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PENSIONS AND THE FINANCIAL CRISIS - INFORMAL BACKGROUND BRIEFING NOTE

HOW DOES THE FINANCIAL CRISIS IMPACT ON PENSION SYSTEMS?

The inherent nature of pension funds and the way overall pension systems are organised in Europe helps to insulate pensions from the worst impacts of the financial crisis. So for those retiring today or already retired we can expect the effects for most people to be limited, though nonetheless some people may face more serious consequences. The impacts are dependent on the mix and proportions of various types of pensions in Member States' overall systems, the detailed design of these various elements and the severity and length of the ongoing financial crisis and wider economic impacts.

The crisis should focus minds in particular on addressing weaknesses in the design of some future overall pension arrangements.

Statutory State Pay-As-You-Go (PAYG) pensions

The overall pension income of people retiring today in Europe is still mostly provided by statutory state pensions funded on a **Pay-as-you-go (PAYG)** basis. PAYG pensions are (largely) paid from current contributions of workers and so they are not affected by investment performance, unlike funded pension schemes. So the overall pension income of European people is typically less vulnerable to impacts on investments. In the majority of Member States PAYG provides almost all of the pension income for those retiring today and there are only five Member States where funded provision is above 10% (these are DK on 16%, SE and UK both on 22%, IE on 54% and NL on 60%). A further three Member States are at, or slightly below, the 10% level (DE, CY, BE).[1]

Defined Benefit (DB) Occupational Pensions

For those retiring today who *do* have funded pension provision this is typically from **Defined Benefit (DB)** occupational pension schemes where the investment risk is taken by the scheme, not the individual scheme member. So the DB pension scheme member retiring today will still get the pension they expected based on their service and salary record, although for some indexation may be lower. The pension scheme itself will have been affected by the fall in the value of its investments, but given the very long term nature of its liabilities and investments, it can absorb these falls in the short term. For the longer term, the regulatory framework at both EU and national level is there to ensure that pension funds take action early to address funding levels to safeguard their long term health.

In the shorter term this action often involves (eg in NL) some impacts on pensioners and future pensioners now, as indexation of benefits are reduced and/or as contributions are increased. For some Member States (eg UK) employers will need to increase their contributions which could lead to them negotiating reduced benefits or higher

[1] According to table 7 "Contributions of various schemes to theoretical replacement rates (base case)" - page 19 of the SPC report "Privately managed pension provision and their contribution to adequate and sustainable pensions" published on 20 October 2008 available at http://ec.europa.eu/employment_social/spsi/adequacy_sustainability_en.htm

contributions with their employees on an ad hoc basis. The burden of extra contributions on employers may encourage some employers to close their DB schemes altogether and switch to a Defined Contribution scheme instead. This would reinforce a long term trend from DB to DC provision which puts more risk with pension scheme members (see graph below showing DB scheme closures in the UK).

UK DB schemes closing each year[2]

Numbers of scheme closures by year

Beyond these effects, a potentially more serious impact could occur where a company which sponsors a DB pension scheme becomes insolvent in the difficult economic conditions. Where the pension fund is in deficit pensions may have to be reduced, although the Insolvency Directive, as interpreted by the ECJ in the Robbins case, provides some protection. Insurance type fall back arrangements (such as the UK's Pension Protection Fund) may assist pension scheme members in these circumstances, but such assistance may be less generous than the original pension scheme would have been.

Defined Contribution (DC) Pensions

In **Defined Contribution (DC)** funded pensions the investment risk is taken by the individual and it is this type of funded provision that is expected to be behind the future growth of private funded provision in the EU. These are also often organised collectively (occupational schemes – UK, IE, SE) or by Government (statutory schemes – new Member States, SE and IT) but they can also be individual voluntary schemes

[2] Source UK The Pension Regulator and Pension Protection Fund publication "The Purple Book 2008" table 3.2. http://www.thepensionsregulator.gov.uk/pdf/PurpleBook2008.pdf

typically used to top up other pension income. Given transitional arrangements DC pensions are not very significant for most people retiring in Europe today but they are gradually replacing some DB or PAYG elements of pension provision for the future. Obviously as the investment risk is with the individual in DC schemes there is the potential for direct impacts when investments fall. However, for those some way from retirement there may be time for falls in investments to recover or recover partially. But for those close to retirement the impact can be real, leading to less well paid, or possibly delayed, retirements. However, these pensions are often only a small part of overall pension income for most Europeans reaching retirement today.

