Pension and long-term savings gaps

1. Main challenges and obstacles to overcome

1.1 Main challenges facing pensions in the EU

A policy-maker stated that Pillar I regimes, which remain the main source of income at retirement for a majority of European households, are facing considerable challenges. Due to an ageing society it will be increasingly difficult to finance Pillar I pay-as-you-go (PAYG) systems in the coming years. Many Member States have already conducted pension reforms, but Pillar I systems will struggle to ensure a sustainable future income for European citizens and will need to be completed by Pillar II and III occupational and personal private pension schemes.

A regulator confirmed that the ageing population is the main challenge. The old-age dependency ratio[1] of 34.4% is due to increase to 59% by 2100, meaning that there will be significantly fewer working-age people to pay for the state PAYG pensions of older people. Three working people are currently contributing to the state pension of one pensioner, but in the next 40 years that will drop to between 1.5 and 1.7. State pensions are expected to fall as a percentage of retirement income from 46.2% in 2019 to around 37.5% in 2070. Only 23% of the European population currently participates in an occupational pension scheme, and 19% own a personal pension product. Much is being done however to improve Pillar I systems, which are the basis of the pension system. Pillar I systems are important to preserve, as they provide mutualisation in society and prevent poverty.

The regulator added that 18.5% of senior citizens are at risk of living in poverty in Europe, which may cause major problems as it comes with other costs to society. In addition, there is a significant gender gap, with a 35% higher risk of poverty in old age for women than for men. Women also have pensions that are, on average, 30% lower than men.

1.2 Obstacles to overcome for addressing pension challenges

A regulator noted that increasing the uptake of Pillar II and III private pension schemes is not easy. Young people are not interested in saving for their pensions, and by the time they are aware of the importance of doing so it is often too late to build up a sufficient pension.

An industry representative highlighted three main issues that need to be addressed in order to stimulate savings for retirement and reduce the pension gap. The first aspect is that the level of financial education is heterogeneous across Europe. Building awareness about the need to save for retirement is more difficult for people who have limited understanding of financial concepts. The second aspect is the over-reliance of many citizens on the Pillar I state pension system. The third element concerns the access that people have to adequate information on their future pension, which is still limited in many cases.

A second industry representative observed that financial literacy must be distinguished from awareness. Most US citizens are not more financially literate than Europeans, but they live in a country where the State is not considered as a solution to individual problems such as retirement, which creates awareness for the need to prepare one's own pension.

A consumer representative highlighted that if current pension gaps are not tackled then Europe might be facing a major pension crisis at some point that may be much more challenging to handle. Pillar I pensions are still important for many people, particularly those who have limited saving capacity, but will be insufficient in the future, so private pension products need to be developed in parallel. However this requires improving product quality and the functioning of pension product markets. In some countries there are adverse selection problems due to poor market design. Bad products are being sold by financial intermediaries because of incentives such as inducements and tax reductions. If the product offering in Europe is not attractive and does not correspond to customer needs, then consumers will start looking for alternative products such as exchange traded funds (ETFs), many of which are managed outside the EU and invest in non-European assets. The consumer representative added that a consequence of the insufficient financial literacy and awareness about long term financial planning needs of many Europeans is that saving rates are high in Europe, but investment rates in the capital markets are extremely low.

2. Importance of pension savings for the EU economy

A policy-maker noted that well functioning occupational and private pension systems (Pillars II and III) are essential for increasing the scale and the competitiveness of EU capital markets and achieving the objectives of the capital markets union (CMU). They are an important potential source of capital for financing the green and digital transitions in particular. State pension systems are a key source of revenue after retirement for many households, but they function mostly on a PAYG basis and do not accumulate assets.

1. The old-age dependency ratio is the ratio of the number of elderly people at an age when they are generally economically inactive (i.e. aged 65 and over), compared to the number of people of working age (i.e. 15-64 years old).

