Key-note speech to EFRP conference on "Private Pension Systems in the Central and Eastern European Countries"

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Introduction

Thank you for the opportunity to give the key note speech to this conference. I am speaking on behalf of Commissioner Spidla who is unfortunately unable to be present but asked me to assure you that he takes a great interest in today's work as he considers well functioning pension systems the core of EU social policies. He pays great attention to the impact the present crisis might have on our pension systems and on the welfare of our older citizens who are more than many others dependent on well functioning welfare states.

The financial crisis and the wider economic impacts stemming from it make this conference so topical. These events are forcing us to look at private pensions again and indeed on pension systems in general. We cannot exclude that for some people in some countries who are dependent on certain types of private pension there will be serious impacts on their retirement income. And there will be lessons for future provision. But on the other hand what we have seen up to now suggests that the crisis in Europe has had less serious impacts on pension funds than on other types of financial institutions and on funded pension systems in some other parts of the world. In general, especially for those already retired or about to retire today, European pension systems have so far been quite resilient.[1]

Decline in confidence

There has been, though, a decline in confidence in funded pension schemes. For instance, in a recent survey of Dutch pension fund members, only 44% of people had confidence in pension funds, down from 64% just three years ago[2]. We can expect similar drops in confidence elsewhere, including in statutory funded pension schemes set up in many Central and Eastern European Countries over the last ten years. Poor performance in pension fund investments will inevitably have at least a psychological impact on contributors to such funds, even if they are not due to access their pension for many years.

Learning lessons from the crisis will be important if confidence is to be restored. But of course I would not want to suggest there are lessons only for private funded pensions. No pension system can be immune to an economic impact of the magnitude we are seeing. I should also say that it is still early days in considering the full consequences of the crisis for pension systems. But I think there are some important questions we can ask.

EU role

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[1] A short Memo was issued on 6th March 2009 aimed at explaining The Commission's role and giving background on the potential for impacts on pension systems http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/99&format=HTML&aged=0&language=EN&guiLanguage=en

[2] Netherlands Interdisciplinary Demografic Institute, based on a poll of 1036 Dutch pension scheme members.

Before I do that, I should make clear that the design of pension schemes and social security systems is basically the responsibility of Member States. Pension systems, their structure and composition differ widely between Member States. However, there are some EU legal framework rules that apply also to pensions such as those concerning equal opportunity and anti-discrimination. Certain occupational pension schemes are also regulated at EU level.

More generally we in the Commission take a pragmatic approach to the design of pension systems. Whether public or private, pay-as-you-go or funded what matters is the ability of pension systems to deliver on the European level pension objectives that benefits are adequate and systems are sustainable. We hope to facilitate Member States in achieving those objectives, in three main ways:

1. Sharing best practice and policy advice,

2. Offer a reference framework – objectives and indicators to monitor progress.

3. Provide legitimacy for the national reform effort

This take place within a process known as the Open Method of Co-ordination. We have recently published a major report – the Joint Report on Social Protection and Social Inclusion 2009[3] - as part of this. The Joint Report includes a wealth of information and highlights some of the key challenges facing Member States' pension systems.

[3] http://ec.europa.eu/employment_social/spsi/joint_reports_en.htm

Lessons and responses - PAYG

Of course State Pay-as-you-go schemes are not immune to the economic crisis, as they are directly linked to public finances. Fewer people in work paying contributions, increased national debt and lower or negative growth all place strain on the long term sustainability of pay-as-you-go schemes. And pension systems were already facing long term pressure from the demographic shift. The old age dependency ratio compares the number of people aged 65 and more to the number of people of working age 15-64. We project that in the EU-27 the ratio will increase from 25% in 2008 to 54% in 2060[4]. In other words from roughly four people of working age for each person over 65 to just 2 people.

Of course it is not just this ratio that matters, but how many people of working age are *actually* working. Perhaps the least painful way of adjusting to ageing societies is if more people work more and longer before they retire. So it is vital to ensure we don't repeat the mistakes of the past and use early retirement to cope with the downturn.[5] There has been positive progress in increasing employment rates for older people in the EU – up from 37% in 2001 to 45% in 2007[6]. These gains need to be preserved and, for the future, built on.