Some approaches to DC pension investments can help mitigate investment risk. For instance most European funds given their often collective/government nature take a diversified approach to investment, spreading risk. In some cases European DC pension funds also take a 'lifestyle' or 'lifecycle' investment approach. With this approach investment risk is taken when the pension scheme member is younger and investments then automatically gradually switched to lower risk assets like cash and Government bonds as retirement approaches. People close to retirement in such lifestyle/lifecycle funds are unlikely to be much affected by market falls in equities or other riskier asset classes, as they will no longer be invested in them.

For the future, DC schemes are expected to play an increasingly important role in pension provision in many Member States (see the table below for new Member States who have taken this approach). As DC schemes become a more important element in overall pension provision, the design of the investment strategies becomes more critical. In particular minimising risk when close to retirement, for instance by having lifestyling/ lifecycling as the mainstream investment choice.

Pension systems in Eastern Europe and Central Asia[3]

Country	% Wage to Funded Scheme	Proportion of total Contribution to Funded Scheme	Year Funded Scheme Started	Participation in Funded Scheme	Year Funded Participants Retire
Bulgaria	5%	**21.7%**	2002	Mandatory <42	Full cohorts in **2023**
Estonia	6%	**20.0%**	2002	Voluntary	Partial cohorts by **2012**
Hungary	8%	**23.9%**	1998	Mandatory new entrants; voluntary for all others	Partial cohorts by **2008**; full cohorts by **2035**
Latvia	8%	**24.0%**	2001	Mandatory <30, Voluntary 30-50	Partial cohorts by **2013**; full cohorts by **2033**
Lithuania	5.5%	**22.0%**	2004	Voluntary	Partial cohorts by **2014**
Poland	7.3%	**26.1%**	1999	Mandatory <30; Voluntary	Partial cohorts of women by

[3] Relevant EU countries extracted from World Bank Human Development Network paper "The Financial Crisis and Mandatory Pension Systems in Developing Countries Short- and medium-term responses for retirement income systems" http://siteresources.worldbank.org/INTPENSIONS/Resources/395443-1121194657824/PRPNote-Financial_Crisis_12-10-2008.pdf

				30-50	**2009** and of men by **2014**; full cohorts of women by **2029** and of men by **2034**
Romania	2%, increasing to 6%	**6.7%**	2008	Mandatory <35; voluntary 36-45	Partial cohorts of women by **2023** and of men by **2028**; full cohorts of women by **2033** and of men by **2038**
Slovak Republic	9%	**31.3%**	2005	Voluntary for all	Partial cohorts by **2015**

Source: Regional Bank Staff

As mentioned, there are also voluntary DC pension schemes that are available in a number of Member States and saving in these can be encouraged via fiscal incentives. Data on these voluntary pension saving arrangements is limited but they are not that significant in most Member States today with low coverage and/or contribution levels typical. In addition the payout arrangements can allow the money saved to be used for purposes other than providing retirement income, making the line between pensions saving and general long term saving blurred. What we can say is that at the time the data was gathered for the 2008 Commission/SPC report "Privately managed pension provision and their contribution to adequate and sustainable pensions" coverage was only really significant in CZ (45%), DE (28%), UK (18.9%) and IE (14.8%)[4]. With the exception of DE where the *Reister pensions* are expected to show continued rapid growth on the back of comprehensive incentives, most Member States are not anticipating strong growth in these kinds of pensions. But, where they will feature as an important element of overall retirement provision, there may be similar issues around investment approaches as with other types of DC pensions.

