A Pot of Gold at the End of the Rainbow?

The Future of Pensions in the EU

Christian M. Stiefmueller

Finance Watch

Finance Watch Conference on Public Pensions

Brussels, 27 June 2017

Finance Watch

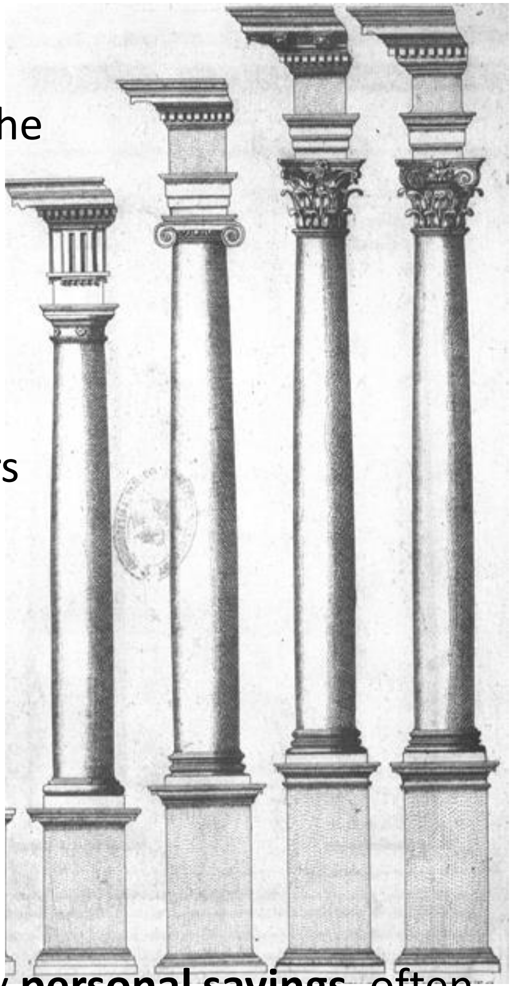
Making finance serve society

A fairly recent invention …

Bismarck	Beveridge
Approach	
– Earn retirement through work	– Prevention of old-age poverty
– Capital-funded (originally)	– Tax-funded
Experience	
– Long start-up phase, sustainable	– Flexible to implement
– Vulnerable to political, economic upheaval	– Vulnerable to demographic, economic deceleration
➔ **Requires stability**	➔ **Requires growth**

Pensions and pillars

Finance Watch
Making finance serve society



Pillar 1

- Statutory pension schemes provided by the State to the entire population subject to broad qualifying criteria
- Usually structured as **PAYG** schemes, sometimes in combination with capital-funded elements

Pillar 2

- Occupational pension schemes provided by employers to their **employees**
- Voluntary or mandatory, funded by contributions and structured usually as **capital-funded** schemes

Pillar 3

- **Individual** private pension schemes, usually through collective investment vehicles managed by public- or private-sector managers
- Structured as capital-funded (DC) schemes, funded by **personal savings**, often supported by the State with tax benefits

Trends and challenges

Finance Watch
Making finance serve society

Challenges

- **Demographics**
  - Declining population
  - Higher life expectancy
- **Employment**
  - Globalisation
  - Technological innovation
- **Inequality**
  - Income
  - Wealth
- **Public finances**
  - Fiscal capacity
  - Social security

Impact

- **Socio-economic**
  - Intergenerational contract
  - Social contract
- **Financial**
  - Liquidity of pension systems
  - Solvency of pension systems