[4] From "The 2009 Ageing Report: Underlying Assumptions and Projection Methodologies" table 1.14 available at http://ec.europa.eu/economy_finance/publications/publication_summary13784_en.htm

[5] See, for example, our report produced with the Social Protection Committee "Promoting longer working lives through pensions reforms - Second part - Early Exits from the labour market" available at http://ec.europa.eu/employment_social/spsi/docs/social_protection_commitee/spc_study_on_early_exits_final_en.pdf

[6] Joint Report of Social Protection and Social Inclusion 2009 http://ec.europa.eu/employment_social/spsi/docs/social_inclusion/2009/supporting_document_en.pdf

Necessary adjustments to state pay-as-you-go schemes in response to structural issues, ageing populations or impacts of the financial crisis can be made gradually. Such schemes also allow changes to be made in a manner that distributes the burden of adjustment equally – following the solidarity principle.

Lessons and responses - DB

Of course funded pension schemes have suffered more obvious and immediate impacts from the financial crisis. Defined Benefit pension funds, where sponsors take the investment risk, help to shield their members from falls in investments. But adjustments to restore their funding balance and keep these schemes viable for the long term mean there will be some impacts for members. To absorb the shock contributions and benefits are likely to have to be adjusted to some extent. In countries like the UK it may come back to scheme members through collective negotiations on the remuneration package. Elsewhere present systems may already contain shock absorbers. For instance in the Netherlands there is an element of risk sharing through discretionary indexation and increases in contributions.

One issue worthy of further thought is around how defined benefit pension funds are linked to the economic cycle. Whilst the de Larosière report of 25th February did not focus on funded pensions, it did make some interesting points about the need for financial regulation, supervision and for accounting rules to avoid imposing pro-cyclical effects. There may be some analogous issues for defined benefit pension funds.

Clearly it is pro-cyclical that during a downturn defined benefit pension funds may pay lower pensions or require higher contributions. Equally during good times funds may make extra pension promises or reduce contributions (though in hindsight will often be seen as regrettable). Clearly it would be better if pensions funds could help smooth the cycles by acting counter cyclically.

A final point about Defined Benefit schemes is that when times are good strong investment growth may mask underlying problems in the sustainability in scheme finance. With the crisis some difficult structural issues are now surfacing.

For instance the UK company British Telecom negotiated changes to its pension arrangements with its employees and the pension scheme trustees. This included increasing the retirement age for the scheme and moving to pensions based on career average earnings rather than final salary. And in the Netherlands, Social Affairs Minister Donner has raised the issue of retirement ages as something to look at in the context of restoring Dutch pension funds to balance.

Whilst such issues will always be challenging to look at, the crisis may provide the impetus for difficult decisions to be taken. As in the case of state pay-as-you-go pensions, these collectively organised schemes with the active participation of employers and workers representatives can allow for collective solutions. So there can be a certain degree of burden sharing within the membership when making necessary adjustments.

Lessons and responses - DC

I'd like to now turn to the statutory Defined Contribution pension schemes. Although typically they are not yet that important for those retiring today, funded defined contribution schemes in general are becoming more important every day. Perhaps the most significant change is to mandatory defined contribution schemes which seek to partly replace some existing state pay-as-you-go provision.

A report we did with the Social Protection Committee last year shed some light on the size of the expected changes. According to theoretical replacement rate calculations, Hungarian pensioners in 2046 will be getting a quarter of their overall pension from the statutory DC scheme. And a number of other countries - including Poland, Lithuania and Latvia - will have levels above that.[7]

The crisis has put a renewed focus on these schemes. Key questions include who bears the investment risk and to what extent? What options and information do people have? How much volatility and risk can individuals in different situations accept? And how much responsibility sits with Governments who mandate participation?