A regulator agreed that private pension systems can have significant economic impacts beyond improving revenue at retirement for future pensioners and contribute to the transition of the economy, which explains why the pension topic is gaining traction in the CMU context. For this to happen, it is however necessary to retain the capital in the EU in addition to providing savers with appropriate return, which is an issue that remains to be addressed. A further aspect worth considering is that countries with well-developed Pillar II and III systems also tend to have a large contribution of the 50+ generation to the economy in terms of contribution to GDP. Academic work shows the prospects of the silver economy, which is needed in a region with an ageing population.

Another regulator confirmed that Europe needs a funded pension system to foster the CMU. Pre funded pensions are significant in the Netherlands, with Pillar II savings representing around 150% of annual GDP. Pension adequacy issues for the older generation are also limited, but it is an exception in the EU. The regulator agreed that the impact of pre-funded pensions on EU capital markets and the funding of EU enterprises is less obvious. The capital accumulated in the pension system does not necessarily flow to European enterprises and SMEs, because a large part of it is invested abroad. About half of the capital accumulated in Dutch Pillar II pension schemes is invested in the US and Asia. In addition, it is not certain that European capital markets have the capacity at present to absorb a significant increase in the amount of pension savings.

3. Possible measures to address pension and long term savings gaps

A policy-maker expected that the Commission will attach more importance to the topic of pensions in the next European political cycle. This issue will need to be addressed jointly by all relevant services, notably the employment and social affairs side of the Commission and DG FISMA. Pensions require both a citizen-centric and an employee centric approach.

3.1 Implementing mandatory or automatic enrolment private pension systems

The Chair asked the panellists whether Pillar II and III pension systems need to be mandatory for their success.

A regulator noted that the current system in the Netherlands is mandatory for employees, who represent 90 to 95% of the population. However, it is different for the self-employed, resulting in a pension gap in that area. Policy measures related to pensions go far beyond financial market regulation and also concern social, fiscal and labour market policies.

A consumer representative observed that mandatory systems have proven to be effective in some countries such as Sweden, and that this is something that should be further explored across member states. In addition, any market-led solution must take customer interest into account particularly in terms of product performance and quality.

An industry representative was not certain that making Pillar II and III mandatory for all citizens is the right approach, as it may depend on the specificities of different countries. Creating appropriate incentives to encourage more long-term savings is more important. A mandatory system or a system based on auto-enrolment can be helpful to nudge people to start saving for their pension, but efforts must also be made to build awareness around the need to save for retirement, otherwise contributions will end up being lower than expected. In Italy there is an auto-enrolment system with opt-out applying to severance payments whereby the sums due to employees by their employers are automatically transferred to Pillar II pension funds with certain fiscal benefits, unless employees explicitly opt-out[2]. It worked well, because it forced people to reflect on the different available options before making a decision on the payment modalities, which contributed to building awareness around pension related decisions.

A second industry representative stated that there are pros and cons associated with mandatory pension systems. A mandatory Pillar II provides a long-term saving capacity for all customers, but it reduces their investment options and does not contribute to increasing awareness about the need to save for pensions. The US does not have a mandatory Pillar II system and has similar distribution systems to the EU, but has much better results than the EU in terms of pension savings. Pillar III, which is also well developed in the US with the individual retirement accounts (IRAs) market, can help to create that awareness and provide customers with more investment options. In the EU the preferable solution could be to develop Pillar III products, leveraging existing distribution networks and products.

A second regulator suggested that the automatic enrolment of employees (auto-enrolment) with the possibility to opt-out could be considered as an alternative to mandatory enrolment. Such a scheme should also apply to the self-employed. People do not tend to opt out very quickly from schemes with auto-enrolment due to a certain degree of inertia. Decades of dialogue between different stakeholders have been necessary to build mandatory systems such as those that exist in Sweden and the NL.

A policy-maker noted that the Commission has opted for encouraging the development of auto-enrolment and conducted preparatory work on such mechanisms with input from EIOPA.

