Securing Pensions for the Next Fifty Years

Varieties of Pension Governance under Pressure: Funded Pensions in Western Europe

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Introduction

For over two decades, the financial sustainability of pay-as-you-go financed public pensions has been questioned, while the privatization of prefunded supplementary pensions has been advocated. The recent financial crisis, however, has challenged the merits of private (funded) pensions in view of the significant decline in the value of their assets. As a result, trust in the expected long-term returns of funded pensions has been shattered at a time when saving for retirement has become more important. The privatization of responsibility for old-age income and the shift towards more funded pensions thus raises important issues about developing better governance and regulation.

Drawing on the experiences of ten Western European countries with mature or expanding multi-pillar systems (Ebbinghaus 2011), the comparative analysis of the variety of supplementary pensions presented here will focus on the role of state and collective actors in regulating and governing private pensions (Ebbinghaus and Wiß 2011). Although the state seems to be retreating from former commitments to guarantee secure and adequate public pensions, the need for public regulation has increased rather than diminished. Moreover, social partners – employers and workers' representatives – play an important role in private (funded) pensions. This article begins by analysing the three different modes of governance in the area of private pension schemes. It will map the differences in the current weight of private (funded) pensions and discuss how they were affected by the financial market crash of 2008, as well as the long-term consequences for private pension governance and regulation.

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The stakeholders in private pension governance

The recent financial crisis raises some fundamental issues of private pension governance. Conflicts of interest over supplementary pensions occur due to the complex principal-agent relations between beneficiary and sponsor, and between sponsor and financial agent. Employees, for instance, rely on their employers who co-sponsor pension contributions, while both have to trust financial managers investing on their behalf. Problems arise due to asymmetric information between the agent and principal (McCarthy 2006). To control their agents, principals have an 'exit' option through market mechanisms or rely on 'voice' (participatory rights). We can distinguish three governance modes of supplementary pensions based on the sponsor-beneficiary relations (Ebbinghaus 2011; Ebbinghaus and Wiß 2011): collective negotiated social partner schemes, employer-sponsored occupational pensions and the individual's decision to save for retirement (see Table 1).

In the case of *collective schemes* employer and unions agree on jointly managed schemes for a sector, providing for broad coverage and risk pooling, while the voice of stakeholders (sponsors and beneficiaries) is indirectly represented by their organizations. The advantages of such schemes include more professional portfolio management, lower administrative costs due to economies of scale, and labour mobility within the nation-wide or sectoral scheme. Schemes self-administered by social partners assume an important second-tier income function in Finland (a partially funded scheme) and France (an unfunded scheme for private employees), as well as in Denmark, the Netherlands and Switzerland, while negotiated top-up benefits exist in Sweden and are gaining in importance in some sectors in Belgium, Germany and Italy.

Employer-sponsored plans can be financed by book reserves, by a trust fund external to the firm, or by a defined contribution (DC) contract with an insurance company. Traditionally firms offered defined benefits (DB) in order to bind qualified workers to the firm, thereby limiting labour mobility. Employers as sponsors mainly control these plans, while the employees and retirees only have a limited voice through minority representation (for instance, in UK trust funds). These employer schemes have higher administrative costs than collective plans, and pool risks less broadly. Employer-sponsored occupational pensions play an important role in the UK, although many have moved from DB to DC schemes in recent years. Employer-specific plans are also a preferred form for Dutch and Swiss larger firms, and some German firms provide such plans as voluntary fringe benefits (often with on the book reserves only).

Table 1

Collective, employer-sponsored and personal supplementary pensions

Collective occupational pension	Employer-sponsored occupational pension	Personal pension
Sector-wide (social partner negotiated): Netherlands, Denmark, Finland, Sweden, Switzerland, Belgium, France*, Germany, Italy	UK *(opt-out),* Netherlands, Switzerland Germany *(also book reserve*),* Belgium, France	*Mandatory public pension:* Swedish Premium P., Danish Special Savings P. UK *(opt-out),* Germany *(voluntary, Riester)*

Note: Main systems underlined; * = unfunded.
Source: Ebbinghaus (2011); Ebbinghaus and Wiß (2011).

