# GREEN PAPER
# towards adequate, sustainable and safe European pension systems

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## 1. INTRODUCTION

An adequate and sustainable retirement income for EU citizens now and in the future is a priority for the European Union. Achieving these objectives in an ageing Europe is a major challenge. Most Member States have therefore sought to prepare for this by reforming their pension systems.

The recent financial and economic crisis has aggravated and amplified the impact of the severe trend in demographic ageing. Setbacks in economic growth, public budgets, financial stability and employment have made it more urgent to adjust retirement practices and the way people build up entitlements to pensions. The crisis has revealed that more must be done to improve the efficiency and safety of pension schemes.[1]

President Barroso highlighted in his political guidelines for this Commission that:

*"Millions of Europeans are wholly dependent on pensions. The crisis has shown the importance of the European approach to pension systems It has demonstrated the interdependence of the various pension pillars within each Member State and the importance of common EU approaches on solvency and social adequacy It has also underlined that pension funds are an important part of the financial system We need to ensure that pensions do the job intended of providing the maximum support to current and future pensioners, including for vulnerable groups "*

Member States are responsible for pension provision: this Green Paper does *not* question Member States' prerogatives in pensions and it does *not* suggest that there is one 'ideal' one-size-fits-all pension system design At European level national retirement systems are underpinned by a framework of activities spanning from policy coordination to regulation since some common themes, need to be addressed in a coordinated way – be it the functioning of the internal market, the requirements of the Stability and Growth Pact, or to ensure that pension reforms are consistent with the Europe 2020 strategy. Sound pension systems are crucial for citizens, and the significance of public pension expenditure for public finance developments in one Member State may have strong repercussions on others. EU policy coordination on pensions has proven useful and necessary in order to make progress at Member State level. Pension funds are an integral part of the European financial markets and their design can promote or inhibit free movement of labour or capital, therefore requiring appropriate measures at EU level including certain tax issues[2].

Following a decade of reforms that have altered pension systems in most EU Member States, there is now a need to thoroughly review the European framework. Demographic ageing has been faster than previously expected and the recent financial and economic crisis has exerted a dramatic impact on budgets, capital markets and companies There have also been deep structural changes such as new intergenerational balances, shifts from Pay-As-You-Go

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1 The European Parliament is also engaging a policy discussion on the lessons learnt from the crisis: see, for example, Working Document No 2 on the social impact of the crisis: employment, demographic challenges and pension systems (rapporteur Pervenche Berès), 18 February 2010, prepared in the context of the Special Committee on the Financial, Economic and Social Crisis.

2 A concrete example is the Commission's Pension Tax Communication of 2001 (COM (2001) 214 final) and subsequent infringement procedures to help ensure a level playing field for the taxation of pension contributions and investment income.

(PAYG) pensions to funded pensions and the shift of more risks to individuals. This Green Paper launches a European debate through extensive and early consultation about the key challenges facing pension systems and how the EU can support Member State efforts to deliver adequate and sustainable pensions.

This Green Paper takes an integrated approach across economic, social and financial market policies and recognises the links and synergies between pensions and the overall Europe 2020 strategy for smart, sustainable and inclusive growth[3]. The goal of generating adequate and sustainable retirement incomes through pension reforms and the important goals of the Europe 2020 strategy are mutually reinforcing. The Europe 2020 strategy emphasises higher and better quality employment and positive transitions: both are decisive for workers (both women and men) to accrue pension rights. The 75% employment target requires employment rates significantly beyond the present levels in the age group 55 to 65. Addressing gaps in pension adequacy, which can be a significant cause of poverty among the elderly, can also contribute to achieving the Europe 2020 poverty target. Other goals include tackling bottlenecks in the completion of the single market, for example through strengthening the safety and integration of the internal market in financial products and facilitating the mobility of workers and citizens across the EU. In return, pension reforms will not only contribute towards reaching the Europe 2020 employment target but also towards the long-term sustainability of public finances. Moreover, completing the internal market for pension products has a direct impact on the EU growth potential and therefore it directly contributes towards the Europe 2020 objectives.

## 2. KEY CHALLENGES

### 2.1. DEMOGRAPHIC AGEING

Whilst it is well known that Europe is facing a major demographic challenge[4], things are coming to a critical stage as the first cohorts of baby boomers are now approaching retirement and Europe's working age population is set to start shrinking from 2012 onwards.

The fact that Europeans live longer than ever before is of course an enormous achievement for our societies. Over the last 50 years, life expectancy has risen by about five years in the EU. The latest demographic projections[5] reveal that a further rise of about seven years could materialise by 2060. Combined with low fertility rates this will lead to a dramatic change in the age composition of the population. As a result, the old-age dependency ratio will double: where at present there are four people of working age for every person over age 65, by 2060 there will be just two people of working-age per person over age 65.

[3] This Green Paper takes into account work undertaken in the Economic Policy Committee and the Social Protection Committee (the Joint Report on pensions). The joint analysis of the Committees is focused on the results of the last decade of pension reforms, the impacts of the crisis on pension systems, and the long-term perspectives beyond the crisis. The Interim Report was noted by the 7-8 June 2010 EPSCO and ECOFIN Councils (check delivery). It contains detailed tables and figures and can be found under the following link: http://ec.europa.eu/social/main.jsp?catId=752&langId=en (update)

[4] See Commission communication on Ageing of 29th April 2009 "Dealing with the impact of an ageing population in the EU (2009 Ageing Report)" and the Commission staff working document *Demography Report 2008 – Meeting social needs in an ageing society* (SEC (2008) 2911).

