Personal pensions in the EU: the case for establishing a second regime

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1. Introduction and general background

Pension policies and reforms have a number of overarching objectives (adequacy, financial sustainability, coverage, fairness…)[1] and have to manage trade-offs between these objectives. Multi-pillar pension systems, with a funded component that is put beside the unfunded, PAYG public component, are considered to be sounder and more resilient to shocks of different nature than single-pillar, PAYG only, pension systems.

In particular, in the context of ageing populations multi-pillar systems are better suited to achieve the objective of financial sustainability, as the funded component helps financing retirement benefits for larger cohorts of retirees, against a labour force that is not increasing at the same pace (or is even shrinking). Funded schemes improve adequacy as well, integrating retirement income from PAYG schemes through additional resources and/or through returns that are usually largely uncorrelated with the indexation mechanisms set for unfunded schemes[2].

It is worth noting that, for the purposes stated above, a diversification that occurs in the dimension "unfunded/funded" is more important than one in the dimension "public/occupational/personal". Indeed, the latter dimension has mainly to do with the allocation of responsibilities and risks among the different actors; the unfunded/funded dimension, more basically, has to do with the (public and private) inter-temporal budgeting and financing of retirement needs and their interaction with the dynamics of the population and the workforce.

Across the EU, the role played by funded pension schemes is diverse. Only few countries have well developed, funded occupational pensions, sometimes with relatively small PAYG arrangements, providing for only basic retirement benefits. A group of Central and Eastern European (CEE) countries introduced the so-called first pillar-bis schemes: funded schemes based on individual accounts typically financed by contributions diverted from PAYG schemes. The diffusion of voluntary, personal pension schemes is scattered across the EU and anyway their importance is quite limited in term of assets and members.

Recent developments in the EU countries regarding funded schemes are also mixed and often not positive. The introduction of auto-enrolment in work-based pension schemes has so far worked well in the UK, but not as well in Italy. In some CEE countries, the reforms that introduced first pillar-bis schemes have been reversed, and contribution flows as well as accumulated assets have been diverted to public PAYG schemes[3]. Some public reserve funds created in the social security context in order to finance pensions to be paid in the future decades were used for other purposes in the context of the great financial crisis of 2008-11.

2. Looking for a more effective role of the EU for the development of funded pension schemes

Although the design of national pension systems is left to the responsibility of individual countries, pension policies are increasingly gaining relevance at EU level. National pension strategies and reforms are periodically assessed through the so-called Open Method of Coordination. In addition, the implications of national pension policies and reforms for the public budgets are considered in the framework of the Stability and Growth Pact (SGP).

In principle, the EU institutions do favour the establishment of multi-pillar systems and funded pension schemes (for instance, see the European Commission White Paper on Pensions published in February 2012). Unfortunately, in the context of the calculation of the public budget deficit that is relevant for the SGP, the treatment of contributions paid to funded pension schemes is very unfavourable in comparison to contributions paid to unfunded, public PAYG schemes. If the EU truly wants to favour the development of

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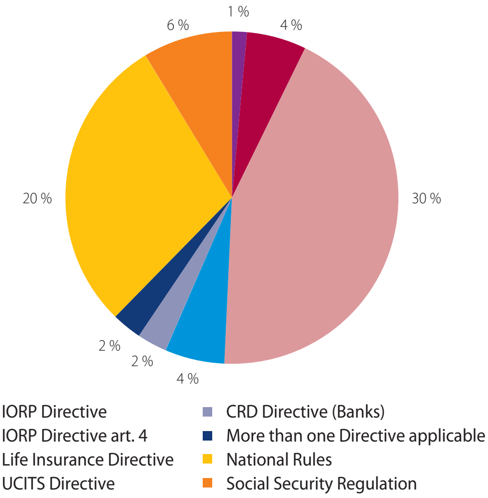
1 *See OECD, Pensions at a glance 2013, chapter 1 . See also Rinaldi A., Major Trends in Pension Reforms, presentation made at the 6th World Bank Conference on Savings and Pensions, April 2014, Washington DC, available on the World Bank website.*

2 *The famous World Bank book Averting the old-age crisis, published in 1994, holds the prime for arguing in favour of multi-pillar systems. See also European Commission (2012), White Paper: an Agenda for Adequate, Safe and Sustainable Pensions.*

3 *See World Bank (2013), Reversals and Reduction, Resolution and Reform. Lessons from the Financial Crisis in Europe and Central Asia to Improve Outcomes from Mandatory Private Pensions.*

Personal Pensions in place in the EU countries classified according to the applicable EU or National Rules



Source: EIOPA Pensions Database.

multi-pillar systems, such arrangements should be reviewed[4].