In the case of *individual decisions,* there may be a collective action problem for individuals: they may not have much of a voice vis-à-vis their investment fund; and may only be able to vote with their feet (exit) by switching to a different fund. Here responsibility remains solely with the individual, although the state as regulator may define particular obligations or tax incentives. One advantage of personal pensions, which are commonly DC schemes, is portability, at least within national borders. In addition to the two mandatory personal pensions in Denmark and Sweden, voluntary personal pensions have become very widespread in Germany since 2001 due to tax subsidies. Their popularity has also grown in the UK since 1986 when the government granted an opt-out option of the second state pension.

Varieties of pension fund capitalism

Europe's pension landscape varies in the importance of private funded pensions, depending on the gap eft by more or less generous public pensions (Ebbinghaus 2011). Pension fund capitalism, as revealed by the size of pension fund investment, has a major impact on financial markets and corporate governance. Based on the Varieties of Capitalism approach (Hall and Soskice 2001), we would expect there to be a strong relationship between the importance of financial markets in Liberal Market Economies (LMEs) and their reliance on funded private pensions, whereas in Coordinated Market Economies (CMEs) there is a larger reliance on patient capital and non-funded pensions (book reserves) by private sector firms. The variations in fund assets show the differences in the maturity of private pensions (see Table 2). The correlation between financial markets and funded pensions is very strong for liberal Britain, while pension fund assets in Germany's coordinated market-economy are still relatively small, although growing. Similarly, Belgium, France and Italy are laggards in pension fund asset growth. However, two CME countries, Switzerland and the Netherlands, outperform the UK in funded capitalism, channelling substantial investments through the Dutch collectively negotiated and the Swiss mandatory pension funds. Moreover, the Nordic CMEs (Denmark, Finland, and Sweden) also now have substantial funded pillars as part of both public and private pensions.

Among the more mature multi-pillar systems, the UK has a long tradition of pension fund trusts and voluntary personal pensions as alternatives to the state second pension. Indeed, both schemes cover over half of the UK population. Recent pension reforms (2007/08) have limited contracting-out and require employers to provide access via auto-enrolment in a supplementary pension, which will phase-in over five years as of October 2012. Dutch occupational pensions are mainly based on sector-wide agreements that can be extended by the ministry and which, together with a few larger company plans, cover almost the entire workforce. Swiss occupational pensions have been mandatory since 1985, but take different forms: some are administered by social partners, while others are administered as

multi-firm or single-firm DC plans (with bipartite representation).

Scandinavian countries have made substantial progress in funded pensions. Denmark was a laggard until the labour market pensions were developed as sector-wide agreements in the 1990s, parallel to a temporary, mandatory personal pension. In Sweden, there are four occupational schemes for public and private employees, providing negotiated funded top-up benefits for all employed persons. As part of the 1994 reform, a DC premium pension is part of mandatory pension contributions and individuals are given the choice between multiple investment funds (including union-run schemes). In Finland, partially funded occupational pensions are mandatory, co-administered by the social partners, and cover all private and public employees. They are currently the main source of retirement income. While Finland and Sweden have ended their basic pensions, Denmark has retained its scheme, but all three countries have seen an increase in (more or less privately) funded pensions in order to maintain living standards in retirement.

Finally, until recent cutbacks in public pensions, continental pension systems left much less space for funded pension systems to develop. In France, non-funded private pension schemes run by social partners dominated for a long time; and the development of voluntary funded pensions has only been introduced slowly over the last decade. Occupational and personal pensions have grown in Belgium since the mid-1990s as a result of shrinking public pensions. While many larger and few smaller German employers have provided occupational pensions as fringe benefits, voluntary *Riester* pensions have been introduced (and subsidized for low-income groups and families) since 2002. In Italy, former severance pay is now transferred automatically or voluntarily into various occupationally funded pensions, thus complementing a predominantly public pension system to date.