Risks and volatility

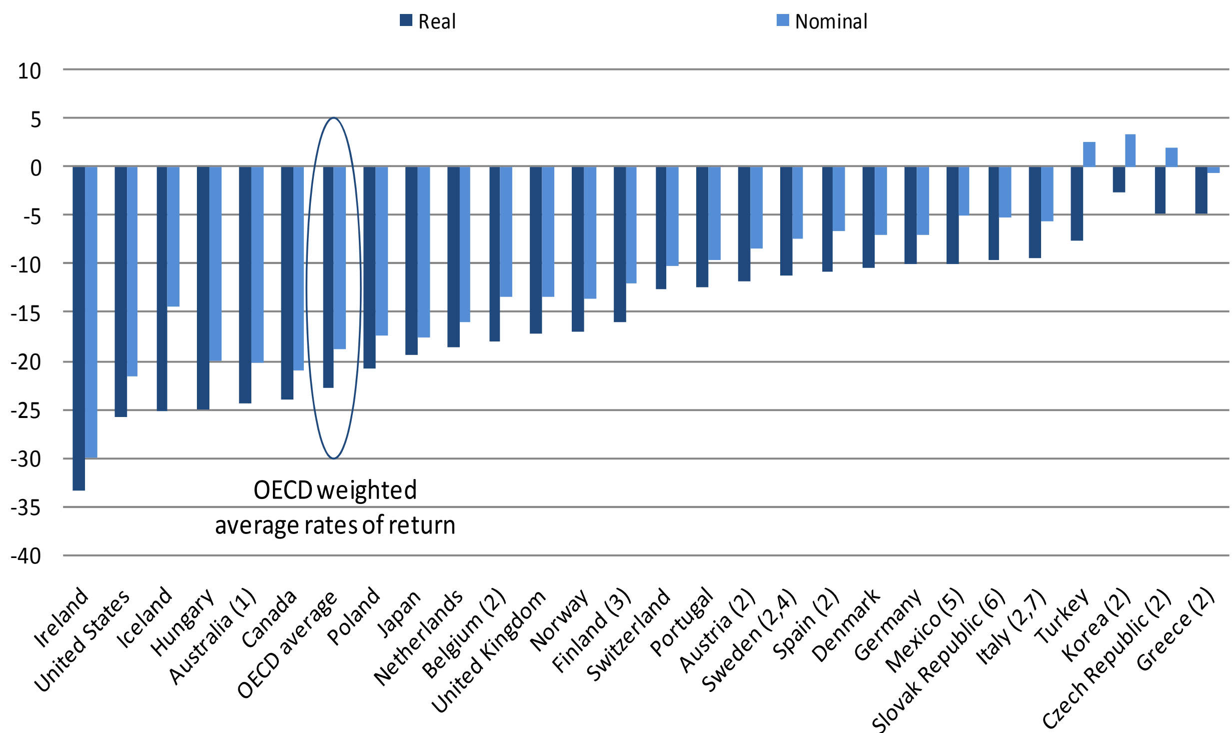
The overall risks and volatility of a person's pension income will depend on the overall pension provision and the proportion of different types of pensions any particular individual has, together with the detailed design choices of those pension schemes.

Funded pension schemes have clearly been impacted by the financial crisis as the graph below shows.

Nominal and real pension fund returns in selected OECD countries January-October 2008[5]

[4] "Privately managed pension provision and their contribution to adequate and sustainable pensions" published on 20 October 2008 available at http://ec.europa.eu/employment_social/spsi/adequacy_sustainability_en.htm

[5] OECD "PENSION MARKETS IN FOCUS" December 2008, Issue 5 http://www.oecd.org/dataoecd/42/19/41770561.pdf



Note: Some data draw on official data received from OECD Working Party on Private Pensions Delegates (Australia, Austria, Belgium, Czech Republic, Denmark, Finland, Greece, Hungary, Ireland, Italy, Korea, Mexico, Poland, Portugal, Slovak Republic, Spain, Switzerland, and Turkey), various sources and OECD estimates. OECD average is an asset-weighted average. Source: OECD Global Pension Statistics

However, given the long term nature of pensions investment, performance should be looked at over longer horizons than a single year.

The key, for those Member States that choose to include funded pension provision as part of the overall pension package, is that this volatility and risk is properly managed. From the individual's perspective, in general, most volatility and risk comes with funded DC schemes, although lifestyling investment strategies can help to mitigate this. DB schemes are normally much less risky and volatile, barring extreme events like sponsoring employers becoming insolvent when schemes are in deficit. And PAYG schemes by their nature do not take investment risk.

So in managing risks and volatility it is important to consider the appropriate maximum proportion of overall pension income to come from DC provision and to look at measures to mitigate the investment risks of DC provision. This is particularly the case for the less well off or those with shorter employment careers who may be less able to absorb the inherent risks. For DB provision, good risk sharing and/or security arrangements are important for the long term safety and viability of such schemes.

Prudential regulatory system and responses of supervisors

Although many aspects of the pension systems are the responsibility of Member States, occupational pension funds operate within a broader EU regulatory framework. The EU Directive concerning Institutions for Occupational Retirement Provision (IORP

Directive) was adopted in 2003.[6] The Directive aims at promoting cross-border activity of occupational pension provision within the internal market in order to offer more choice at a lower cost to employers and employees. This is flanked by a comprehensive set of rigorous prudential regulation to safeguard the security of pension rights for current and future pensioners. Solvency rules are an essential component of the prudential framework for funded occupational DB pension schemes. Regulators need to oversee the funding levels of DB pension schemes to ensure they can meet their promises over the long term. The Commission launched a consultation on the need for further harmonisation of solvency rules for IORPs in September last year.[7] Sixty replies were received. A Public Hearing is scheduled for 27 May 2009 to draw first lessons from these contributions.

