Faced with ageing populations, most EU Member States have taken measures to reform their public pension systems with a view to preserving the sustainability of their public finances. Although considerable progress has been made, many Member States will need to do more still given the long-term trends they are facing.

In simple terms, the choice boils down to accepting either a further increase in retirement ages or reduced levels of public pension schemes’ provision. In the latter case, voluntary private pension products can play a central role in helping pensioners to maintain an adequate level of income. However, too many Europeans are still channelling their savings into bank deposits rather than supplementary pension schemes, despite lower returns.

This situation, which leads to an under-supply of long-term capital for investing in productive activities necessary to support sustainable economic growth, results from a number of supply and demand-side constraints that could be addressed through the creation of an effective European internal market for voluntary private pension products. This would both help pensioners to maximise their savings, while also supporting the long-term growth of the economy.

Unavoidable fall in public pensions
Retirement incomes from public pension schemes will fall if policy reforms to mitigate the impact of increased longevity and demographic change do not go further. The less the retirement age keeps pace with increased life expectancy, the more severe the drop will be.

Voluntary private schemes can improve pension adequacy
Voluntary private pension products can help to supplement the lower retirement incomes from public pension schemes. But, due to constraints on the supply and demand side, the EU internal market is having limited success in delivering cost-efficient and transparent private pension products, denying European savers the benefits of economies of scale, increased competition, lower prices and, ultimately, a higher return on their retirement savings.

Long-term capital crucial to economic growth
From a capital markets’ perspective, fostering the development of pensions savings would create an important source of long-term capital that could be used to fund long-term job and growth-creating projects in the Member States. It would also contribute to financial resilience by deepening European capital markets and reducing reliance on bank loans.

Long list of benefits
A legislative initiative at the EU level to address the shortcomings in the design of the internal market for private pension products through a pan-European pension product (PEPP) would entail significant benefits for all future pensioners and for the long-term growth potential of the EU.
Public finances and pension adequacy under pressure

Old-age dependency ratios rising across the board

By 2060, the total EU population will be somewhat larger than it was in 2013, but it will be much older, driven by improved living standards and medical progress, as well as lower fertility rates.

The working-age population in the EU-28 already started shrinking as of 2012, while the number of people in retirement is increasing.

Consequently, the number of pensioners that have to be supported by the working population will increase significantly: the EU’s demographic old-age dependency ratio (people aged 65 or above relative to those aged 15-64) is projected to increase from 31.4% in 2015 to 56.8% in 2060. This means going from having about four working-age people to support every person aged over 65 years to about two working-age people.

Although the distribution is uneven among Member States (Figure 1), all EU countries are expected to face a significant increase in their old-age dependency ratio, unless the people are required to work for longer periods of their lives.

Reform efforts have already been significant

Despite this, many Member States have already made significant efforts. The first wave of reforms took place between the mid-1990s and the mid-2000s and was characterised by a shift away from defined benefits (DB) to defined contribution (DC) designs and prefunding, rather than pay-as-you-go schemes.

The second wave of reforms took place after 2008 and focused on raising the pensionable age. Unlike prior reforms, there was little attempt to further shift assets from public pay-as-you-go schemes to privately funded ones. Measures included limiting access to early retirement; raising the age for early retirement; bringing up women’s pensionable age to the level of men’s, and increasing both; lengthening the contribution period; introducing an automatic indexation of retirement age to life expectancy; and easing limitations to combine work and pension. Increasing the pensionable age has the advantage of increasing the total contributions a worker can make, while also lowering the costs of retirement.

As a result of these thus-far enacted pension reforms, the rise in public pension spending, as a share of GDP over the long-term, is projected to be mitigated; continuing to increase until 2040, but then returning to 2013 levels by 2060 (albeit with large differences among Member States due to differences in public pension arrangements).