The Commission and Council noted in the Joint Report the need to mitigate risk in defined contribution pensions, particularly for those

[7] "Privately Managed Funded Pension Provision and their Contribution to Adequate and Sustainable Pensions" Table 7 – Contributions of various schemes to theoretical replacement rates (base case). http://ec.europa.eu/employment_social/spsi/docs/social_protection_commitee/final_050608_en.pdf

people approaching retirement and called for appropriate solutions for the pay-out phase which are still missing in a number of countries with mandatory schemes.

We also stressed that Member States should give careful consideration to the proportion of overall pension income expected to come from defined contribution pensions and whether they are not groups who may be less able to absorb the inherent risks in these kinds of pensions. This is especially important for less well off people and for those with shorter or atypical employment careers and those closer to retirement who might not be able to pass through the whole cycle of up and down of rates of return and risks.

In relation to the capacity to bear risk, the question arises whether a mandatory scheme should not foresee provisions that protect against too much volatility. Two options are discussed in this respect – one is guarantees of the principal and possibly of some minimal rate of return and the other is adjustments to the investment risk over the life cycle. Not all mandatory schemes contain such provisions at the moment. It is argued that the costs of such provisions are high. Indeed we pointed out the need to look at the full costs involved in guarantees in our report on privately managed pension schemes that we did with the Social Protection Committee last year. But nonetheless people have to have a pension they can live on. Not too small a pension because of these costs, but also not too small because people have suffered big falls in their pension's value just as they are about to retire.

This leads to another question around the accuracy of information. Where there was choice between continuing in pay-as-you-go state schemes or moving part of the contributions to the new funded scheme, people often opted for the DC schemes even if it was questionable whether this was indeed the best solution for them. And when it came to fund choices, many people went for riskier options then may be justified given their earning capacity and the length of their working life.

At least partially these choices were driven by the information people had at the time. Rates of returns observed in the past, the positive growth expectations for central and eastern European Countries and the fact that nobody told people that a decline of asset values as has happened over the last 12 months is possible all proved influential.

Hence information is key and by the way not only in DC schemes. Would it not be a solution, as suggested by the Peer Review, to support non-partisan organisations such as consumer protection NGOs to provide additional information and thereby help people to make the right choices? Perhaps too there could be a greater role for default options designed to be a reasonable choice for most people.

Mandatory defined contribution schemes also have implications for public finances. Paying some contributions into funded schemes whilst continuing to pay pensioners in the existing pay-as-you-go scheme means more cost now and less cost later. This can help to bring forward some of the costs of the demographic change and so smooth the longer term impacts. But of course the transition costs (double payment for now) imply a bigger burden today.

With the new economic situation and the importance of public finances for a rapid recovery, the speed of these transitions may need to be looked at again and indeed some Member States have changed related provisions. Similar considerations may also apply in cases where building a reserve fund has been intended to smooth the cost of ageing for pay-as-you-go schemes such as in Ireland.

While measures today to adjust DC notably mandatory schemes may be necessary one should not forget that pension systems need stability over the long term if they are to have the necessary credibility among citizens. Hence policy changes need to be carefully thought through.

While in some countries one type of pension scheme might dominate, the landscape is also changing. Hence the assessment of adequacy and sustainability and the analysis of the solidarity offered and how the burden of adjustment is shared will need to take account of the changing mix of schemes. Reform needs will not only depend on the nature of particular schemes as such, but also on the relative contribution they make to the overall retirement income and on the level of risk and volatility people can sustain.

Conclusions

The Commission will play its part in instigating policy dialogue, encouraging best practice exchange and supporting Member States in considering the difficult issues they face. This could include looking at whether the regulatory framework needs to be considered further and if so at what level. My colleague from DG Internal Market and Services, Jung Lichtenberger, will talk to you later today about European developments affecting the EU Directive on occupational pension funds. Ongoing work focuses not only on solvency rules for these pension funds, but it also to some extent encompasses issues relating to investment rules, governance and disclosure, which are of importance for defined-contribution schemes. More generally we will together with member states, notably in the Social Protection Committee, look at the lessons we can take from the impacts of the crisis on pension schemes.