Funded pensions facing the current crisis

Funded pension schemes faced major problems during the financial market downturns of the early and late 2000s (Casey 2012; Ebbinghaus and Wiß 2011). In *funded* systems contributions are invested in capital markets for high long-term returns, albeit with some risks, which have been exposed by the last two crises. In DB schemes, the employer or social partners are responsible for covering pension liabilities in case of underfunding or adjusted defined benefits, while they may profit from contribution holidays in good times. In funded DC schemes, however, the

Table 2

Public and private pensions in Western Europe, 2007-2010

	Pension expenditure [a]		Private pensions [b]			
	Public	Private	All assets	Growth 2007–2010 [c]	Contributions	Benefits
Denmark	5.6	2.2	177.8	127.8	6.9	5.1
Netherlands	4.7	5.2	128.5	108.7	4.8	4.0
Switzerland	6.5	6.0	113.7	97.9	8.6	5.1
UK	5.4	4.5	88.7	93.8	3.1	3.3
Finland	*8.3	0.2	91.0	93.7	*10.2	*10.9
Sweden	*7.2	2.1	56.9	..	..	..
France	*12.6	0.3	8.5	..	0.6	0.4
Italy	14.5	1.4	5.3	98.1	0.7	..
Germany	10.7	0.8	5.2	108.0	0.5	0.2
Belgium	8.9	3.7	3.8	87.8	1.7	2.9

* Including mandatory private pensions (Finland: partially funded; Sweden includes mandatory Premium Pension; France: non-funded)
[a] % GDP, 2007
[b] % GDP, 2010 or earlier, includes insurance and autonomous pension funds but excludes on-the-book reserves (Germany: only Pensionskassen/fonds). Growth: cumulated returns from 2008 until 2010.
[c] Index (2007=100).
Source: OECD (2011b); OECD (2012a); own calculations.

financial market risks are completely individualized, meaning that lower than expected returns may lead to the postponement of work exit or lower retirement income. All Dutch and Swiss occupational pension plans are funded, the British, Danish and Swedish private sector pensions are fully-funded, and in Finland all occupational pensions are partially funded. Most new German personal and occupational pensions, Belgian occupational pensions, French voluntary pensions and Italian occupational pensions are funded, although Germany still has some older schemes with book reserves.

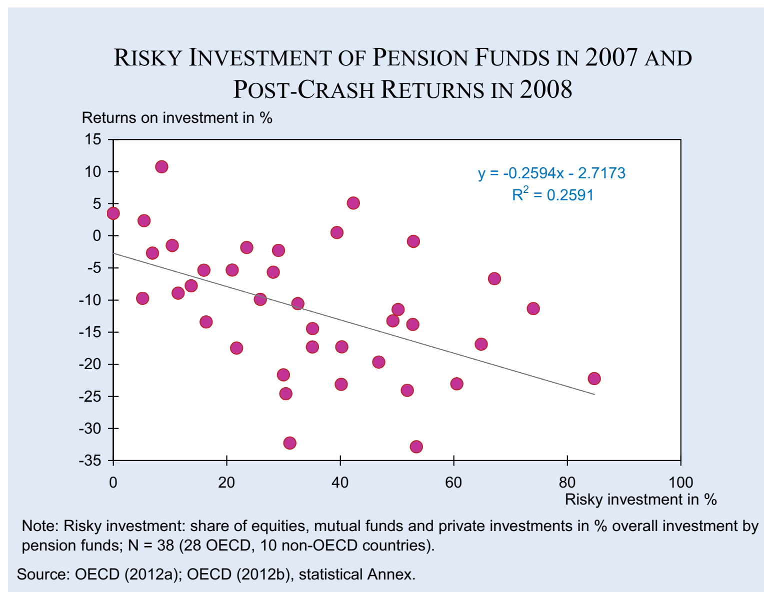
Defined benefit (DB) schemes tend to protect employees' interests better than defined contribution (DC) schemes; as they allow for the pooling of social risks across employees in a firm, across employers in a sector or even nation-wide. While individuals bear the financial risks in DC schemes and need the foresight to stick to a lifecycle portfolio investment strategy, DB schemes can balance risks by pooling and thus guaranteeing some predefined benefits. While the majority of current pensioners is still covered by DB schemes, new schemes or plans for new entrants are increasingly DC schemes in most countries. The Netherlands and Finland still stand out by virtue of providing DB schemes through occupational schemes with nearly full coverage.