But decline in public pension levels is largely inevitable

From the perspective of future pensioners, a reduction of public pensions benefit levels will be largely unavoidable. Public pension replacement rates – i.e. the percentage of pre-retirement incomes that are paid out by a pension upon retirement – are expected to decline significantly over the next five decades (Figure 2). The average decline for the EU is 7.8 percentage points, with only Denmark, the Czech Republic and Cyprus seeing an increase. Some Member States, such as Spain, Portugal and Poland, will see a decline of over 20 percentage points in their public pension replacement rate.
Since the increase in retirement ages has not kept pace with increases in life expectancy and because the working age population is shrinking in relation to the number of pensioners, declining replacement rates from public pensions are, to some extent, unavoidable. Measures that increase the effective retirement age, i.e. that encourage workers to actually work up to the statutory retirement age, are important and could mitigate the drop in most Member States. And other policies could help to cushion the resulting reduction in income after retirement, such as easing restrictions on combining work and retirement, supporting the health and skills development of older workers, as well as increasing flexibility in work places and labour markets to enable older workers to remain in work for longer or to move into jobs which are better suited for them. Finally, promoting the build-up of supplementary retirement savings besides public pension systems (the so-called ‘1st pillar’), either through occupational (‘2nd pillar’) or private (‘3rd pillar’) schemes would help support replacement rates.

Capital markets can foster pension adequacy and growth

Savers often lack long-term perspective

Given these developments, it is important that future pensioners are able to maximise their retirement savings. Yet, today, European households tend to save for retirement in inefficient ways. While they should save for the long term, putting the money aside from an early age for a retirement that lies many years down the road, too many households continue to hold their savings to a disproportionate degree in bank accounts or even in cash. EU households held an average of 31% of their total financial assets in cash and deposits between 2007 and 2014 – against just 13% in the US.

In fact, the share of cash and deposits in the financial assets of euro area households increased from 29% in early 2000 to 34% in the third quarter of 2016 – albeit down from 36% in 2009 (Figure 3).

As such, future pensioners are missing out on higher returns that would be available if they committed their savings for longer periods (e.g. thanks to higher returns from illiquidity premia on investments, as well as lower turnover of investment portfolios and the lower administrative costs associated with this). It is worth noting that even slightly higher returns can have a significant impact on net gains over a long period.

Elusive patient capital

From a wider economic perspective, the fact that a large part of the EU’s financial wealth is held in cash or in short-term debt means that there is less capital available for longer-term investments.

Long-term investments are often less liquid and take time before they generate a profit. Such investments require what is often referred to as ‘patient capital’, i.e. investments made without the expectation of turning a quick profit but rather with a view to more substantial returns down the road.
Often these are investments that support productive economic activities such as:

- R&D and innovation, education and professional training;
- Infrastructures, including transport, energy and communication networks;
- Industrial technology transformation and long-term capital-intensive projects;
- Healthcare and other welfare related assets;
- Environmental and climate change-related technologies, and;
- Enterprises, including, in particular, SMEs, throughout all stages of their development.

In a context of declining productivity growth, it is all the more important to ensure that these types of productive projects receive the funding they need. This is particularly true given the current shortfall in aggregate investments in the EU.

However, cash is not available to the wider financial system, while deposits are short-term liabilities that banks are more likely to match with short-term assets in order to prevent a maturity mismatch that would expose them to liquidity risk. In fact, there is evidence that banks, which play a major role in financing the European economy, are considerably more likely to invest in shorter-term maturities than other institutional investors (pension funds and insurers), even if they also invest more overall in longer-term maturities (Figures 4, 5 & 6).

From a financial system perspective, this situation contributes to increased systemic instability given that short-term liabilities can be withdrawn at any moment. What is more, many banks have had – and partly still have – to undergo a painful process of deleveraging, which has reduced their long-term lending activity, as have the increased capital requirements in the context of the implementation of Basel III requirements at European level.

Institutional investors, on the other hand, with their primarily long-term liabilities, tend to invest relatively more in longer maturities and equity (more than one year) than investors with short-term liabilities (banks and money market funds) (Figures 4, 5 and 6).

These long-term investors (and those handling the funds on their behalf) do not have to react to short-term volatility in their investment strategies. This enables them to sit out periods of volatility and declining asset prices and instead keep their long-term strategy in mind. Also, long-term and large investors often engage with the companies they are investing in by making use of the voting rights they acquire, thereby improving corporate governance.