The IORP Directive also contains some rules on pension fund governance that are contained in the OECD guidelines on pension fund governance.

In response to the crisis, national supervisors have so far taken very measured actions. They have used the possibilities provided in the EU framework and national regulations to make it easier for funds to establish realistic recovery plans that aim at returning to acceptable funding levels over time. Schemes themselves have looked to get a more stable view of valuations and extend recovery periods to smooth the impacts. They have also taken action for instance by increasing contributions from employers and/or reducing indexation.

Role of EU

Pensions are primarily the responsibility of Member States. However, the European level Open Method of Coordination (OMC) seeks to assist Member States in developing their pension systems towards the shared goals of providing adequate, sustainable and transparent pension systems for all. The Commission's role in this is to highlight issues and assist and encourage the sharing of data and best practice.

A key output of the OMC in the pension's field is the Annual Joint Report and supporting documents on social protection and social inclusion which are produced by the Commission and Council based on material provided by Member States in their National Strategy Reports. These joint reports assess progress made in implementing the common objectives, set key priorities and identify good practice and innovative approaches of common interest to Member States. The 2009 Report has recently been published and contains a wealth of interesting information[8]. The Commission also assesses the economic and budgetary challenge posed by pension systems, notably PAYG schemes, given the ageing of the population. These projections are carried out jointly by the

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[6] Directive 2003/41/EC on the activities and supervision of institutions of occupational retirement provision. Commonly known of the IORP Directive.

[7] Further information is available at: http://ec.europa.eu/internal_market/consultations/2008/occupational_retirement_provision_en.htm

[8] Joint Report on Social Protection and Social Inclusion 2009 available at http://ec.europa.eu/employment_social/spsi/joint_reports_en.htm

Commission and the Member States in the Economic Policy Committee[9]. An update of this assessment is due in 2009.

By definition, areas subject to the OMC process are ones which are primarily the responsibility of Member States. Nonetheless some aspects of pension provision are subject to the framework of European level regulation. A key example is the above-mentioned IORP Directive. Another important regulation is the Insolvency Directive[10] as it offers protection to pension scheme members in the event that the company which sponsors their pension scheme becomes insolvent. The Robbins ECJ case of 2007 provided further clarity on this protection. Some Member States (eg UK) have mandatory insurance type schemes which offer protection to pension scheme members in the event of the insolvency of the sponsoring employer.

Frequently Asked Questions

What's the difference between Defined Benefit (DB) and Defined Contribution (DC) pensions and who takes the investment risk?

DB schemes use a fixed formula to determine what the pension will be. Normally this is based on things like the number of years of contributions a pension scheme member has made and their salary level. So the level of pension (benefit) is set (defined). Therefore funded DB pension schemes need to have enough assets to meet these pension promises as they fall due over the long term and pension contributions are invested for this purpose. In general the expected pension will be paid to the scheme member according to the fixed formula. So the pension scheme takes on (most) of the investment and other risks, though there is often some element of formal or informal sharing of risk.

DC schemes on the other hand involve paying a set amount into a fund which is then invested on behalf of the pension scheme member. The value of the fund on retirement is then used to provide retirement income. So the contribution into the fund (from employer and/or employee) is fixed (defined), but the amount of pension is not. If the invested fund does well, retirement income will be higher than if it does badly. So the risks are taken by the individual scheme member.

How can Defined Benefit (DB) pension funds be in deficit?

As Defined Benefit (DB) pension schemes make promises about the level of pension to be paid in the future they need to have enough assets to meet these pension promises as they fall due over the long term. At any one time any particular DB pension fund can be in deficit or in surplus depending on the difference between the measured level of liabilities (the cost in today's money terms of all the pension promises made) and the assets (investments). Fluctuations are normal, what matters is having a balance between assets and liabilities over the long term.

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[9] http://ec.europa.eu/economy_finance/epc/epc_sustainability_ageing_en.htm

[10] Council Directive 80/987/EEC of 20 October 1980 on the approximation of the laws of the Member States relating to the protection of employees in the event of the insolvency of their employer

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If my Defined Benefit (DB) pension scheme is in deficit does this mean my pension won't be paid?