2. Historically, in Italy employers accrue every month the equivalent of a severance payment (TFR, "trattamento di fine rapporto") for each of their employees. When a contract is terminated (layoff, retirement, etc.), the employer pays a lump sum, equal to the accrued amount, to the employee ("liquidazione"). Since 2007, upon signing a new contract, employees have 6 months to decide if they want the TFR to be paid as a lump sum upon termination of their contract, as was done previously, or if they prefer the TFR payments to be transferred monthly to a Pillar II pension fund (with certain fiscal benefits). In the absence of an explicit decision by employees during the first 6 months of their contract on the modalities of the payment, the default option is that all the payments are automatically transferred to the pension fund (hence the "auto enrolment"). Employers must propose the two options to their new employees and this remains an employee decision.

The first regulator stated that the most effective solution is mandatory enrolment, but agreed that there are political challenges around that. The next best solution would be auto-enrolment with opt-out, which is likely to stimulate more interest in pensions. The main objective is getting people to save more for the long term.

Reacting to a comment by the Chair that the existence of safeguards and adequate supervision are critical aspects for a mandatory system, the regulator observed that such safeguards exist in the Dutch Pillar II system. The system is run by the labour unions and the employers, as they are closer to the interests of employees than the government may be. The whole system is also closely supervised by both the central bank and the conduct regulator. There are also tax incentives for savers. This shows that Pillar II systems are not just a matter of financial regulation, but also concern social, labour market and fiscal policies.

3.2 Implementing pension dashboards and personal pension tracking systems

A regulator suggested that a key first step should be to produce a comprehensive dashboard per country of all existing pension schemes, including Pillars I, II and III. This could be done jointly by DG FISMA and DG Employment, Social Affairs and Inclusion. It is essential to have a clear picture of the present situation of pension systems at national level to decide what additional measures are needed. Such dashboards already exist in certain Member States such as Sweden and the NL.

The regulator added that a personal tracking system is also needed. Every European should be able to go online and get an overview of what they have saved for their retirement and of their potential pension. This can also encourage people to save more. Only seven Member States currently have that system in place. Tracking systems are mostly created by the industry in countries where they are available. EIOPA has provided advice on how to implement dashboard and pension tracking systems. All three pension pillars have to be considered when these systems are established to evaluate ongoing changes and improvements in an adequate way, as in some Member States incentives have been shifted from one pillar to the other.

A policy-maker noted that the Commission has performed preparatory work on pension dashboards and tracking systems on the basis of the input provided by EIOPA. The Commission is also looking into the development of a tool that will strengthen the monitoring of pension developments across Europe.

A consumer representative agreed that systems such as dashboards and pension tracking systems can be useful, as they can help to create awareness and give an outlook to people of what their situation will be. An industry representative added that pension tracking systems and individual simulation tools are useful to make the pension situation more tangible for people.

A second regulator acknowledged that pension trackers are useful, but stated that they are not sufficient because young people do not look at these projections. Good-quality, low-cost, simple pension products are also needed to encourage more long-term investment, supported by independent advice in the interest of the client. An additional approach that is being discussed in the Netherlands is to set up a system of periodic financial health checks, where people are presented with their financial position at certain intervals or at certain stages of their life. That can help to clarify pension saving needs, support more adequate financial planning and nudge people early on into investing with a long-term perspective. Such an approach seems more effective than actions to enhance financial literacy, because many people who are fully trained do not sufficiently take care of their pensions.

3.3 Reviewing the Pan-European Pension Product (PEPP)

A regulator stated that the PEPP needs to be relaunched, as it can be an appropriate solution not only for people working cross-border in the EU to save for their pensions, but also for people changing jobs within a member state. Many of the features of PEPP, like low cost, simple, digital, are helpful for many. Taxation must also be considered, as different tax treatments across Europe have been a major barrier to the uptake of PEPP so far. The 1% fee cap imposed on the basic PEPP must also be reconsidered. To be successful, the relaunch of the PEPP must also be combined with measures aiming to create urgency around the need to save for the long term. Citizens in some member states have indicated in a survey that they would be more likely to save in a European pension product because they would trust it more.