[5] See European Commission and Economic Policy Committee (2009) "2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-2060), European Economy, No 2

In addition to demographic ageing, there are also other longstanding trends in the labour markets. People now often start their full time working lives later because of the increased need for education and they retire earlier due to age management in labour markets and prevailing policies. Although early retirement has started to reverse, most people, and in particular women, still leave the labour market significantly before the typical pensionable age of 65, entailing fewer workers per pensioner.

On present trends it is clear that the situation is not tenable. Unless people, as they live longer, also stay longer in employment, either pension adequacy is likely to suffer or an unsustainable rise in pension expenditure may occur. Indeed, the impact of the demographic challenge as aggravated by the crisis will tend to reduce economic growth and put pressure on public finances. The 2009 Ageing Report[6] showed that, on account of the shrinking labour force, the only source of growth by 2020 will be labour productivity. At the same time, while reforms have already significantly reduced the impact of ageing on future pension costs, age-related public expenditure is still set to increase overall by almost 5 percentage points of GDP, half of which is due to spending on pensions.

Another longstanding trend is societal change – such as single households, couples without children and different generations of a family living far apart from each other – which is fuelling more formal provision of care services otherwise provided within the family. New forms of family structures and inter-generational solidarities are posing further challenges regarding the financing of the costs for health and long-term care. This might have wider implications for the adequacy of pensions and the sustainability of public finances

Aside from the obvious impacts on PAYG provision, funded pensions could also be affected by demographic ageing. Arguably, ageing societies would reduce the potential growth rate of the economy implying lower real rates of return and this could also affect financial asset prices. Such potentially lower returns on pension fund investments may lead to higher contributions, lower retirement benefits, increased capital outflows to emerging markets or greater risk taking.

## 2.2. RESULTS OF PENSION REFORMS

Against the background of demographic ageing, the European Council at its March 2001 meeting in Stockholm agreed a three-pronged strategy for dealing with the impact on public budgets. This strategy consisted of:

- reducing debt at a fast pace;
- raising employment rates and productivity; and
- reforming pension, health care and long-term care systems.

Moreover, in December 2001 the European Council meeting in Laeken followed this by agreeing a set of common objectives for pensions emphasising the need to make them adequate sustainable and adaptable[7].

6 Ibid.

7 "Quality and viability of pensions – Joint report on objectives and working methods in the area of pensions [10672/01 ECOFIN 198 SOC 272]

In light of these orientations, there has been significant progress in adapting and reforming European pension systems over the past decades. While Member State systems differ markedly, a majority have been adapted so as to put them on a more sustainable footing. At the same time, Member States have attempted to protect adequacy and have modernised systems to respond better to changes in labour markets and gender roles. Key trends of particular relevance have been[8]:

1) Encouraging more people to work more and longer so as to obtain similar entitlements as before through measures including: increases in pensionable ages; bonus/malus incentives rewarding later and punishing earlier retirement; moves from benefits based on earnings in best years towards entitlement based on working career average earnings; closing or restricting early exit pathways; labour market measures to encourage and enable older workers to stay in the labour market and encouraging greater gender equality in the labour market.
2) The move from largely single to multi-tiered systems where pension income is provided through a combination of different schemes. This shift has emerged as a result of the trend in most, but not all, Member States to lower the share of public pay-as-you-go (PAYG) pensions in total provision while giving an enhanced role to supplementary, prefunded private schemes, which are often of a Defined Contribution (DC) nature.
3) Measures to address adequacy gaps, for instance through efforts to broaden coverage, support building up rights, easing access to pensions for vulnerable groups and increase in financial support for poorer pensioners.

Reforms have underpinned recent increases in effective retirement ages and opened new avenues to deliver adequate pensions in an affordable and sustainable manner. At the same time, reforms have given rise to new risks and larger individual responsibility for outcomes. While citizens now have more choice, they are also exposed to more risk. This has implications for facilitating good choices and managing risks. For reforms to be successful, all pension schemes must deliver their part and risks must be well understood and mastered. Future pension adequacy will rest on a combination of returns in financial markets and labour markets delivering opportunities for longer and less broken contributory careers. Some adequacy gaps remain and new ones have opened. A number of Member States still need to address issues such as minimum pensions, coverage of atypical workers and crediting of some involuntary employment breaks, for example when caring for frail dependents. These issues have important gender equality implications, as women tend to predominate among those with atypical contracts and they take career breaks for caring responsibilities more often than men. While periods of care are recognised in some PAYG systems, this is less straightforward in funded pension schemes, where the question of how to finance such forms of solidarity needs to be answered.

The reformed pension systems increase adequacy risks for a considerable number of workers The net replacement rates will be reduced in many Member States, though the starting position and the degree of reduction vary significantly across countries, and some, especially those having very low initial levels, have also succeeded to increase them. Delaying labour market exit can reduce the declines depending on national circumstances.