Short term deficits are not that critical – most of a pension schemes liabilities by definition are not due to be paid for many years, so there is plenty of time for the situation to be put back in balance. Existing pensions in payment typically amount to only a small proportion of a pension scheme's assets, so pension schemes could carry on paying these for some years even if they had no income coming in. Of course in reality pension schemes still receive some income from investments (eg yields on bonds, dividends from shares and rents from property to name three common pension investments) even in difficult economic times and funds normally also have income from new contributions for current workers.

How will DB pension fund deficits be closed?

European and national regulations are there to ensure that DB pension schemes that are in deficit take action to return to balance. The exact actions taken depend on the particular pension scheme and Member State's system but they typically include additional contributions from employers and/or employees or reductions in indexation or other elements of the pension. Given the long term nature of pension schemes' liabilities any deficits can be gradually closed over a number of years which helps smooth the impacts.

For instance, in NL, conditional indexation of pensions or increases in members' contributions can be used to balance the schemes funding. In the UK, the sponsoring employer is legally obliged to support the pension scheme and makes extra contributions where necessary. But, particularly in difficult times, ad hoc negotiations can lead to some sharing of the burden with scheme members via higher employee contributions or changes to pension benefits.

But what happens to DB occupational pensions if the company sponsoring the pension fund goes bust? What role does the EU have?

Member States take a number of different approaches to protecting the interests of DB occupational pension scheme members. These include having higher scheme funding standards to give a buffer, making employers legally liable for pension fund deficits and strict oversight by national pension supervisors. Where the pension fund is not in deficit, then the insolvency of the sponsoring employer should not have an impact – there are sufficient funds to pay pensions and future pensions.

But should the worst happen despite these measures and a sponsoring employer become insolvent at a time when the pension scheme is in deficit then pensioners and future pensioners may not get everything they expected. At EU level the Insolvency Directive, as interpreted by the ECJ in the Robbins case, provides some protection in these circumstances. National level insurance type fall back arrangements, such as the UK's Pension Protection Fund, can help ensure most (but not necessarily all) of the expected pension is paid.

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Can Defined Contribution (DC) pension schemes be in deficit?

No. By definition DC pension schemes cannot be in deficit as there is no promised pension outcome to be met – poor investment performance simply means lower pensions for pension scheme members.

Does the Commission advocate a certain pension model? In particular does the Commission advocate funded pensions as a solution to the ageing challenge?

Pensions are primarily the responsibility of Member States. However, the European level Open Method of Coordination (OMC) seeks to assist Member States in developing their pension systems towards the shared goals of providing adequate, sustainable and transparent pension systems for all. The Commission's role in this is to highlight issues and assist and encourage the sharing of data and best practice.

The Commission does not take a dogmatic view one way or the other on pension models or the specific issue of private funded pensions. What matters is that coverage, adequacy and sustainability of the overall pension frameworks are ensured. All Member States are facing the long term challenge of demographic change as the ratio of those of working age in the EU to those over 65 halves by 2050, from 4 workers for every person over age 65 to only 2. Amongst other things, this has serious implications for the adequacy and sustainability of all types of pension systems including pay-as-you-go (PAYG) or funded private provision. It is for Member States to decide how best to tackle this challenge within the context of their particular circumstances and existing overall pension system. Elements the Commission consider important in any long-term strategy are working longer, reducing public debt and pension reform. Some Member States have made the choice to increase private provision as part of their attempts to tackle sustainability of pensions whilst maintaining adequacy.

What has/does the EU do to improve pensions systems in the EU?

The European level Open method of Coordination (OMC) seeks to assist Member States in developing their pension systems towards the shared goal of providing adequate and sustainable pensions for all. The Commission's role in this is to highlight issues and assist and encourage the sharing of data and best practice. A major output is the Joint Reports and the 2009 Report has recently been published. There are many other ad hoc outputs including the recent report "Privately managed funded pension provision and their contribution to adequate and sustainable pensions" published on 20/10/08. The report points out variations between Member States in their approaches to private pension provision and need to ensure that where funded private provision exists, its coverage and adequacy match its intended role.

Although pensions are primarily the responsibility of Member States, there is also some EU level framework legislation, notably the IORP Directive which covers occupational pensions. This Directive, whilst leaving the detailed rules to Member States, establishes prudential standards for occupational pension schemes. Another important Directive is the Insolvency Directive which provides protection in the case of the insolvency of a company which sponsors an occupational pension scheme.