Source: European Central Bank, Statistical Data Warehouse
Note: These figures relate to Monetary Financial Institutions (MFIs) and hence include the assets of money market funds (MMFs). A disproportionately high share of MMFs in the short-term debt holdings for MFIs can be expected. However, total assets of Money Market Funds stood at €1.1 trillion compared to €30.2 trillion for Credit Institutions in Q3 2016, hence their overall share is very small.
By channelling more of Europeans’ savings from cash and bank deposits to longer-term investment products, such as voluntary pension schemes, the impact would therefore be beneficial both for individuals (who would benefit from higher returns and improved pension adequacy) and for the broader economy.

As part of the Capital Markets Union initiative, the European Commission is seeking to foster long-term investments, among others by lowering credit risk capital requirements for banks’ exposures to infrastructure as part of the Capital Requirements Regulation / Capital Requirements Directive (CRD).

Furthermore, in response to concerns that recent changes in financial regulation may hamper long-term investments especially by insurance companies, the European Commission has amended the Solvency II Delegated Act to reduce the risk charges for qualifying equity and debt investments in infrastructure projects and ELTIFs (European long-term investment funds). But more can still be done as part of the Capital Markets Union agenda, in particular by stimulating the recourse to voluntary private pensions schemes (see the United States’ experience in Box 1).
For many consumers, this is not a minor step as it requires considerable upfront costs to ensure legal conformity as the contract itself is the product they intend to sell. Barriers also result from potential double taxation where built-up capital is moved from one Member State to another, severely limiting the portability of pension claims. This variety of barriers means that pension providers tend to stay small and that cross-border activity remains very low (at just 4%), leading to very limited cross-border competition among suppliers and higher costs for consumers.

The current EU framework has been only partially effective in creating a thriving market for pension products. A number of Member States already have well-developed occupational (‘2nd pillar’) or private (‘3rd pillar’) pension funds that supplement public pension schemes. But this is not the case everywhere and there are a number of obstacles that are holding back the development of a thriving pension product market at EU level.

Deepening the internal market for pension products, by addressing cross-border barriers, would increase competition, enabling consumers to benefit from an improved quality of products and lower prices, while producers could benefit from economies of scale. As such, even Member States where demographic trends are favourable and whose pension systems are well funded, would benefit from a more effective internal market for personal pension products.

A closer look at the issues on the supply and the demand side that hinder the emergence of a true internal market for pension products can help to better understand the shortcomings of the market and of EU regulations, and derive potential remedies.

Fragmentation of national markets keep efficiency low and prices high

On the supply side, pension product providers face a number of hurdles that make it difficult for them to offer pension products across borders and at competitive prices, keeping producer rents high at the expense of consumers.

National barriers are manifold and relate to restrictions on the investment of pension funds (for instance in different currencies), transferability of funds, social, labour and contract law, but the most important barrier is tax legislation. Pension products, unlike other financial products, are linked to explicit retirement objectives set out in national income tax, social and labour laws, thereby distinguishing them from other long-term investment products, and making their cross-border provision more cumbersome. The eligibility for favourable tax treatment of contributions and investment income is often linked to the characteristics of the product, like its duration until reaching the tax-relevant retirement age, specific investment strategies or pay-out structures. The result is that pension product providers have to change the contract whenever they intend to sell it in another country. This is not a minor step as it requires considerable upfront costs to ensure legal conformity as the contract itself is the product they intend to sell. Barriers also result from potential double taxation where built-up capital is moved from one Member State to another, severely limiting the portability of pension claims.

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The high administrative costs of pension funds are well documented: in 2012 the costs associated with running pension schemes in the Netherlands amounted to 5-6 billion euro a year, equivalent to 20% of total annual pension contributions. This contributes to driving a wedge between the performance of capital markets and the real returns on pension savings. Even a small increase in fees can have considerable effect on the long-term return of the invested saving. A decrease of one percentage point in annual charges on assets results in a 27% increase in pension plan assets after 40 years of contributions. The current low-interest rate environment lowers returns on pension funds and makes it all the more important to ensure that less of the generated returns are eaten up by fees.