Following the 2008 financial crash (see Figure 1), most funded pensions suffered major losses on investments, while Denmark, Germany, and Italy fared much better. Prudent management can reduce the risk of losses, while regulation may impose quantitative restrictions to limit risky investments, or require a minimum rate of return to protect individuals from undue financial risks. The less strict, 'prudent person' rule, allowing greater investment flexibility and higher, but risky returns, is prevalent in the UK (and also the Netherlands), while the other countries considered in this article have more quantitative restrictions (Laboul and Yermo 2006, 508).

The recent financial market crisis led to major losses among many pension funds across the OECD. The financial crisis following the breakdown in September 2008 impacted pension funds immediately, although with some cross-national variations. Asset values declined by over 25 percent in the USA and Ireland, while most other European pension funds saw a nominal decline of over ten but less than 20 percent, with very few exceptions (OECD 2009). Certainly, most of these funds have recovered somewhat since 2008 (particularly in Denmark), but it will take several years for all of them to make up for the forgone growth (see growth index in Table 2). Moreover, the financial crash had various economic and financial repercussions that led to ad hoc intervention by governments, particularly in countries with sovereign debt problems (Casey 2012).

The differential impact is largely determined by the investment portfolio, and particularly risky stock market investments (equities, currencies, hedge funds, commodity trading) vis-à-vis more conservative investments (public bonds, non-risky loans, and domestic real estate). The countries with the largest losses have the highest percentage of equities in their portfolios (OECD 2009, 34; Pino and Yermo 2010). There is indeed a strong negative linear relationship (see Figure 1) between post-crash losses of pension funds and their overall share in equities (and private investments) shortly before the financial market crash. More risky investments, most notably in the United States and Ireland, but also in the United Kingdom and the Netherlands, lead to higher negative investment returns than in countries

Figure 1



Note: Risky investment: share of equities, mutual funds and private investments in % overall investment by pension funds; N = 38 (28 OECD, 10 non-OECD countries).

Source: OECD (2012a); OECD (2012b), statistical Annex.

like Switzerland and Germany with more prudent investment in bonds. Among the OECD countries, LMEs tend to rely much more on a growth-oriented, but more risky equity-based strategy, while CMEs (including Swiss funds) are more conservative in their investment, but were also much less severely struck during the crisis as a result, perhaps due to their smaller long-term returns.

Consequences of the financial crisis

The crisis highlights the problems of shifting responsibility to private players. The sudden losses and lower than expected returns affect employers or social partners as sponsors of DB schemes, as well as current and future pensioners relying on DC schemes. Even if pension funds have been partly recovering since 2008, the effects of the crisis will last by undermining long-term growth expectations and trust in funded pensions. In collective schemes, the social partners can function as mediators between employers and employees and can balance the interests of current and future pensioners. Via collective bargaining and involvement in the operation and management of pension funds, burdens can be shared between employers (higher contributions) and employees/pensioners (lower or frozen indexations, higher contributions and lower benefits).

The consequences for individuals depend on pension plan designs. Workers might possibly have to postpone retirement (exit work later), pay higher contributions or accept lower than expected benefits if long-term returns are low. Current retirees or those close to retirement are more severely hit by the current crisis if savings are still in risky investments. Therefore, nudging rules in DC plans should insure life-cycle investment strategies, that is, a shift towards more conservative investments as retirement approaches and a transfer to annuities instead of lump-sum pay-outs when reaching retirement. Pensioners covered by DB schemes are less directly affected by the financial crisis, but their benefits could decrease in real value when pension indexation is suspended as in the Netherlands. DB schemes place particular strains on their sponsors, the employer or social partners. Reinsurance against the bankruptcy of the sponsoring firm is needed; indeed, premiums have increased, for instance, in Germany, the UK, and Switzerland.

