. DC plans do not yet work properly for the bulk of the population. Hence, institutional and financial innovation is urgently called for.

CRISIS CALLS FOR FINANCIAL AND SOCIAL INNOVATION

Europe thus faces three major challenges involving the financial sector, the government

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and the social partners, respectively. First, the financial sector should develop better retirement products and tackle the serious governance and agency issues originating in the financial illiteracy of most consumers.

Second, to restore financial stability within the EU, public finances should become more sustainable in the face of the rapidly aging European populations. More private provision of old-age insurance helps to restore fiscal and financial stability in Europe.

Third, employers and workers should develop, utilize and maintain human resources better. In this connection, social and cultural innovation is needed to reinvent the retirement process so that the labor market for older workers functions better and people can work longer. The pension crisis in Europe is mainly a retirement crisis, which is a labor-market crisis.

Later retirement also exploits and leads to longer healthier lives – the main source of rising welfare in rich European countries. On the one hand, by raising longevity and reducing morbidity, better health care makes human capital more durable and makes later retirement feasible. On the other hand, later retirement provides the labor resources for the labor-intensive health-care sector.

EUROPEAN MARKET IS KEY

The European internal market can play a major role in addressing these three challenges. Each country should devise its own pension system on the basis of its own preferences and specific circumstances. A ‘one size fits all’ pension system is not on the horizon. The EU, however, can help ensure that the internal market for pension products and services can develop further. In this way, each country has access to a richer set of building blocks to build more retirement security for its citizens.

A larger internal market offers more opportunities for specialization. The various agents can then focus on their core business and contract out other tasks to others. Indeed, in the pension business several distinct tasks can be distinguished, such as administration, communication, distribution, various advisory services, investment, custodian services and insurance. Some of these tasks will be

difficult to contract out to foreigners because local relationships are crucial. Such non-tradable services may be provided by fiduciary sponsors. These trusted parties act on behalf of often financially illiterate consumers in their interactions with the commercial financial industry and strengthen the buying power of these consumers. For other services, however, international trade is attractive to create more scope for specialization.

Also a deeper capital market with more tradable financial instruments can provide more building blocks for enhancing old-age security. In particular, a deeper capital market can facilitate better international risk sharing, provides more opportunities for international diversification and results in a more efficient allocation of capital.

In any case, basic earnings-related retirement provision for the middle class will always involve private–public partnerships. Pensions are very complicated ‘trust’ products that involve a long time horizon with substantial risks and are poorly understood by consumers. The associated market and individual failures are so serious that extensive involvement of governments and other institutions is required. The choice is not between markets and governments but the question is how various parties can best cooperate in the challenging task of providing retirement security: markets, the financial industry, employers, unions, individuals, public regulators and governments.

ACCUMULATION PHASE

Let us now consider the challenges in the accumulation and pay-out phases, beginning with the accumulation phase in which people work and accumulate their pensions.

Taking and hedging financial risks

During the accumulation phase, people are well advised to take some stock-market risk in order to benefit from the equity premium and, even more importantly, to ensure that their pension capital rises in line with wage increases so as to yield a stable replacement rate at retirement. Retirement savings thus remain a major source of risk-taking capital for the European economy. At the end of the working life, however, the share of stocks in

the portfolio should be gradually reduced. At the same time, interest rate and inflation risks should be managed throughout the accumulation phase. Indeed, we need innovative DC products – DC 2.0. These products should manage risks with the decumulation (pay-out) phase in mind. Hence, the asset-liability framework and associated liability driven investments should be applied to the balance sheet of individuals rather than that of pension funds.

Manage risks by using human capital

During the accumulation phase, risks should be acknowledged and communicated rather than be hidden on the balance sheet of pension funds. Only in this way can the workers manage these risks. After adverse investment shocks, for example, workers should be given the opportunity to save part of future wage increases so that they can still attain their retirement goals. Alternatively, they should invest more in human capital or move to another job so that they can exploit their talents longer. Indeed, human capital is the key toward a good retirement income. This requires a well-functioning labor market for older workers in which these workers enjoy a stronger position and are free to move around. Pension systems should therefore not discourage labor mobility. Hence, backloading of pension benefits or imposing vesting requirements should be phased out.

Governance

As regards the governance of pension schemes, employers can act as sponsors of the DC plans rather than as risk bearers (as they used to in the old-fashioned DB plans). Indeed, the workplace provides an excellent platform for collective DC plans. As trusted parties, employers can reduce transaction costs by transforming a costly retail product into a less costly wholesale product. In cooperation with trade unions, for example, employers can increase the buying power of workers in financial markets, arrange group insurance, and develop choice architecture addressing individual foibles. In all these ways, sponsors deal with the serious governance issues in providing long-term financial products to financially illiterate individuals.

PAY-OUT PHASE

Insurance perspective relevant only during pay-out phase

The investment perspective rather than the insurance perspective should be the dominant perspective during the accumulation phase. Indeed, more and more pension systems no longer insure macro longevity risk before retirement – and rightly so; retirement ages at which full benefits can be enjoyed should rise with longevity. In this way, the pay-out phase does not automatically rise with longevity. In view of limited insurance capacity for society as a whole, the insurance perspective on retirement should become relevant only at a rather late stage in the life cycle. To illustrate, insurance companies should take on only tail longevity risks. Solvency requirements for pension insurers should thus apply only to a relatively short pay-out phase.