[8] [The Interim Joint Report on pensions of the Economic Policy Committee and the Social Protection Committee, available at http://ec.europa.eu/social/main.jsp?catId=752&langId=en, contains a more detailed assessment (check delivery)]

There are also some important risks which still have to be addressed. In many Member States additional reforms of pension policy will be needed in view of the scale of demographic changes ahead and to ensure the lasting success of reforms already implemented. For Member States where the pension reform process has not been sufficiently set in motion, there is an urgent need to review the 'pension promise' in view of what the rest of the economy - and public budgets in particular - can be expected to provide.

## 2.3. IMPACT OF THE FINANCIAL AND ECONOMIC CRISIS

The financial and economic crisis has seriously aggravated the underlying challenge from demographic ageing. By demonstrating the interdependence of the various schemes in national pension systems and revealing weaknesses in some current scheme designs it has functioned as a wake-up call for all pensions, whether pay-as-you-go or funded. Private schemes can relieve some of the pressure on public pension provision. However, increasing reliance on private schemes has fiscal costs, given the widespread practice of providing tax incentives during the accumulation phase. As noted by the SPC,[9] depending on the design, the costs of tax relief can be considerable and their effectiveness and redistributive impacts questionable. With public budgets under heavy pressure, some Member States are now reconsidering the efficiency of this spending. Better sharing of information on pension tax reliefs, their costs and effectiveness in supporting pension adequacy may help policy makers across the EU, when considering these issues for themselves[10]. Furthermore, if private schemes are in difficulty and cannot deliver on their promises, there will inevitably be pressures on the public purse to pick up part of the tab. Importantly, higher unemployment, lower growth, higher national debt levels and financial market volatility have made it harder for all systems to deliver on pension promises.

With secure incomes from public pensions, which generally have been allowed to perform their role as automatic stabilisers, current pensioners have so far been among the population groups least affected by the crisis. Exceptions apart, benefits from funded schemes still play a marginal role in the pensions of retired Europeans and just a few Member States with very acute public budget problems or well-anchored automatic adjustment mechanisms were compelled to reduce public pensions in payment. But the crisis and lower growth prospects will impact on all types of pension schemes and in the future funded schemes will be much more important in benefit delivery.

The scale of fiscal deterioration following the crisis is equivalent to offsetting 20 years of fiscal consolidation, implying that fiscal constraints will be very strong in the next decade. Moreover, estimates suggest that the crisis will put further pressure on public pension spending over the long-term because economic growth is set to be considerably lower and there is great uncertainty as to when and to what extent the EU's former growth potential will fully recover.[11] In a number of Member States some social security contributions were diverted to newly established mandatory funded pensions, leaving lower total contributions to fund existing PAYG pensions. The crisis has underscored this double payment problem.

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9 Section 4.2 page 26 of SPC Report "Privately managed funded pension provision and their contribution to adequate and sustainable pensions" (2008) http://ec.europa.eu/social/main.jsp?catId=752&langId=en

10 This could include, for instance, sharing experience on approaches such as 'communicating vessels' whereby the amount of tax relief available for voluntary individual savings is inversely related to the amount of statutory and occupational pensions an individual already has.

11 See European Commission and Economic Policy Committee (2009) "2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-2060), European Economy, No 2

This has caused a few governments to halt or lower contributions to private pensions to improve the finances of public pensions for current pensioners.

In the short term, the return rates and solvency of funded schemes have been affected in major ways. Private pension funds lost more than 20% of their value in the course of 2008[12] and interest rates (thus the returns) fell back considerably. Moreover several sponsors of occupational pension funds found themselves in a very difficult financial situation, hindering their ability to honour their obligations. However, as few schemes had to lock in losses in the market value of their assets to meet their current liabilities, national supervisors have in the first instance been able to react by easing valuation and solvency regulations to allow time for markets to recover. After the steep tumble in financial markets prices in 2008 many pension funds have been able to recoup some of their losses in 2009[13]. But many still remain far from the required solvency levels.

Variations in the ability of funded schemes to weather the present crisis have demonstrated that differences in design, regulation and investment strategy clearly matter. While all funded schemes are affected, their losses vary with investment practices and their ability to absorb the shock depends not just on the scale but also on how well the burden is shared among providers, active contributors and benefit recipients. Unfortunately, schemes in countries where solvency requirements were lower and asset value losses particularly large also tend to have poorer protection of accrued entitlements and the least flexible mechanisms for burden sharing. As a result, entitlements can be lost and providers inclined to discontinue schemes, since they cannot on their own afford to bring schemes back to solvency.

The crisis will also have a serious impact on future pensions as many workers will have lost their jobs and have been unemployed for a certain period and others might have had to accept lower earnings or shorter working hours[14].

The crisis has, therefore, added the following dimensions to the pre-existing reform agenda:

- an increased urgency to address adequacy gaps
- a greater urgency for reforms that improve the sustainability of public finances
- an increased emphasis on raising effective retirement ages
- a need to revisit the regulation of funded pension schemes to ensure that they are efficient and remain safe in the wake of major financial crises whilst ensuring regulation is proportionate and does not push employers into insolvency or abandoning pension schemes;
- a need to ensure that financial market regulation is effective and intelligent given the growing role of pension funds. The G20 Pittsburgh summit has emphasised that all financial institutions should be regulated and that there is a greater need for common rules.