With the EU market size currently standing at over 1 trillion euro, the potential efficiency gains to be achieved through economies of scale and risk diversification thanks to the removal of national barriers can be expected to be considerable. Economies of scale for pension funds with respect to membership and assets under management are well documented in a number of countries and lead to lower fees. It is estimated that decreasing asset management costs by 0.25% could see pensions increase by 10% over a 40 year horizon.

Information asymmetry inherent to complex products keeps demand low

The main obstacle on the demand-side is the information asymmetry that is strong in financial services and financial products. For many consumers, financial products are too complex and difficult to understand. Consequently, they are less informed about the product and the service than the provider, resulting in a classical principal-agent problem and potential conflict-of-interest.
A number of prominent cases featuring ‘mis-sold’ financial products or financial service providers selling their own products at high costs rather than those of competitors, have reinforced mistrust with regard to the financial services industry at large. It is telling that personal pension products ranked third last in the European Commission’s latest consumer markets monitoring survey, which evaluates 13 goods and 29 services markets according to their performance in meeting consumer expectations, as well as on trust, comparability, and the occurrence of problems and complaints.\textsuperscript{25}

One important step would be to increase transparency and require the ongoing publication of information about the performance and expected future income from the retirement product. However, while greater transparency and robust governance requirements are essential to restoring trust – particularly in the aftermath of the economic and financial crisis triggered in 2007 – this is unlikely to address the asymmetric information on its own because the causes are manifold, such as uncertainty, low financial capability, time inconsistent behaviour and consumer inertia. Insights from behavioural economics and financial research show that, ‘when faced with uncertainty, risk and complexity, three attributes inherent to private pensions, consumers do not always behave rationally as defined by standard economic theory. They will often avoid or postpone decision-making even if it is in their best interest’.\textsuperscript{26}

This suggests that beyond transparency, the simplification of published information as well as of available choices can help to overcome these issues and address the limited financial literacy of many consumers. In a voluntary private pension scheme, the decision-making can, of course, not be entirely outsourced, but the number of available investment options can be limited.

The problem of information asymmetry is exacerbated by the ‘inverted production cycle’ of pension products which means that a buyer only effectively consumes and experiences the product upon retirement, when it is too late to change the product or provider. This feature makes it largely impossible to learn from previous experience. Standardisation of simplified information helps consumers to compare products and benchmark performance and hence overcome information asymmetry. Addressing these market failures at national and European level would improve the market for personal pensions in the EU (with the retail consumers being the primary beneficiary); increase labour mobility – as the pension product would be recognised throughout the EU and hence be portable; support the sustainability of public finance in light of demographic change; and unlock a large amount of long-term oriented capital. It would also spur innovation more rapidly than is arguably the case now, given the largely separated national markets. In short: the list of benefits of a deeper internal market for private pension products is long.

Box 2: Disintermediation and online distribution enable cost savings and higher returns

To date, most consumers access pension products through the service of an intermediary, such as an insurance company or a bank. Since the advice – which is part of the service – drives up costs and lowers the return on the savings made, it is questionable whether this is necessary for very basic investment options, or whether retail clients with a sufficient degree of financial literacy could be able to directly access pension products online, without intermediary services.

With the advent of FinTech and robo-advice, and as many of today’s ‘digital natives’ are more inclined to make use of FinTech services that promise cost savings, simplified processes and enhanced trust, through new forms of verification and certification, the landscape of intermediation is set to change drastically, also with respect to pension products. Not requiring investment advice for ‘safe’ default investment options would support this trend and help to cut costs. Online distribution of standardised products would also significantly increase the comparability of pan-European pension products.

Policy options at EU level

There are essentially two policy options for creating a deeper internal market for pension products. One is to harmonise national frameworks for private pension products to a sufficient degree that providers can compete across borders on a level-playing field. The other is to create a parallel, dedicated pan-

European pension product that is an alternative to existing national products and largely leaves national legislation untouched.

As outlined above, national hurdles to a cross-border marketing of pension products are high and many of them, primarily taxation, touch upon very sensitive areas of Member States’ competences. It can be expected that
any meaningful attempt to harmonise national regimes will encounter significant resistance. Also, regulatory arbitrage resulting from ‘gold-plating’ at Member State level could result in a not fully harmonised framework.