An industry representative observed that PEPP makes sense from a European integration point of view, as it provides access to additional Pillar III products for all European citizens. The issue is tax treatment, which differs across European countries.

A consumer representative considered that a PEPP with a 1% fee cap will not get distributed, but simply increasing this cap is not an appropriate solution. Europe first needs to fix market failures in the retail investment product distribution market in order to foster the development of products offering adequate investor outcomes and a viable option for producers and distributors.

A policy-maker stated that the Commission is committed to make the necessary changes to PEPP for it to work. This includes considering the effects of the fee cap. The Institutions for Occupational Retirement Provisions II (IORP II) framework is also currently up for review. Input has been received from EIOPA on how to improve the IORP II framework and a decision has to be made on the way forward.

3.4 Increasing retail participation in the capital markets

A consumer representative stated that the right incentives need to be in place for people to save in private pension products. If they start investing, their investment culture will progressively improve. The Retail Investment Strategy (RIS) proposal of the Commission, which includes measures aiming to enhance the value-for-money of investment products

and reduce conflicts of interest by limiting inducements, is a step in the right direction. With more expert and independent advice, citizens would also have a more open access to the better-performing products. Conduct must also be improved, which requires that the European Supervisory Authorities (ESAs) and the national competent authorities (NCAs) have the right powers and adequate resources. Finally, tax incentives must be reviewed to ensure that they do not steer retail customers towards low-performing products.

Answering a question from the Chair about the role that technology may have in facilitating access to independent advice, the consumer representative agreed that technology could play a role in reducing the cost of independent advice, for example with robo-advice platforms, provided they are designed in an unbiased way. Most people investing online however do so on an execution-only basis at present, so the impact may be limited and part of the market also prefers in person advice for products in which there is a long term engagement, such as insurance-based investment products (IBIPs).

A regulator considered that inducements tend to favour expensive products. In the Netherlands the decision was taken in 2013 to ban inducements completely, because some extremely bad products had been on the market. A policy-maker emphasized the importance of improving the value-for-money of investment products to ensure that the products on the market are worth investing in. To a certain extent that is more important than making investment in pension products mandatory or based on an opt-out.

An industry representative agreed that the measures of the RIS may encourage more retail investment. The value for money requirements and the measures aiming to avoid conflicts of interest in distribution networks can contribute to improving investor outcomes. The proposed reviews of the Insurance Distribution Directive (IDD) and the Markets in Financial Instruments Directive (MiFID) are also relevant in this perspective.

A regulator emphasised the importance of adequate supervision in connection with the RIS measures for developing retail investment. Supervisors can check whether products that are sold to consumers provide sufficient value-for-money and are understandable. Supervisors should also be able to intervene if this is not the case. In the context of IDD, a European mechanism is needed involving EIOPA to allow the removal of a cross-border product from the market that is detrimental for consumers, if the issue cannot be solved by the NCAs on a home-host basis.

3.5 Role of the financial sector

An industry representative stressed that the private sector also has a key role to play in encouraging more retail investment in private pension products, by providing adequate products and supporting customers in their choice at the point of sale. Distributors, agents and brokers can indeed play a significant role in improving the awareness of citizens about the need to save for their pension and can provide advice about adequate products for achieving pension objectives.

Another industry representative agreed that private companies can play an important role in drawing people into the pension system and compensating for the lack of financial literacy. The operating model of different companies and the types of distribution networks differ, but in many cases there is a capacity to reach individuals and engage with them on these topics, including some who are not naturally interested in saving for their retirement. Insurance-based investment products can also contribute to reducing the long-term saving and pension gap due to their flexibility and their capacity to support the evolving needs of customers throughout their lifetime.