12 OECD, "Pensions and the crisis – How should retirement income systems respond to financial and economic pressures" 2009

13 See OECD "Pension Markets in Focus". October 2009, Issue 6

14 [Chapters 3.3 – 3.5 of the Interim Joint Report on pensions of the Economic Policy Committee and Social Protection Committee, available at http://ec.europa.eu/social/main.jsp?catId=752&langId=en, provide further information on the potential impact of the crisis on pensions (check delivery)]

## 3. PRIORITIES FOR MODERNISING PENSION POLICY IN THE EU

The overarching objectives of pension reforms are to ensure that pension systems are adequate and sustainable. Further policy action is needed on a number of fronts: addressing adequacy gaps; closing sustainability gaps; extending working lives, notably through increases in pensionable and effective retirement ages; removing obstacles to mobility within and between Member States; and strengthening safety in pensions.

There has been a tendency to treat the three-pronged Stockholm strategy as a list from which to pick and choose. But if pension systems are to deliver and if the Europe 2020 strategy is to succeed, it will now be necessary to address all three issues in a co-ordinated way.

### 3.1. OVERARCHING OBJECTIVES: ADEQUATE AND SUSTAINABLE PENSIONS

The overarching objectives of *adequacy* and *sustainability* are two sides of the same coin. While in the short run the two goals might conflict, in the long run this is no longer the case, on the contrary. If there is a risk of pensions not being adequate, it may result in unforeseen pressures for *ad hoc* increases of pensions or higher demand for other benefits, jeopardising sustainability. Equally if a pension system is unsustainable it will prove to be inadequate in the long run when sudden corrections are needed. Thus the issues of pension adequacy and sustainability need to be considered jointly. There is no one-size-fits-all solution for pension arrangements; all systems in the EU need to adapt to long-term demographic and economic trends.

- **Addressing pension adequacy**

Ensuring adequate retirement income is the purpose of pension systems. This relates to fundamental inter- and intra-generational solidarity. Most reforms of pension systems so far have been aimed at improving sustainability. Further modernisation of pension systems will be needed to address adequacy gaps. As replacement rates in public pensions in most cases will be reduced, it will be important to give people sufficient opportunities to building other entitlements: measures could include enabling longer working lives and increasing access to supplementary pension schemes. Moreover, the lack of compensatory crediting of periods of unemployment, sickness or caring duties can also lead to gaps, as can the lack of coverage of short-term contract workers or insufficient minimum pension guarantees but raises questions about its financing. In funded schemes, reducing investment risk for pension funds notably close to and in the pay-out phase and improving risk sharing between pension savers and pension providers, building on the advantages of collective insurance, can have a positive impact on the adequacy of retirement income. Broadening the sources of retirement income beyond pensions may also need to be considered.

- **Securing sustainability**

Further reforms of pension systems are now necessary and urgent to put them on a more sustainable footing, thereby contributing to the long term sustainability of public finances. Many pension reforms have contributed to limit the increase in future public pension spending, but additional steps are needed. In particular, in countries where future public pension spending is projected to be on an unsustainable path, further reforms of pension arrangements will be a necessary ingredient. Failing to take resolute policy action to enhance sustainability will push forward the burden of adjustment to either future workers who will have to pay the pensions for more pensioners, or to future pensioners who might not have prepared themselves for a situation where pensions are lower than they had expected under current polices, as underlined by the European Council[15]. Given the dire state of public finances and the projected unsustainable increase in public debt levels with unchanged policies, fiscal consolidation will be a binding constraint for some time to come on all policies, including pensions. The Stability and Growth Pact (SGP) provides the framework for monitoring the sustainability of public finances, including pension systems. Moreover, there could be further pressures for spending on care for the elderly if formal care were to increasingly replace informal care in the future. Reforms that enhance the EU's economic growth potential, e.g. by stimulating labour supply, would, therefore, be particularly important since these reforms would improve the sustainability of all pension systems and alleviate the pressure on public finances. Higher labour productivity growth is beneficial for all citizens, as it enables higher living standards. As regards fiscal sustainability, achieving higher employment rates in particular for older workers remains is even more important.

1. *How can the EU support Member States' efforts to strengthen the adequacy of pension systems? Should the EU seek to define better what an adequate retirement income may entail?*

2. *Is the existing pension framework at the EU level sufficient for ensuring sustainable public finances?*

### 3.2. ACHIEVING A SUSTAINABLE BALANCE BETWEEN TIME SPENT IN WORK AND IN RETIREMENT

Time spent in retirement has increased considerably over the past century and there are large differences across Member States. Currently, typically about one third of adult life is spent in retirement and this share will increase substantially with future gains in life expectancy[16] unless the length of working life increases and people retire later. Only about 50% of people are still in employment by the age of 60. This goes against Member State commitments at the Barcelona European Council to postpone the age at which people stop working by 5 years. It is also inconsistent with the objective of reaching the Europe 2020 75% employment rate target and it impacts negatively on growth and income potentials. As crisis setbacks have aggravated the challenge of the imminent reduction of the working-age population, it is becoming impossible to sustain present retirement patterns. At the average actual labour market exit age of just over 60 years, the economic dependency ratio amounts to three people in active age to one pensioner. This would decline to two people of active age to one pensioner in 2030 and to three actual workers per four pensioners in 2060. This otherwise very steep rise in economic dependency ratios could be largely avoided if people would work longer. Without this a painful combination of lower benefits and higher contributions would be inevitable.