This suggests that an approach that largely leaves national schemes in place and creates a dedicated European product, coupled with a requirement to treat it as a national product, would be the best solution to address the supply-side market failures described above. In this way, the alternative product would be pan-European and hence standardised, but flexible enough to accommodate the varying legal frameworks at national level, achieving maximum effectiveness. There seems to be broad support for such an initiative as a consultation organised by the European Insurance and Occupational Pensions Authority (EIOPA) revealed that most stakeholders were positive towards the introduction of a voluntary standardised pan-European pension product (PEPP). Such a product could also lay the foundation for efficiency and productivity gains through lower production and distribution costs for suppliers. To this end, it is equally crucial to ensure that all channels of private pension products compete with one another.

Consequently, a mandatory guarantee element as part of the European pension product should take account of risk mitigation strategies such as life-cycling. Without such an approach, a considerable part of financial product providers, namely asset managers, would be largely excluded from competing in the market, to the detriment of the consumer.

On the demand side, a consumer-centric approach to the design and distribution of the pan-European product will be crucial to overcome asymmetric information. As outlined above, simplified, standardised and continuous information about all key parameters of the product throughout its life-cycle, combined with a strong governance regime and a credible supervisory mechanism can help overcome asymmetric information and cognitive and behavioural biases. Standardisation would also facilitate the cooperation of host and home supervisors. More precisely, a European Personal Pension Product should aim to guarantee the following principles:

- **Transparency** throughout the life-cycle of the pension product as well as the pre-sale phase with a view to establishing trust.
- The available **standardised and simple information** should outline the risks, costs, returns and options available, such as switching, cancellation of contributions, and pay-out.

- **A robust governance framework** is crucial to build trust in pension product providers. The framework should cover all necessary areas to ensure transparency and proper management also with respect to outsourcing.
- In order to reduce complexity and help overcome behavioural biases, the pan-European pension product should have a **limited number of investment options** as well as a **default or ‘core’ investment option** to simplify decision-making. Investments should be guided by the ‘prudent person’ principle and possibly a few high-level principles.
- **Investment advice for the ‘safe’ default investment option** is arguably not necessary and should hence not be made mandatory.
- **Switching to another provider** should be easy and possible at minimal cost. Currently, the switching of providers is either not possible at all or only at a high cost. This makes pension products unattractive and reduces competition.
- **A clear and credible supervisory regime** that can monitor the market and the implementation of European legislation will be crucial as well. The European Insurance and Occupational Pensions Authority’s (EIOPA) role in this regime should be significantly enhanced. Also, the Authority should play a key role in the authorisation of pan-European pension product manufacturers i.e. in issuing a single passport.
- Finally, the **taxation of the pension product should be non-discriminatory** with respect to national products. Member States should recognise the opportunity this new product offers for their citizens and ensure non-discriminatory treatment of schemes.

It should be explored whether extending and amending the existing sectoral policies that cover other financial instruments and activities – i.e. Solvency II, the Insurance Distribution Directive (IDD), the Institutions for Occupational Retirement Provision Directive (IORP), the Undertakings for Collective Investment in Transferable Securities (UCITS), the Markets in Financial Instruments Directive (MiFID) – could potentially address some of these elements.

**Conclusions**

Pension system reforms were and continue to be necessary to secure the long-term sustainability of the pension system and public finances. As a consequence of these reforms, retirement incomes from public pension schemes are likely to fall. Among other policy measures, **voluntary private pension schemes can be an important pillar to supplement falling**
An internal market for pension products can help support these private third-pillar savings by reaping the benefits of economies of scale and increased competition.

From a capital markets perspective, fostering the development of pensions savings would also generate a major source of patient capital that can help fund important projects in and across Member States, contributing to job creation and economic growth. Additionally, this would contribute to financial resilience.

However, due to a number of supply and demand-side factors, the internal market currently has limited success in delivering cost-efficient and transparent private pension products. A European initiative to address both sides of the market would entail significant benefits for the sustainability of public finances in the face of demographic change and most importantly for all future pensioners.

