EU Green Paper

PENSION SYSTEMS

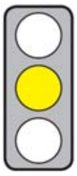
Status: 13 September 2010

Centrum für Europäische Politik

MAIN ISSUES

Objective of the Green Paper: The Commission outlines how it believes an adequate, sustainable and safe pension system can be achieved and initiates a public consultation on the issue.

Parties affected: Member States, employers, employees and providers of private pension products.



Pro: Reference is quite rightly made to the serious problems inherent in pay-as-you-go pension systems and the implicit public debt. The measures under consideration, in particular increasing the effective retirement age, improve the financial viability of the pay-as-you-go systems.

Cons: (1) The EU is neither empowered to decide when a pension is "adequate" nor is there a proper justification for such a decision.

(2) The approach that would mean prescribing minimum return guarantees, investment decisions and annuities to all funded pension systems reduces profitability and the choice options of the insured.

CONTENT

Title

Green Paper COM(2010) 365 of 7 July 2010: **Adequate, sustainable and safe European pension systems**

Brief Summary

► **General**

– The Commission holds the view that neither pay-as-you-go (PAYG) – usually public – nor funded pensions – usually private – pension systems can ensure an "adequate and sustainable retirement income" (p. 2) in their current structure.
– It describes the problems the respective pension systems encounter and which reform initiatives might be helpful.
– Based on a checklist it wishes to find out if and how the EU should take action to reform pension systems.
– It stresses the importance of a "European approach to pension systems" and of "common EU approaches to solvency and social adequacy" (p. 2).

► **Problems of PAYG pension systems**

– Under PAYG pensions systems a shrinking number of contributors must pay for an increasing number of recipients.
– The Commission identifies four developments as an explanation for this:
  - The EU fertility rate is falling.
  - People are entering their professions later due to longer training periods.
  - People taking retirement earlier due to "labour market management and "prevailing policies" (p. 4).
  - Life expectancy is rising.
– Furthermore, in view of the "projected unsustainable increase in public debt levels", the Commission questions the sustainability of public pension schemes.
– The Commission projects that in 2060:
  - for every person over 65 years there will be only two people of working age (currently it is four) and
  - age-related public spending will rise by almost five percent of GDP with half of it being spent on pension systems.

► **Solutions to the problems of PAYG pension systems**

– In general, the Commission calls for an increase in EU growth potentials. An improved labour supply should enable more growth in labour productivity.
– The Commission wishes to prolong the working life and, to this end, proposes:
  - increasing the statutory retirement age, e.g. through an automatic adaptation of the retirement age to gains in life expectancy,
  - increasing the effective retirement age, e.g. by reducing the options of early retirement,
  - adapting "social and financial incentives to work" in order to create an improved employability of women and older workers,
  - complementing PAYG systems with funded pensions,
  - aligning pension rights to the average salary of an entire working life, instead of basing it on the salary of selected working periods.

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– The Commission raises the following questions:
  - does the policy "coordination" framework at EU level suffice to coordinate pension systems at EU level and to ensure solid public budgets in Member States and
  - should the Commission decide "when" it is "adequate" to retire?

► **Problems with funded pension systems**

– The financial and economic crisis demonstrated that funded pension systems can also fail. In particular, "the return rates and solvency" are affected "through falls in interest and asset values" (p. 7). As a consequence, pension funds lost over 20% of their value in 2008 and so far have not been able to fully recoup their losses. Several occupational pension funds could not meet their liabilities.
– The Commission's view is that the vulnerability of funded pension systems to fluctuations on the financial markets mainly lies in their investment strategy.
– According to the Commission, the character of the legal framework is "fragmented and incomplete" (p. 13):
  - Similar schemes are covered by different rules.
  - Several schemes are not registered at all.
  - There is a lack of clear boundaries between public, occupational and private schemes.
  - There is no clear definition of what makes a saving product a retirement product.
– Several schemes, such as occupational pension schemes, are not transferable to the new employer in the case of a job change.

► **Solutions to the problems of funded pension systems**

– The Commission intends to improve the efficiency and safety of funded pension schemes – including occupational saving schemes and "statutory mandatory funded schemes" (e.g. pension schemes for professional associations) – through legal provisions and, at the same time, ensure that occupational schemes remain an option and that employers do not become insolvent through the provision of such services.
– The Commission proposes:
  - regulating funded pension systems at EU level,
  - better harmonising the national supervision of Member States,
  - including the criteria of safety, limited access and continuous cash flow during retirement in the definition of a "pension product" and
  - enabling providers of occupational pension schemes to engage in "cross-border" activities (p. 11).