A key to supporting adequacy and sustainability is ensuring that the time spent in retirement does not continue to increase compared to time spent working. This means increasing the age

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15 The Presidency conclusions of the 23 March 2005 COUNCIL OF THE EUROPEAN UNION 7619/1/05, REV 1, stressed the need *"to safeguard the sustainability of public finances in the long run, to promote growth, and to avoid imposing excessive burdens on future generations."*

16 [See chapter 3 2 1 of the Interim Joint Report on pensions of the Economic Policy Committee and Social Protection Committee, available at http://ec.europa eu/social/main.jsp?catId=752&langId=en, (check delivery)]

at which one stops working and takes up a pension. Many Member States have already decided to raise the eligibility age for a full pension in their public pension schemes. There seems to be a growing awareness that upward adjustments to the pensionable age represent an important signal to workers and employers, which motivate them to aim for higher effective retirement ages. A number of Member States have demonstrated that the sustainability of pension systems can be greatly strengthened by introducing an automatic adjustment that increases the pensionable age in line with future gains in life expectancy. This practice represents a promising policy options.

The feasibility of universal pensionable ages has always been debated due to occupational differences in labour market entry ages and to the health status of workers in different occupations. Most Member States address this challenge through resolute policies to improve health and safety at work while providing access to pathways for those in real need before the pensionable age. National efforts are underpinned by the European Health and Safety Strategy. A few Member States have also taken account of differences in entry ages by combining measures to increase pensionable ages with those increasing the number of contributory years required for a full pension, thereby prolonging working lives.

As labour market exit ages are still low, the question is whether common EU principles and pathways to adequate and sustainable pensions, applied in a differentiated manner, to cater for differences in pension systems and degree of challenges between Member States, would be helpful? Such pathways would aim at enabling people to seize opportunities to build adequate entitlements whilst also making EU economies more sustainable. This requires pension system reforms to be supplemented with substantial efforts to allow workers to maintain their work ability and employability throughout their working lives. For example, it has been suggested that a gradual transition to retirement via part-time work could help support retirement income.

Key measures enabling older workers, both women and men, to remain longer in the labour market would include access for all, irrespective of age, gender and ethnicity, to labour markets, to training and adjustments. The European Social Fund supports measures to improve the employability and raise the employment rates of women and men of all working ages.

This could involve adapting social and financial incentives to work, including Member States examining the role of their tax rules. Other measures could include adjusting age management, working arrangements and attitudes in labour markets and work-places, as well as considering conditions for older self-employed workers. Successfully implementing a prolongation of working lives reflecting continuous gains in life expectancy over time will give rise to a double dividend: higher living standards and progress towards sustainable pensions.

Member States are already endeavouring to extend working lives and have taken a number of measures to help achieve this[17].

17 [See chapter 2.1 of the Interim Joint Report on pensions of the Economic Policy Committee and Social Protection Committee, available at http://ec.europa.eu/social/main.jsp?catId=752&langId=en, (check delivery)]

*3. How can higher effective retirement ages best be achieved and how could increases in pensionable ages contribute? Should automatic adjustment mechanisms related to demographic changes be introduced in pension systems in order to balance the time spent in work and in retirement? What role could the EU level play in this regard?*

*4. How can the implementation of the Europe 2020 strategy be used to promote longer employment and to address age discrimination in the labour market?*

## 3.3. REMOVING OBSTACLES TO MOBILITY IN THE EU

Policies and regulation need to facilitate the free movement of production factors, notably labour and capital, so as to use the available resources in an efficient way and create favourable conditions to maximise income for every person. Greater flexibility in job mobility supports the adjustment capacity of the economy and thereby strengthens the European social model. Workers must be able to move freely around the EU without losing important work-related pension benefits. This might imply the need for minimum standards to improve mobile workers' access to supplementary pension rights within and between Member States. Such standards could be important not only for fairness, but also to ensure that workers can more easily change jobs, thereby enhancing the adjustment capacity of the economy. Unleashing the full potential of the single market could bring significant benefits for all citizens. Integrated and well-functioning labour and capital markets are key ingredients in the EU's growth-orientated macro-economic policy framework. More information on the current EU framework on pensions can be found in the annex.

### 3.3.1. Strengthening the internal market for retirement products

The adoption of the Directive on Institutions for Occupational Retirement Provision (IORP) in 2003 was a major achievement. But this Directive only covers those funded pensions that are occupational in nature and not even all occupational schemes fall under its scope (e.g. book reserve schemes are excluded). Moreover, this Directive is not a framework directive, which makes it difficult to adapt the regulation to market changes. Consultations carried out by the Commission and by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) in 2008 and 2009 have confirmed that there are still considerable barriers for cross-border activity. The main obstacles include the unclear definition of cross-border activity, the lack of harmonisation of prudential regulation and the complex interaction between EU regulation and national Social and Labour law. Removing these obstacles may require above all a review of the IORP Directive, further supervisory convergence and more transparency about national differences. Moreover, important aspects of pension fund governance need to be addressed, including an adequate understanding of investment decisions, remuneration, incentive structures for service providers and socially responsible investment (SRI). Pension funds are increasingly important institutional investors and they need to integrate the opportunities and risks that Environmental, Social and Governance (ESG) factors bring to their investment process.