A further long-term impact of the last two financial crises has been the further acceleration of the shift from DB to DC benefits, from more buffered to individualized risk exposure. The crisis in the early 2000s propelled a shift from final-salary to average-career-salary DB schemes, while the recent crash of 2008 led to a paradigm shift from DB to DC schemes, or at least to cut-backs in promised defined benefits. The European Commission proposes the introduction of minimum return guarantees in DC schemes or new mixed DB/DC pension plans, as well as improved life-cycle portfolio management in order to reduce short-term volatility (European Commission 2010, 14).

To restore sustainability in DB schemes, employers (or the social partners) face a choice between raising contributions or reducing promised benefits in the long-run. The funding ratio of Dutch pension funds has fallen below 95 percent, ten percentage points below the required minimum funding, but the government extended the period for recovery from three to five years. The UK average funding ratio has dropped by around ten percent to 85 percent following the 2008 crash (Antolin and Stewart 2009, 128). Swiss funding ratio in the private sector also dropped to 97 percent in 2008, and pension indexation was suspended as a result, while contributions increased. An overall trend is a post-crash shift to less risky investments like bonds and loans, which, however, entails historically low returns, while more growth-oriented international diversification increases risks (Antolin and Stewart 2009).

Conclusion

Although we often speak of pension privatization, the regulation and governance of supplementary pensions varies tremendously. Whether occupational pensions are collectively negotiated, employer-provided or consist of individual schemes has major consequences for the overall scope of private pensions and benefits in retirement. The more funded pensions have grown in economic importance, the more an individual's retirement income will depend on long-term financial market performance. However, the financial risks depend largely on the scope and portfolio of asset investments. The main lessons from the two financial crises are the need for stricter rules regarding public supervision (e.g. more regular stress tests), investment restrictions and partly new benefit protection mechanisms. This indicates that

the role of private pension governance, including (state) regulation, is continuing to gain importance, despite the claims of privatization, representing a retreat on the part of the state. Furthermore, state regulation is often complemented by the governance and regulation of social partners.

The stronger inclusion of employee representatives in supplementary pensions may help to balance interests and risks between employers, financial institutions and beneficiaries. The state's retreat from public pension commitments has not only increased the need to fill the retirement income gap with privately-funded pensions, but has led to demands for better regulation of those pensions (see also Ebbinghaus and Whiteside 2011). Otherwise it may be questionable whether the funded pension route remains political sustainable, should it remain a rather risky business for people facing retirement.

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pension fund, I was wanting to ensure their pensions were secure and therefore asked the. question about the pension fund. NORTHAMÂ government pension funds, how does the future look for the great majority of public sector. employees whose pension schemes, perhaps surprisingly, donâ€™t have a fund at all, but just. live hand to mouth?Â public sector pensions are going to grow over the next fifty years? DAVIS: The forecast is that the cost will be as much as. Â£80 billion in fifty yearsâ€™ time. Now on the face of it that does sound like a very significant. rise. The State Pension is the UKâ€™s pension arrangements, but how much you get depends on your age and contribution record. Anyone can make a claim for a State Pension, as long as they have completed the minimum number of qualifying years of work. The State Pension went through a change in 2016. You can claim the new State Pension if you are According to the assessment of the Central Bank, the pension reform will be the only predictable factor in further accelerating economic growth, which will start working soon enough with some estimated efficiency. True, this efficiency is low: total 0,1 next year and roughly 0,2-0,3 percentage points in 2020 and 2021. That is, with the current economic growth in 1,6% (with the forecast for the year to 2%, and this is the maximum), next year we will get the maximum of 2% plus the mentioned increase from pension reform, that is, 0,1%. Total, with the most optimistic scenario, 2,1% percent.