In the field of occupational pensions, the EU did set a harmonized framework already in 2003, with the IORP Directive. However, the effect of the Directive in terms of favouring the development of occupational schemes has been dubious. One may argue that any growth of occupational pensions that took place in the EU after 2003 was independent of the IORP Directive and would have occurred anyway. In particular, the Directive hardly had any effect in terms of the development of cross-border activity[5].

In March 2014 the European Commission finally published its proposal of revision of the IORP Directive. For the time being, the Commission has put aside its original intention to propose the introduction for occupational pensions of harmonized solvency requirements inspired to the "Solvency II" rules applicable to insurance undertakings. However, in terms of the future development of occupational pensions and in particular of their cross-border activity, this choice is not likely to have any significant effect. Indeed, there is very little appetite for any pan-European development of defined benefit (DB) pension funds. Indeed, one may argue that the harmonization of solvency rules is not worth the effort: it may be just too complex to try to take into account appropriately all the different security mechanisms that are in place across the EU countries.

The proposal of revision of the IORP Directive focuses on the strengthening of governance rules and on the harmonization of requirements for the information to be given to members. For the time being, the impact of a revised IORP directive on the potential for future growth of funded, occupational, pension schemes is difficult to assess. Anyway, not in all EU countries occupational pensions are the most promising vehicle for the diffusion of funded pension schemes supplementing the PAYG pension pillar.

Indeed, there are differences in the labour market structure of EU countries that have an obvious impact of the relative potential for growth of occupational vs personal pensions. These differences include the role of trade unions, the stability of employment, the diffusion of self-employment. In some EU countries, personal pensions could actually have a stronger potential for growth. For instance, this is probably the case of the CEE countries, where first pillar-bis schemes were introduced, indeed based on individual accounts and with no linkage to an employment relationship.

3. Overview of personal pensions in the EU

Therefore, personal pensions indeed represent a crucial element for the development of funded pension schemes in a number of EU countries. In this field, it should be recognized that a comprehensive EU-wide regulation is already in place for several types of personal pension schemes. According to the EIOPA Pensions Database, in the European countries 60 different "kinds" of personal pension schemes can be counted, half of which fall under the scope of insurance directives. Among the 20 types of schemes that are established on the basis of national rules, many are anyway inspired by EU legislation.

Despite the EU framework already in place, the diffusion of personal pensions is limited in most European countries[6]. This is due to a number of factors, including the limited need for personal pensions in countries where PAYG schemes are relatively generous or occupational pensions are well developed. Nevertheless, there are indeed countries where important portions of the workforce are in a clear need to supplement the retirement income expected from PAYG schemes. Countries that introduced first pillar-bis schemes aimed exactly at fulfilling that need, though with mixed results – especially in their ability to keep costs low (a fundamental precondition to ensure satisfactory net returns).

Indeed, in the personal pensions field a sort of collective, EU-wide regulatory failure seems to occur. On the one hand, the EU legislation in place has not been able to favour the development of an ample single market, economies of scale, critical mass and competition. On the other hand, national legislations, especially those introducing pension reforms based on first pillar bis schemes, have segmented national markets making economies of scale impossible to achieve. In addition, in most cases they have not satisfactorily addressed the issue of designing in a cost-effective way the distribution of personal pensions and the collection of contributions – thus exposing the reforms to serious criticism and, finally, in some cases, to their reversal.

4 See again World Bank (2013), that explicitly mentions the rules of the SGP as factor contributing to the reversals of reforms in Eastern Europe.

5 Currently, only about 80 IORPs have notified the intention to carry some cross-border activity. The quantitative relevance in terms of assets/members of this cross-border activity is very limited.

6 Unfortunately, comprehensive EU statistics on the diffusion and volumes of personal pensions are not available.

4. Another Directive, or a "second regime" for personal pensions in the EU?

What could the EU do to favour the diffusion of personal pensions and by this way the strengthening of the funded component of pension systems? In principle, there are two instruments available[7]:

a) a EU directive, applicable to the personal pension schemes that currently not fall in the scope of any EU legislation;

b) a so-called "second regime": an EU regulation defining a set of standards that a product has to comply with in order to qualify as an "EU personal pension plan". This second regime would be put in place in parallel with the existing regulations, both at the EU and national levels. Pension plans compliant with the second regime could be set up by a number of different institutions (such as insurance undertakings, asset management companies, banks, IORPs), provided that they are subject to prudential regulation at EU level.

A new EU Directive, targeted to regulating the personal pension plans that currently do not fall in the scope of any EU regulation, could aim at levelling the playing field for all kinds of personal pensions; in particular, it would create the preconditions for cross-border activity also for the schemes currently regulated only at national level. However, as it should include in its scope of application a wide range of personal pension schemes, such a Directive would necessarily adopt a wide definition of personal pensions, and therefore would not be able to address appropriately the issue of creating economies of scale and critical mass.