Appropriate and comparable accounting standards are important to enhance transparency about pension liabilities. In response to calls from a broad range of stakeholders[18], the IASB

18 For example, European Federation for Retirement Provision (EFRP), "Workplace pensions: beyond the crisis", 10 February 2010

has undertaken a project to review its pension accounting standard IAS 19 [19] The European Commission jointly with its technical advisor, the European Financial Reporting Advisory Group (EFRAG), will closely monitor the IASB project to improve pension accounting, possibly also for the pension funds themselves, in accordance with the endorsement process established through the IAS Regulation.[20]

Although the Internal Market for insurance products has been in place for a longer time, cross-border activity for life assurance products has also remained limited. Data from the European insurance and reinsurance federation (CEA) suggests that cross-border activity remains well below 10% of total life assurance premiums written in most Member States. The Internal Market could also be helpful in extending access to additional sources of retirement income beyond pensions, such as reverse mortgages. Finally, there have also been calls to create a regulatory framework for an EU-wide private pension regime alongside the existing pension regimes in Europe in order to realise the advantages of a single market without affecting the national structures of pension systems.[21]

*5. In which way should the IORP Directive be amended to improve the conditions for cross-border activity?*

### 3.3.2. Mobility of supplementary pensions

Unlike social security pensions, which are aggregated under EU rules supplementary pension rights can be lost when they move jobs within or between countries. The Commission proposed a new Directive in October 2005 to set minimum standards for the acquisition, preservation and transferability of supplementary pension rights. These would apply to people moving both within and between EU countries. Internal mobility was included because a separation of internal and external mobility was impractical.

The 2005 proposal was revised by the Commission in 2007 to drop the transferability element which had been opposed by some as technically difficult and potentially burdensome or open to abuse. This left the emphasis on the timely acquisition of pension rights and their subsequent preservation. However, it has still not been possible to reach the necessary unanimous agreement in Council. The proposal remains 'live' and this Green Paper launches a broad consultation on how to now make progress.

Fresh impetus is needed to reach a solution. In today's labour market, particularly with the added challenges from the financial and economic crisis, people need to be able to change jobs easily and without hardship and employers should be able to recruit the right person with the right skills. And with ageing demographics, people need to have opportunities to work and build up pension rights, not lose them just because of a change of job. Further need for action comes from the rise in the importance of funded pensions in general. The existence of many different types of such schemes also raises the issue of scope. For instance, should statutory mandatory funded schemes or book reserve schemes be included in EU regulation?

Transfers seek to make the pension mobile thereby supporting the free movement of labour. At the same time, some Member States operate pension tracing or tracking services which

19 IAS 19 Employee Benefits applies to the sponsoring undertakings
20 IAS Regulation 1606/2002
21 For example, *PAN-EUROPEAN PENSION PLANS - FROM CONCEPT TO ACTION JUNE 2007*, European Financial Services Roundtable study.

help people keep track of their pension rights from different sources within that Member State. Given the growing degree of labour mobility within and between Member States and reliance on a broader set of public and private sources of retirement income, an EU level tracking system could help mobile individuals keep track of their pension rights.

6. *What should be the scope of schemes covered by EU level action on portability?*

7. *Should the EU look again at the issue of transfers or would minimum standards on acquisition and preservation plus an EU level tracking service for all types of pension rights be a better solution?*

## 3.4. SAFER, MORE TRANSPARENT PENSIONS WITH BETTER AWARENESS AND INFORMATION

Safety in pensions is important to support adequacy. Moreover, the macroeconomic benefits of making pension systems safer can be felt quickly as pensioners are a growing source of stable and regular consumption. The disparate developments in Member States' pension systems and the trend towards DC schemes, however, raise new policy questions. Key instruments to ensure safety are the solvency rules for pension funds and legal protection in case of insolvency of the pension fund and/or of the sponsoring employer. Enhancing transparency, information and awareness can also help. Financial education is needed so that people are better equipped to make informed decisions regarding their pension benefits.

### 3.4.1. Closing gaps in EU regulation

The fragmented and incomplete character of the present European framework is becoming more of an issue. As pension provision moves from single to multi-pillar systems and from simple to complex pension packages, current EU regulation and coordination may no longer be sufficient. Several key issues can be mentioned with regard to the present EU regulation for pensions:

(1) The distinction between the various pension pillars has become less straight-forward in recent years. This has led to a situation where some funded pension schemes, both public and private, are covered by EU regulation in some Member States but not in others. That is neither in line with the relevant G20 Pittsburgh declaration ("13. [...] All firms whose failure could pose a risk to financial stability must be subject to consistent, consolidated supervision and regulation with high standards. [...]") nor does it reflect the fact that pension funds have become major players on the financial markets.

(2) Similar pension schemes are covered by different EU rules thus raising issues of consistency.

(3) There are unclear boundaries between: social security schemes and private schemes; occupational and individual schemes; and voluntary and mandatory schemes.

(4) It is not always clear what differentiates general savings and assets from pensions. This raises the question whether the label 'pension' should not be restricted to a product that comes with certain features such as security and rules restricting access to it including a payout design which incorporates a regular stream of payments through retirement.