Since pension products are closely linked to a number of policy areas that are at the heart of Member States’ competencies, it seems that offering a parallel, dedicated European product would be the best policy option to create an internal market for cost-efficient voluntary private pension products, rather than attempting to harmonise national regimes. Such a system would also be a major step towards the portability of pensions within the EU, which would support those considering taking up jobs in other parts of the EU, as well as those that already have.

Sources:
- Lane, Clark and Peacock (2012), “Pension costs survey 2012”
Notes and References

1. As many as 14 Member States will see their population decrease by about half (Bulgaria, Germany, Estonia, Greece, Spain, Croatia, Latvia, Lithuania, Hungary, Poland, Portugal, Romania, Slovenia, Slovakia), while the other Member States will see it increase (Belgium, Czech Republic, Denmark, Ireland, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Finland, Sweden, and United Kingdom). Assumptions about net migration and retirement age, amongst other factors, define the nature of the demographic change.

2. The life expectancy at birth for men is estimated to increase by 7.1 years by 2060, reaching 84.8. For women, the increase is estimated to be 6 years, reaching 89.1 (See: European Commission, The 2015 Ageing Report, 2015).

3. European Commission, ‘The 2015 Ageing Report’, 2015. Importantly, this ratio should be seen as indicative, as a) people may rely on old-age pension at a different age than 64. and, b) they may not leave the work force even after retiring. As a matter of fact, in 2012, while the EU28 average age for drawing a pension was 59.1 years, over 15% of those receiving old-age pensions in that same year were still working.

4. In a defined benefits system, the final retirement income is clear at the outset, while in a defined contributions system, the retirement income depending on various factor such as investment performance.


6. In some Member States such as the Netherlands and the United Kingdom, third-pillar – i.e., private pension products – are already well established.


8. European Central Bank, Statistical Data Warehouse.


10. One of the European responses to this short fall in aggregate demand was the Investment Plan for Europe, which includes an investment part (the European Fund for Strategic Investments) and regulatory initiatives to improve the regulatory environment for investments in and into Europe. The Capital Markets Union is an integral part of this aspect of the Investment Plan for Europe.

11. Short-term funding and long-term investments create a maturity mismatch that was an important factor in the 2008 financial crisis. As a response, Basel III introduced measures to strengthen liquidity positions that arguably reduced the ability of some actors to engage in long-term financing based on short-term funding.

12. While increased requirements reduce the ability to lend, in the long term, they heighten the crucial but deeply damaged trust in the financial system and address clear shortcomings of the previous regulatory system, putting the financial system on a much sounder footing.

13. Accounting standards can have an important impact on the incentives to act counter or pro-cyclically in a stress scenario, independently of the original holding intention (trading or buy-and-hold).

14. However long-term investments have been on the Commission agenda for a while. As such, the European Union created European Long-Term Investment Funds (ELTIFs), a new type of collective investment framework allowing investors to put money into companies and projects that need long-term capital. Their success will crucially depend on the tax treatment they receive at national level.

15. The following section outlines a proposal for personal pension products only, and as such does not concern 1st (public) or 2nd (occupational) pillar arrangements of the Member States.

16. Respondents to a study by the European Insurance and Occupational Pensions Authority (EIOPA) listed taxation as the most important barrier followed by product design and notification and approval by national competent authorities.

17. EIOPA 2016 has conducted a quantitative study amongst its members identifying cross-border requirements for third pillar products. 13 Member States replied.

18. Lane, Clark and Peacock (2012), ‘Pension costs survey 2012’, These figures refer to the costs of 2nd pillar pension funds in the Netherlands.


23. There has been significant progress over the past years with respect to pre and post-sale information requirements and distribution requirements through packaged retail and insurance-based investment products (PRIIPs) regulation as well as the Insurance Distribution Directive (IDD) and the Markets in Financial Instruments Directive (MiFID II). However, pension products have often been excluded from these requirements.

24. The principal-agent problem arises when one party (agent) agrees to work in favour of another party (principal) in return for some incentives. Such an agreement may incur significant costs for the agent, thereby leading to the problems of moral hazard and conflict of interest.


28. Life-cycling means to change the risk profile of the portfolio from the beginning of the product to its end i.e. upon retirement. In the beginning the investment strategy is more risky and becomes more ‘traditional’ towards retirement.

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