EU population is changing …

Population decline

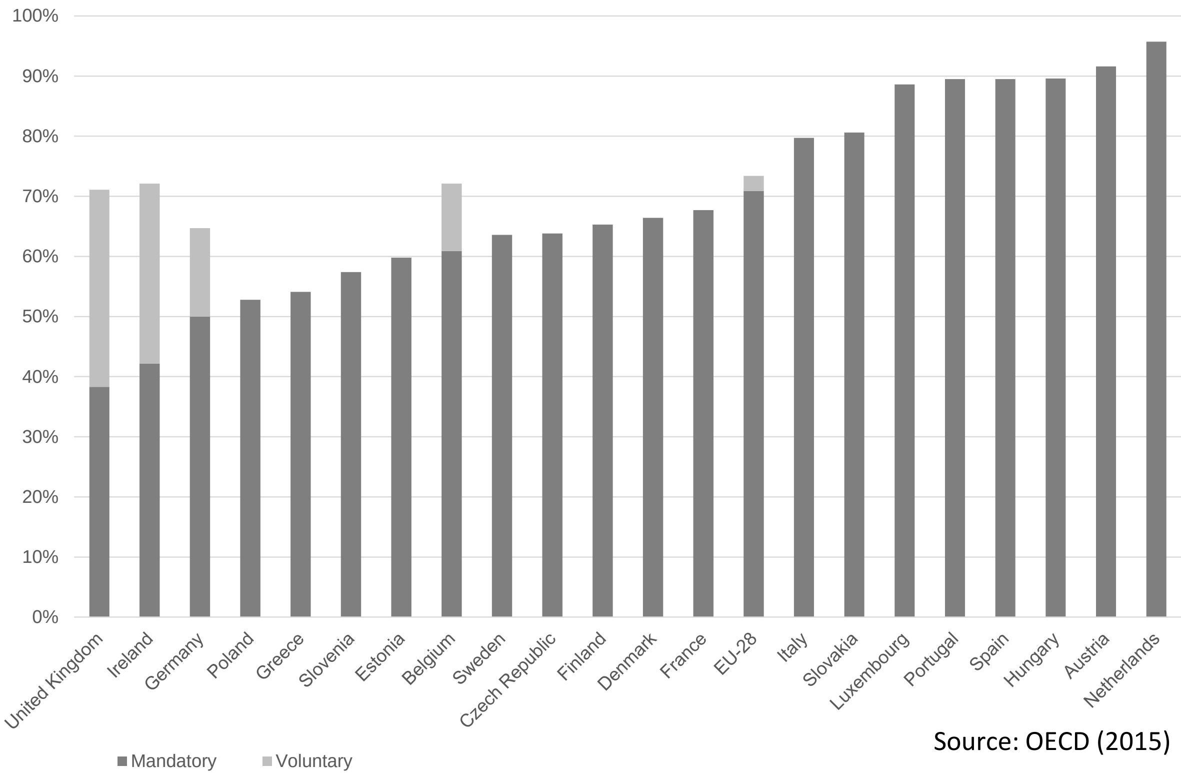
- The working-age population of the EU-28 is expected to shrink by 10% by 2080
- Fertility in the EU is, and is expected to remain, below the replacement rate

Longevity

- Life expectancy has increased steadily (to 78/83 years) and continues to do so
- By 2080, nearly 30% of the population is expected to be aged 65 or older