Moreover, the trend towards DC schemes, away from DB schemes, is continuing, driven primarily by changing needs in labour markets. The aim of tying employees to the company through occupational pension promises is losing ground: on the one hand, employers are less reliant on firm-specific skills due to technological advances; on the other hand, employees are increasingly preferring flexibility and mobility. Furthermore, while occupational DB schemes provide more certainty about future retirement income and reduce costs because of their size and the sharing of risks, they may pose an untenable burden to employers. The recent financial and economic crisis has shown that the size of pension liabilities can be decisive in the survival of a company.

Today, nearly 60 million Europeans are enrolled in DC schemes[22]. Such schemes are much more prevalent today than a decade ago and will continue to grow in importance. In the case of a DC scheme, the sponsor does not bear the risk of a potentially untenable financial burden. DC schemes are more likely to stimulate longer working lives. But a key implication is that they shift the investment risk, inflation risk and longevity risk to the scheme members who are less well placed to bear these risk individually. There are however ways to reduce these risks. Minimum return guarantees and life-styling portfolio compositions come at a cost but good practice across Member States has shown that they can reduce short-term volatility and mitigate risk. Market performance can be enhanced by good economic and public finance policies and better regulation. Better investment practice and scheme design can substantially mitigate risk and increase capacity for shock absorption thus achieving a better balance between risks, security and affordability for both pension savers and pension providers.

Collective risk sharing through hybrid schemes, such as a DC schemes with a minimum return guarantee or a part-DB and part-DC scheme, could modify the current trend to individualised DC schemes. Moreover, higher quality DC schemes are being promoted by industry initiatives[23]. Some occupational DB pension schemes have also adjusted to the demographic and structural changes by increasing the amount of risk sharing between sponsors, workers and pensioners. Existing collective governance structures in DB schemes facilitate such increased risk sharing. Examples include moving from final salary to career average schemes, establishing cash balance schemes, allowing for longevity adjustments, changing accrual rates, adjusting the normal pension age, or applying conditional indexation.

Recent discussions, notably at the level of the OECD, have raised the question whether EU regulation as it presently stands is able to cope with the shift towards DC schemes[24]. This shift may require a reassessment of the IORP Directive in areas such as governance, risk management (e.g. operational risk), safekeeping of assets, investment rules and disclosures. In addition, the current EU framework does not address issues arising during the accumulation phase. These include in particular: (i) plan design to mitigate short-term volatility in returns and (ii) investment choice and default investment options. Moreover, given that the size of the pension in DC schemes can depend on the year in which the pensioner retires, market regulation needs to address issues during the payout phase such as rules on annuitisation (eg mandatory or voluntary, timing).

22 EFRP survey on DC pensions 2010.
23 e.g. the Pension Quality Standard in the UK.
24 OECD Pension Market in Focus Oct 2009

*8. Which elements of the current EU legislation should be reviewed to ensure a consistent regulation and supervision of funded pension schemes and products?*

*9. How could European regulation or a code of good practice help Member States achieve a better balance for pension savers and pension providers between risks, security and affordability?*

### 3.4.2. Improving the solvency regime for pension funds

The IORP Directive contains minimum requirements for prudential regulation, including solvency rules for DB schemes. These solvency rules are currently the same as those applying for life assurance undertakings. With the entry into force of the Solvency II Directive in 2012, insurance undertakings will be able to benefit from a modern, three-pillar and risk-based solvency regime and the question is whether this new regime should also apply to IORPs. There is little agreement across stakeholders, partly reflecting that occupational pensions are delivered in different ways: book reserve, pension fund or insurance contract.

As regards pension funds, Member States have also taken different approaches to protecting acquired pension rights[25]. The Commission conducted a consultation on this subject in 2008 and organised a Public Hearing in May 2009. During this process, stakeholders have clearly signalled that there needs to be a *sui generis* solvency regime for pension funds. With a view to maintaining consistency with insurance regulation, the Solvency II approach could be a good starting point, subject to key adjustments to take account of the nature and duration of the pension promise. One important point to assess, for example, is the variety in the interest rates that pension funds use to discount their liabilities.

A related question is whether, reflecting developments in the areas of banking, insurance and investment, there is a need at the EU level for a pension benefit guarantee system, as already exists in some Member States. Such a guarantee system could not only address failures in sponsor-backed DB schemes or book-reserve schemes, but possibly also compensate excessive losses in DC schemes. This is important to maintain the confidence of members/beneficiaries. At the same time, there are important aspects to address such as moral hazard and potential implicit public support in very turbulent times.

*10. What should an equivalent solvency regime for pension funds look like?*

### 3.4.3. Addressing a possible insolvency of the employer

Considering the important role of sponsoring undertakings in the provision of benefits and the funding of IORPs, their insolvency presents a particular risk that the interests of scheme members remain unprotected. Moreover, the IORP Directive does not apply to companies using book reserve schemes for the payment of retirement benefits to their employees. The need to ensure the protection of pensions in those instances is more acute in the present situation. The financial and economic crisis may increase the number of company insolvencies thus reinforcing underfunding of pension schemes.

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25 Security mechanisms used today rely on a realistic valuation of technical provisions, own funds, sponsor covenants, pension protection funds or a combination of those elements (CEIOPS SSC report).