  To this end, the Commission is considering transforming the Directive on the supervision of institutions for occupational retirement provision (IORP Directive 2003/41/EC) into a framework directive.
– Regarding the transferability of occupational pension rights, the Commission refers to its Proposal for a Directive on the portability of supplementary pension rights [COM(2005) 507, see CEP Policy Brief, in German only].
– In particular: The improvement of consumer protection
  - The Commission's aim is to achieve "a better balance between risks, security and affordability" (p. 14).
  - Regarding defined contribution systems (DC), where the final amount of pension payments is not known in advance, the Commission observes an "investment, inflation and longevity risk" which is currently borne by the investor alone. In order to tackle this "unfair distribution of risks", the Commission proposes introducing minimum return guarantees and investment decisions tailored to the phase of life of the insured.
  - The sum of the pension payment can in certain – e.g. stock-based – pension schemes fluctuate, depending on the year in which a pensioner retires; to tackle this risk, payment should be guaranteed either once in lump-sum, or continuously for the life duration or a certain period ("annuity").
  - The Commission plans to develop rules concerning custodianship and pension fund governance in order to improve the monitoring of investment decisions.
– In particular: Improved protection against insolvency of pension funds and employers
  - The Commission wishes to review whether the solvency requirements applicable to insurance companies as of 2012 (Directive Solvency–II, 2009/138/EC, see CEP Policy Brief, in German only) should equally apply to pension funds.
  - The Commission is considering improving the European rules on the protection of pension rights in the case of corporate insolvency (Directive 80/987/EEC). This applies most notably to pensions funded by reserves.

► **Miscellaneous**

– The Commission also wishes to strengthen social cohesion. Therefore, it is calling for minimum pensions and coverage of atypical workers and the crediting of some involuntary employment breaks, for example when caring for frail dependants.
– Based on the Monti Internal Market Report, the Commission is considering establishing an additional and optional European set of rules for private pensions which is independent of national rules (so-called "28th regime").

Statement on Subsidiarity by the Commission

The Commission does "*not* question" the Member States' responsibility regarding retirement pension. At the same time it stresses, however, that pension funds are an integral part of the financial markets and their design can affect the free movement of workers and the free movement of capital, further that "specific areas" already fall within the competencies of the EU. (P. 2)

Policy Context

In 2001, the European Council stated: "The coming decade offers an opportunity to address the demographic challenge by raising employment rates, reducing public debt and adapting social protection systems, including pension systems." The Green Paper is a follow-up. The current situation of public budgets and public pension schemes demonstrates that the Member States have not yet concluded the requested adaptation process, which is why the Commission is proposing a more coordinated approach now. This also becomes evident in the strategy "Europe 2020" [COM(2010) 2020, see CEP Policy Brief] which aims to bring more people into employment and make them stay there for longer.
The strengthened regulation of PAYG pension systems, as requested in the Green Paper, is also based on framework decisions made at international level. Most notably, during the G-20 summits in Pittsburgh in 2009 and in Toronto in 2010, participants called for a regulation of all financial institutes and the establishment of worldwide rules which would help to avoid any future upheavals in the financial markets. The EU has already taken appropriate measures, in particular the proposals to set up European supervisory authorities [see CEP topic page].

Options for Influencing the Political Process

Leading Directorate General:	DG Employment, Social Affairs and Equal Opportunities
Consultation Procedure:	Each citizen may submit a statement. The procedure ceases on 15 November 2010. The online questionnaire can be downloaded from http://ec.europa.eu/yourvoice/ipm/forms/dispatch?form=pensions

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

The Commission is right to criticise the situation of PAYG – usually public – pension schemes. Prompt and drastic changes are needed now. Given that a massive boost in labour productivity of the continuously decreasing working population is not in sight, an increase of the statutory and effective retirement age is appropriate. The proposed increase of the employment rates of women and older people contributes to the viability of today's pensions, yet will create additional pension rights within future years which will also have to be financed. **Without higher labour participation, the current relationship between working and retired members of the population can only be maintained until 2060 if people really do work until they are 70** (compared to the current EU average of 61 years). (Source: Eurostat Population Projections 2008 and Impact Assessment by the Commission, p. 29).
There is no proper justification for an European definition of an "adequate" pension. Although many PAYG pension systems bring implicitly enormous public debt with them, which could create a severe threat to the stability of the monetary and fiscal system, the Commission should not be empowered with the monitoring of implicit public debt. Mandating the independent European Systemic Risk Board (ESRB) would be a preferred solution.
The proposal to regulate all funded pension systems at EU level would, admittedly, facilitate a smoother operation of the internal market for pension products, as the monitoring and distribution rules are still quite different depending on the Member State. Yet it is questionable whether or not a full harmonisation of the regulation for funded pension schemes can really embrace the sometimes very different products and traditions in Member States.