➔ The old-age dependency ratio in the EU-28 is likely to drop to 1:2 by 2080

Replacement rates



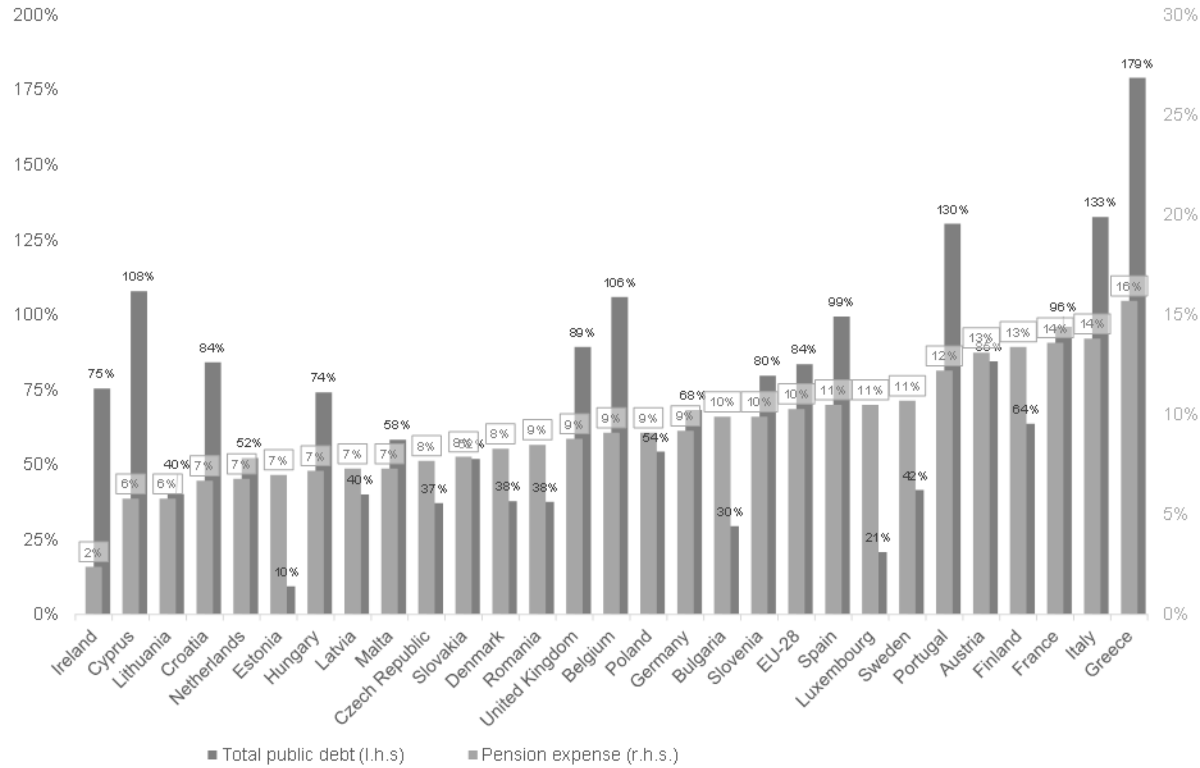
Source: OECD (2015)

- The average net replacement rate in the EU-28 was ca. 71% in 2014, covering a wide range from 38% in the UK to 96% in the Netherlands

➔ **Replacement rates are expected to decline by 10% over the next 40 years**

Public Finances

Finance Watch
Making finance serve society



- Retirement benefits account for ca. 10% of total public expenditure in the EU-28
- With public debt at 85% of GDP, fiscal headroom in many Member States is limited

Innovation

Finance Watch
Making finance serve society

- **Race against the machine**
  - The capabilities of AI and robotics are evolving, even at an exponential rate
  - Substitution of labour is a real threat – even if it has been fairly slow so far and geographically limited
- **Potential impact: potentially huge but uncertain**
  - Studies by Oxford University (2013) and McKinsey (2017): almost every second job in the US at risk
  - Similar studies by PwC (2017): 62 mn jobs in Germany, Italy, Spain, and the UK – depend on activities that could be automated in the next 10 to 15 years
  - More moderate estimates, e.g. OECD (2016): 6-12% of jobs in the EU-28 at risk

Prediction is very difficult, especially about the future.
Niels Bohr (attributed)

➔ **The pace and scale of technological change is difficult to predict but there is agreement that its impact is likely to be momentous**

Policy Implications

Finance Watch

Making finance serve society

Impact on pensions

	Pillar 1	*Pillar 2*	*Pillar 3*
Demographics	!!!	~	~
Public debt	!	~	~
Inequality	!	!!	!!!
Employment	!!!	!!	!

