The Social Protection Committee

PRIVATELY MANAGED FUNDED PENSION PROVISION AND THEIR CONTRIBUTION TO ADEQUATE AND SUSTAINABLE PENSIONS

ADOPTED 2008

HIGHLIGHTS

- As private pension schemes are now used in a number of Member States to achieve the objectives of adequacy and sustainability, it has become essential to analyse the impact of their development on future pension levels.
- Substantial information gaps, lack of harmonised measures and comparable data. Problem of double counting when assessing coverage levels, leading to biased estimates.
- Great variation in coverage and contribution levels between Member States and schemes: depending on their role within the overall system, low coverage in supplementary pensions (together with breaks in contributions) can become a cause of concern for future adequacy, in particular for the most vulnerable groups (women, young, lower educated, low-paid).
- Tax incentives not likely to be effective in increasing savings levels in voluntary schemes for the whole population.
- Increasing shift of risks (employment, longevity and financial risks) from the pension provider (employer or State) to the individual: there is a need for better financial education, and the impact of career breaks on adequacy need careful consideration.
- Need for careful design of pay-out phase if adequacy to be properly addressed.
- Charges need to be kept low via regulation.

EXECUTIVE SUMMARY

This report reviews the development of privately managed funded pension provision, building on former work in this field within the OMC, in particular the 2005 SPC study on the growing importance of privately managed pensions and the 2006 Synthesis report on pensions. The contribution to future adequacy and sustainability of privately managed funded schemes is analysed and discussed, with an aim of facilitating the exchange of best practices and fostering mutual learning.

The study covers all statutory fully funded schemes as well as supplementary funded schemes, both occupational and voluntary. It does not cover reserve funds accumulated within the pay-as-you-go statutory schemes nor individual long-term savings which do not have specific pension purposes.

This SPC study provides an extensive and in-depth review of the field, notwithstanding substantial information gaps as no comparable data sets in this field exist, implying a lack of agreed measures and harmonised national or international data. In particular, the role and development of private funded

pension provision results to be very diverse across Member States. One common reason for a more extensive development of private pensions in some countries is the limited scope of income replacement of the public scheme: in these cases, private schemes have to contribute to an important extent to ensuring adequate replacement rates for pensioners. Other Member States have recently reshaped their statutory schemes by introducing a funded privately managed component to complement the traditional statutory unfunded tier. In many cases the transition is not yet complete and some important policy decisions still remain to be made. Finally, other Member States have shifted part of their adequacy promise to an expansion of existing or newly created supplementary private pension schemes.

A strong link exists between statutory unfunded and privately managed funded pension provision, as the latter is increasingly expected to provide an important contribution to meeting the demographic challenge to the current and future sustainability of the pension system. It is therefore essential to monitor closely the contribution to future adequacy and sustainability of pensions as well as its distributional outcomes.

The report emphasises the concept that future adequacy and future sustainability are linked and need to be necessarily seen together. A number of Member States have taken measures to ensure adequate funded pensions, dealing with sufficient coverage and contributions, levels of charges, developing regulatory framework for annuities (longevity risk) and investments (financial risk). Nevertheless, further research is needed on the side of adequacy, with a focus specifically on more vulnerable groups, lower and middle income individuals, on women and on people with incomplete careers. In particular, the following conclusions can be drawn:

- The appropriate coverage and contribution levels of private schemes depend on their **role in the overall pension system**. If they are an essential component of retirement income for the whole population then coverage clearly needs to be very high and contribution levels need to be set accordingly. In this respect, there is clear evidence of variations in coverage within voluntary schemes with the young and the less well off being least likely to be covered by non mandatory pensions and most likely to have breaks in contributions.

- Voluntary schemes encouraged by favourable tax treatment are generally not likely to be effective in increasing savings levels for the whole population. **Focused tax credits** might help, but whether they are sufficient to reach full coverage where that is an appropriate aim remains an open question. Furthermore, costs of tax treatments can be very significant and concerns have been raised about their redistributive effects.

- **Charges can represent significant costs** and as such significantly reduce pension levels, acting particularly negatively on lower incomes in certain circumstances. In a context of low transparency, voluntary choice and information disclosure alone is unlikely to deliver low costs. Specific regulation, in particular through caps on charges, is therefore likely to be needed. Given the low transparency and degree of comparability of levels of charges, there could be benefits from comparing and discussing how the presentation of charges differs among and within Member States.

- In the context of a stronger link between contributions and benefits that come with funded supplementary pensions, the **impact of career breaks on adequacy can be significant**. It therefore results more important to provide for coverage of career breaks (in particular unemployment, sickness/disability, maternity and parental breaks), focusing the attention in particular to more vulnerable groups such as women or atypical workers. However, the costs of such cover may be significant and also impact on work incentives, requiring careful thought as part of the wider pension system, including the interaction with minimum income provision.

- The current design of the **pay-out phase** of different funded schemes is insufficient for ensuring future adequacy and further steps have to be taken, to protect against longevity, inflation and survivorship risks. Annuities protect against longevity risk by guaranteeing an income for life and, as such, are the most secure means of providing an income in retirement. The option of taking a large share of pension benefits as lump sums can represent a serious threat to the adequacy of pensions. Furthermore, there seems to be very low survivorship protection or protection against inflation.

- Rates of returns tend to fluctuate significantly over time, posing significant risks. In this context, well-functioning financial supervisory bodies and effective **financial regulatory frameworks** are essential. Benefit levels can also be protected on an individual basis by appropriate shifts in the portfolio structure when approaching retirement (life styling) and by some flexibility in the time of pension take up. **Minimum returns** may help to support adequacy, but it is crucial to recognise that such guarantees do not come for free, implying both direct costs (insurance) and indirect costs (change in portfolio structure).
- The greater element of choice inherent in private pensions requires a clear understanding of financial issues on the part of individuals: there is indeed a concrete risk for those who have a lower level of **financial education** of suffering worse outcomes in retirement as a result of passive behaviour. Within such a context of complex decision-making, multi-dimensional and with a long-term perspective, availability of quality information may not be sufficient on its own, underlying the importance of campaigns and policies aimed at increasing awareness, allowing a better understanding of the pension system.
- **Shifting risks** from the State to private institutions and individuals may look financially sound, but problems can arise with the future adequacy, guaranteeing of which may once again be on the shoulders of the State. A clear need emerges as to enhance the monitoring of the development of funded pensions and their potential effects on adequacy and further efforts are needed to enhance the framework of funded pensions (in particular statutory ones). Tools need to be developed to monitor future advances as well as to better assess the current situation, for what concerns in particular cross-country comparability and reliability of national data (for example, solving the issue of coverage and double counting of individuals participating in private pension schemes).