A second regime would indeed be more promising for achieving economies of scale and critical mass. However, in order to do so, it should require an appropriately high level of standardization. Such a second regime would indeed favour comparison and cost competition. In addition, it could have an important impact of the organization of distribution, making cost-effective "non-personalized" channels practicable (workplace, internet, auction systems, etc.) – and could indeed facilitate the definition and introduction of suitable defaults, first of all for the choice of the investment option.

This second regime, even if highly standardized, would not in itself limit product innovation, as it is designed to co-exist in parallel with the personal pension schemes that are regulated under other EU or national rules – both the current and the future (possibly innovative) ones.

The standards set for a second regime in the field of personal pensions could play the role of a benchmark also for other kinds of schemes. With no prejudice for the subsidiarity principle, interested countries could decide to design first pillar-bis schemes in compliance with the standards of the European second regime – thus taking advantage of economies of scale and lower costs. A similar process of voluntary adoption of the standards of a second regime set for personal pensions could occur also for occupational pensions – indeed, occupational pension schemes based on defined contributions often are already organized on the basis of individual accounts, similarly to personal pensions.

Besides all that, it is worth noting that the introduction of a second regime is not incompatible with the introduction of a Directive applicable to all personal pension schemes currently not covered by any EU legislation. In other words, the two regulatory instruments are not mutually exclusive. However, they should be seen as aiming at different purposes. A Directive would be more useful in order to level the playing field and harmonize consumer protection; a second regime would be more useful in order to develop low-cost products, economies of scale and a wider diffusion of funded pensions.

5. Elements of a second regime

In this short note, it is not possible to discuss in detail the contents of a possible second regime for personal pensions. Anyway, it is useful to propose some basic, overarching principles that could offer guidance for the good design of a second regime[8]:

a) provide an appropriately high level of standardization;

b) make things simple for members;

c) put emphasis on the length of the time horizon available for investments;

d) keep costs low;

e) do not discriminate across suitable pension providers.

Taking stock of these principles, specific standards should be defined first of all in the areas of investment choice and communication to members. In particular, a well-designed default option should be set. Good candidates for it are life-cycle investment options that modify the asset allocation as a function of the age of the member or the time left before retirement. For those who do not see the default option as suitable to them, the possibility to opt-out should be ensured, and a limited range of investment options should be offered.

A crucial point is how to define a standard for communicating to members the risk-reward profile of these different investment options. Labelling investment options in terms of their risk-return profile is tricky for pension plans. Indeed, the relative ranking may vary as a function of the length of the investment horizon of the holder and may not be an objective characteristic of the option itself. It would therefore be useful that communication standards on this aspect make appropriate reference to different holding horizons[9].

Governance and administration is a third area that may deserve the definition of standards for the second regime. However, it is unclear whether the standards set up in general for the admissible

7 A more detailed discussion of the two options is contained in the EIOPA Report Towards an EU-single market for personal pensions, published in February 2014.

8 Inspiration is taken from OECD (2012), The OECD Roadmap for the good design of defined contribution pension plans. A useful contribution is also offered by EFAMA (2013): The OCERP: a Proposal for e European Personal Pension Product.

9 Similar reasoning have been included in the EIOPA advice to the European Commission for the revision of the IORP Directive, issued in February 2012.

providers (as mentioned above, already subject to their specific prudential rules) have to be integrated in the case they offer pension plans that are second regime compliant.

Distribution is a fourth, very important area of attention. However, taking in mind the overarching objective of keeping costs low, standards for a second regime should avoid requiring in all cases costly personalized advice and/or assessments of suitability. Indeed, a level of standardization appropriately high and well-designed defaults could indeed ensure a sufficient level of protection already at the level of the design of the products. Indeed, for second regime personal pension plans, non-personalized distribution channels could be appropriate (e.g. internet). Even centralized automated auction systems, that select plans based on their costs and enrol individuals accordingly (with an option to opt-out), could be considered. Besides, second regime personal pension plans could be distributed on the workplace, possibly with some involvement of the employer and/or trade union representatives.

6. Conclusion

Although the design of national pension systems is left to the responsibility of individual countries, pension policies are increasingly gaining relevance at EU level. The development of multi-pillar pension systems, including a significant funded component, is encouraged by international institutions. While in many countries occupational pension schemes are best placed to fulfil this objective, in other cases personal pensions have a significant role to play. However, in order to make the diffusion of personal pensions in the population at large both desirable and feasible, low costs and economies of scale are essential. The introduction of a well-designed second regime would be a promising initiative for the future development of pension systems across many European countries.