Reinvent retirement on labor markets: A new phase of active aging

The desire to keep the pay-out phase relatively brief implies that the retirement process should be reinvented. Retirement should ideally become a gradual process during which people gradually phase out their career but keep involved in work. Between ages 60 and 75, labor income can be supplemented with some investment income. During this period of active aging, it is typically worthwhile to take on some limited investment risk.

Deferred annuities bundled with health insurance and care insurance

Governments should mandate that a substantial part of pension wealth be used around age 60 to acquire deferred annuities for the period beyond age 75. Mandating annuitization for the middle class prevents old-age poverty after age 75, thereby containing the fiscal costs of aging. Bundling annuities with mandatory private health and care insurance also contributes to this public goal.

Buying the deferred annuities already at age 60 prevents selection and contains transaction costs. Group insurance on the employment platform may

also help, while addressing agency issues by mobilizing buyer power. If employers do not take on this role, the government may have to take up this sponsor role for its citizens. Insurance companies can also transform the equity in one's home in annuity income while allowing people to continue to live in their home until death.

Government securities facilitate private pension insurance

Governments can help the private sector to offer old-age insurance by issuing new financial instruments, such as longevity bonds and wage-indexed or consumption-linked bonds. In this way, governments in fact offer guarantees. Market pricing prevents the underpricing of these guarantees. By thus allowing insurers to match their obligations, governments cut the costs of private old-age insurance by reducing the need for large solvency buffers of insurers.

Integrate Financial DC systems (FDC) and Notional DC systems (NDC) through life-cycle investment

In fact, tradable wage-linked bonds allow the private sector to integrate Notional DC and Financial (Funded) DC systems so as to facilitate optimal life-cycle investment. In particular, insurance companies hold wage-indexed bonds on behalf of retirees. At the same time, workers hold equities and are exposed to financial-market risk. In this way, FDC would in effect apply to the accumulation phase and NDC to the pay-out phase.

Intergenerational risk sharing with younger generations through government balance sheet

In addition, the government can facilitate intergenerational risk sharing with younger generations who lack sufficient financial capital to enter financial markets. In particular, governments can take on financial-market risks on its balance sheet by taxing pensions on a cash-flow basis. Moreover, through its power to tax labor income, governments can collateralize the human capital of young workers and thus exploit the associated risk-bearing potential of workers.

Replace PAYG benefits by tradable wage-linked bonds to facilitate financial and fiscal stability

By buying bonds from different EU countries, insurers can better diversify credit risks (of government defaults), thereby enhancing financial stability in the EU. In fact, governments may replace part of their earnings-related PAYG pensions by issuing tradable wage-linked securities to their citizens. Indeed, one can view current earnings-related PAYG schemes as governments forcing their citizens to buy bonds from their own national governments. This distorts a free European capital market. Replacing PAYG systems by tradable wage-indexed debt imposes more fiscal discipline on governments because capital markets must willingly absorb these securities. This additional market discipline contributes to long-run financial stability in Europe.

CONCLUSIONS

Let me conclude by outlining the roles of various key players in pension insurance: governments, employers and the financial industry.

The first core business of governments is to prevent old-age poverty through redistributive tax and transfer systems. To prevent moral hazard as a result of the guarantee not to let the elderly starve, governments should mandate their citizens to save for retirement. This does not necessarily mean, however, that the government should also administer these plans and act as a risk sponsor of these plans. The second core business of governments is to facilitate intergenerational risk sharing by issuing wage-indexed and longevity bonds. These financial instruments provide the building blocks for the private sector to provide earnings-related pensions.

As regards employers, they can provide a valuable platform for transforming human capital in financial capital during the accumulation phase. Together with unions, employers can act as agents of their workers in contracting out tasks to the financial industry, in increasing buying power and in fighting the behavioral quirks of these same workers. Employers can also help to treasure the human capital of workers, while providing

opportunities for flexible retirement so that workers can insure themselves on the labor market. Indeed, employers play a key role in reinventing the retirement process and stimulating active aging.

The financial sector should provide better retirement products. During the accumulation phase, investments should be managed with an eye on ultimate annuitization during the pay-out phase. During the pay-out phase, annuity, health and care insurance should be optimized using the various building blocks supplied by governments. Moreover, the own home should be exploited more as a way to insure old age.

Let me conclude with the role of the EU in all this. The EU should facilitate pension innovation by allowing countries to learn from each other. In other words, the internal markets for ideas should function better. The rich diversity of European pension system provides a great opportunity for countries to learn from each other. In addition, the EU should remove the

barriers pension systems impose on labor mobility; these barriers block a more efficient use of the human capital of elderly workers.

Whereas each country should set its own pension system on the basis of its own preferences and specific circumstances, the EU can help ensure that the internal market for pension products and services can develop further. In this way, each country has access to more building blocks for building retirement security for its citizens. Furthermore, the EU should deepen the European capital market by encouraging governments to make their PAYG promises tradable. By thus creating a deeper European capital market, the EU enhances a more efficient allocation of capital within Europe. Moreover, it facilitates intra-European risk sharing in which Europeans rely on each other for their retirement security. This is an important step toward greater economic and political unity and stability within Europe.