Impact on Efficiency and Individual Freedom of Choice

Though funded pension schemes are low-risk, they are not risk-free. **Minimum return guarantees, investment decisions tailored to the phase of life of the insured and annuities** can certainly reduce the risks. However, it should be up to the insured to decide whether or not this is important and if they are ready to pay for the related cuts in return. Statutory requirements for all **must be rejected**.
The portability of occupational pension rights increases workers mobility but can also lead to occupational pension systems being closed where companies use occupational pensions to bind employees. This is particularly harmful to the insured. Besides, depending on the design of the occupational pension, there are already significant differences in the extent of portability and the resulting worker mobility. **A statutory maximum portability applicable to all products** patronises employees and **is to be rejected.**

Impact on Growth and Employment

Increasing the retirement age makes skilled personnel available to employers for a longer period. In view of the already emerging lack of skilled personnel this could have a positive effect on growth.

Legal Assessment

Legislative Competence

The Commission's competence to adopt Green Papers is laid down in Art. 17 TFEU. It empowers the Commission to take actions deemed necessary to promote common interests in the EU.
For legislative follow-up actions by the EU there are the following competence bases: provisions regarding the portability of occupational pensions can be based on Art. 48 TFEU (workers mobility); the protection of the workers' right to occupational or supplementary pension rights against the insolvency of employers can be based on Art. 153 (1) lit. c TFEU (social security and social protection for workers); the regulation of pension funds can be based on Art. 53 TFEU (self-employed work); the monitoring of pension funds can be based on Art. 114 TFEU (completion of the internal market).
In modernising the systems of social protection (Art. 153 (1) lit. k TFEU), however, the EU is only entitled to promote cooperation between Member States (Art. 153 (2) lit. a). Moreover, any intervention into the basic principles of social protection systems of the Member States is prohibited (Art. 153 (4) TFEU). For the solutions proposed in the Green Paper with regard to PAYG pension system that means: **EU rules regarding statutory retirement ages, early retirement and the adequacy of public pensions would constitute an infringement of the allocation of competencies at EU level**. Incidentally, there is a circumvention prohibition on this restriction . Hence, the related provisions could not be based on alternative competences either.

Subsidiarity

The possibility to follow the considered measures through with legislative proposals is somewhat limited by the principle of subsidiarity. Realistically, the cross-border portability of occupational pension rights and uniform regulation and supervision standards for funded pension systems cannot be set up at national level. Consequently, these areas would not constitute any infringement of the principle of subsidiarity.
An EU-wide obligation to protect pension schemes against insolvency is appropriate. The question of how such a protection can actually be achieved should, however, be left to the Member States to decide, due to their different security institutions and insolvency orders. Similarly, although an EU-wide definition is necessary to determine which pension products fall under which European legal framework, further-reaching EU provisions – notably with regard to promotion aspects under tax and social laws – infringe the principle of subsidiarity.

Compatibility with German Law

Most of the measures mentioned by the Commission are already in force in Germany.

Possible Follow-up Action by the EU

In April 2009, the Commission submitted a Communication on "packaged retailed investment products" (PRIPS) and announced a legal framework for these products which is to contain harmonised information and marketing rules [COM(2009) 304, see CEP Policy Brief]. It can be assumed that the Commission will also apply this "horizontal approach" to the revision of the IOPR Directive.

Conclusion

The Commission draws the right conclusions regarding public pension systems. However, the EU is not empowered to act in this area. There is neither legislative competence nor justification for a European definition of "when" a retirement pension is "adequate". The recommendation to introduce minimum return guarantees for funded pension schemes, investment decisions tailored to the phase of life of the insured and annuities improves the security of investors but also leads to significant losses in competition and the freedom of individual choice. A statutory maximisation of the portability of occupational pension rights is inappropriate.