In this context, the Commission presented a Staff working document[26] on the implementation of the provision concerning supplementary occupational pensions contained in the Insolvency Directive. As a follow-up to this document, the Commission has launched a study in 2009[27] covering defined benefit (DB) and book reserves pension schemes and is currently gathering information on the protection of unpaid contributions to DC schemes in case of insolvency of the employer.

*11. Should the protection provided by EU legislation against insolvency of pension sponsoring employers be enhanced and if so how?*

### 3.4.4. Facilitating informed decisions

The trend towards DC schemes has accentuated the need to enhance transparency and in particular to ensure a clear communication between pension providers on the one hand and members, beneficiaries and policy holders on the other hand. The IORP Directive and the Life Assurance Directive contain information disclosure requirements. But these provisions are based on minimum harmonisation and this has led to a large diversity in the way in which information is communicated to members, beneficiaries and policy holders. Moreover they were designed for DB schemes and may therefore need to be adjusted. In going forward, it would seem important to review the key information specifically for pension schemes and products (e.g. risk, nature of promise, cost/fees, payout method, etc.). This should take into account what is being developed for other financial products. Consumer testing could be used to improve the quality of information in terms of, for example, clarity and comparability.

Shifting choice and responsibility to the individual requires that people understand the information at their disposal in order to make informed choices. This is particularly true as pensions have become more complex. Financial education can help in this respect as demonstrated by the work of OECD. The EU already works with Member States in this field. Financial education complements regulation of the industry, both prudential (e.g. IORP Directive) and market conduct rules, and product disclosure rules. It is important that individuals are properly equipped with economic literacy and planning skills to adequately assess their need for financial and social protection. For example, with the growing importance of DC schemes people need to make informed decisions about investment choice.

At the same time, national experiences suggest that the engagement rate that can be obtained through disclosures and financial education has an upper limit. This raises the question as to whether it is important to consider auto-enrolment with opt-out clauses.

Informed decisions go hand-in-hand with adequate pension provision. When making saving decisions it is important for individuals to be offered appropriate options. There could therefore be a case for defining what exactly constitute desirable features of pensions: if they lacks certain key characteristics, not only could this lead to confusion for the individual wanting to save for their retirement, but it could also lead to under provision in retirement, for example if early withdrawals lead to a depletion of savings or if no steady income is generated from the accumulated assets. Considering the complexity and wide-range of available supplementary pension products, some consumers may need assistance for their

[26] (SEC (2008) 475) of 11 April 2008
[27] OJ 2009/ S 230-329482.

choices. Member States may consider the possibility of putting in place a reliable service of pension advice to facilitate consumer choices of suitable pension products.

*12. Is there a case to modernise the current minimum information disclosure requirements for pension products (e.g. standardisation and clarity)?*

*13. Should the EU develop a common approach for default options about participation and investment choice?*

## 4. IMPROVING EU STATISTICS ON PENSIONS

Data about pension systems available from the different national and EU-level sources could be streamlined to increase their comparability and realise important cost savings. Building on existing international work (e.g. OECD) and various EU initiatives, the development of an EU statistical methodology for pension statistics could facilitate the assessment of the common challenges by policy makers, regulators, supervisors and central banks. Pension funds are important institutional investors and their investment behaviour can affect financial stability. Citizens would benefit from the collection of accurate statistics about their retirement income from the different sources. Pensioners are set to grow as a group of consumers and firms would benefit from reliable and timely information about their total disposable income.

## 5. ENHANCING GOVERNANCE OF PENSION POLICY AT EU LEVEL

Europe must help address growing citizens concerns about the safety of future pensions and revisit how a strategy can be defined to put pensions on an adequate and sustainable basis, including through the better use of EU level instruments.

Whilst Member States generally are responsible for the design and organisation of their pension systems, some specific areas relating to pensions fall directly within EU level competencies. Member States have also recognised that acting together can be more effective and efficient and that the EU level can add value -not least since the challenges are similar across the EU and reform polices need to be consistent with existing frameworks such as the Stability and Growth Pact and the Europe 2020 strategy.

As part of this strategy, the EU can contribute with measures such as coordination and mutual learning through rigorous surveillance and facilitation of national reforms. Examples include best practice sharing, peer reviews, agreeing objectives and indicators, as well as gathering comparable statistics. EU regulation covers the social security coordination of public pensions, rules for occupational pension funds, portability and the protection of supplementary pension rights in the event of the insolvency of the employer, as well as rules for life assurance undertakings.

If the EU is to offer appropriate support to national reform efforts, the framework of policy coordination must take an integrated approach to reflect the increasing complexity of pension systems. Moreover, given the increasing economic and financial integration EU-level regulatory framework as well as good co-ordination across the EU level policies and Member States policies becomes ever more important.

Pension policy is a common concern for public authorities, the social partners, industry and civil society at national and increasingly also at EU level. A common platform for monitoring all aspects of pension policy and regulation in an integrated manner, taking account of their interlinkages and bringing together all stakeholders could contribute to achieving and maintaining adequate, sustainable and safe pensions. The Commission is therefore keen to explore how this can best be achieved in the interest of rendering pensions systems adequate, sustainable and safe in support of the EU's wider economic and social objectives.

*14. What should be the main elements of a strengthened policy coordination framework at EU level to improve the design and implementation of pension policy through an integrated approach? Would the creation of a platform for monitoring all aspects of pension policy in an integrated manner be part of the way forward?*