Pillar 1 policy options

- Higher PAYG contributions
- Lower PAYG entitlements
- Longer working lives

Pillar 2 and 3 policy options

- Continuity of employment
- Labour force mobility
- Administration of entitlements
- Prudential requirements

General observations

- Diversification of pension schemes
- Strengthening of capital-funded component
- Broader solutions to address underlying trends

PEPP: Promoting Pillar 3

SIMPLE

- A genuine retirement product, vesting at the statutory pension age
- A clear decision-making pathway, starting with a default option and a limited number of alternatives, subject to appropriateness testing
- A limited number of choices, based on a default option

SAFE

- A safety-first default option, protecting invested capital and generating income
- A choice of long-term investments but excluding complex, opaque instruments
- Portability and free-of-charge switching options, subject to holding periods

TRANSPARENT

- Standardised, comprehensive and accessible information based on KID model
- Full transparency on fees and charges, flat fees/caps on advisory fees
- Standardised value-for money benchmarks and performance metrics

PEPP: Issues

Taxation

- Differences in taxation of retirement savings – a major obstacle for integration of pan-European market for long-term capital
- Tax incentives play a major role in encouraging initial take-up of personal pensions BUT EU legislators have no competencies in the area of taxation
- EIOPA: strong views from stakeholders that it *"may be useful to harmonise tax treatment or to propose a solution to overcome this major issue"*

Other limitations

- Pillar 3 pensions currently play only a minor role in the EU-28, except for a small number of member states
- Take-up is also a function of disposable incomes and savings rates – which differ widely among member states

➔ **Co-operation by Member States will be critical for the success of the PEPP**

The bigger picture

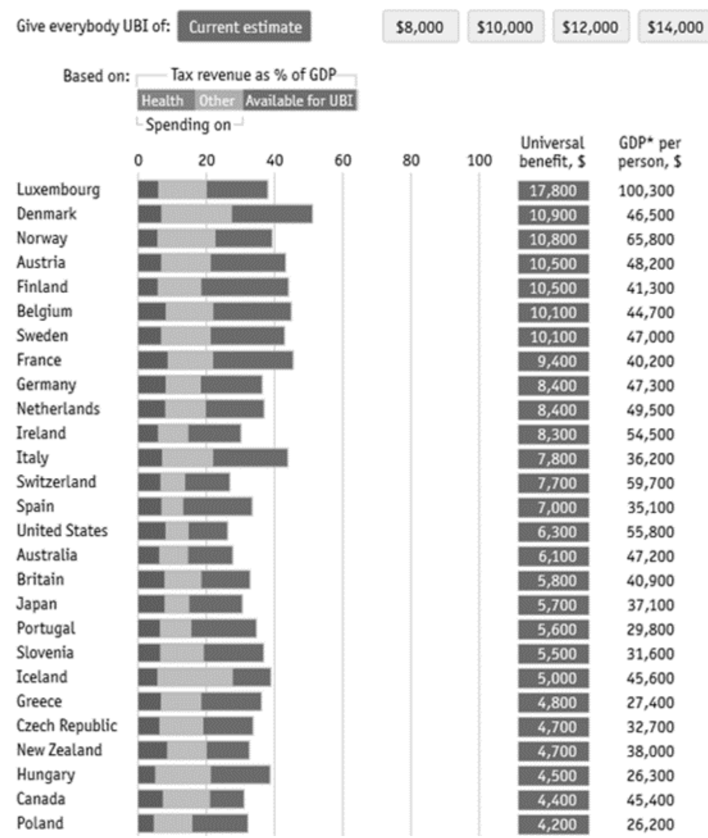
Finance Watch
Making finance serve society

Pensions and Social Security

– Exposure to demographic change (older labour force, longer working lives) and disruption in the labour markets concern all areas of social security

– Broader policy responses may be needed to redress the balance

– Alternative approaches, e.g. a Universal Basic Income, are being considered and trials are ongoing



Source: The Economist, OECD (2016)

➔ **More ambitious policy responses may be needed to rebalance adequacy and sustainability of Social Security in the EU**

Finance Watch

Making finance serve society

Thank you!