EUROPEAN PENSION SYSTEMS

No longer pillars of strength

Are cracks appearing in the traditional first and second-pillar pension system models across Europe?

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First and second-pillar pension system structures across Europe are facing several serious threats to their strength and sustainability.

From the continent's ageing population to a growing number of self-employed or 'gig economy' workers, to a lack of trust after years of poor returns and high costs, these challenges have prompted often radical action from policymakers at both national and European levels.

In Eastern Europe, several governments have proposed or enacted changes to their second-pillar systems after private-sector providers were deemed to have failed to meet their promises. In several cases, assets have been lifted out of the second pillar and moved to the first.

In the Netherlands, meanwhile, looming cuts to occupational schemes as a result of falling funding levels have undermined public trust in one of the world's most highly-regarded pension systems. This led one union to call for a boost to the country's state pension benefits to compensate those who stand to lose out when cuts start to be implemented from next year, arguing that the government had "a responsibility to maintain pensioners' spending power".

Eastern Europe

What is driving these often radical changes to pension systems? In Estonia, the coalition government recently published a plan to effectively dismantle much of the country's second pillar. Its pension system posted an average investment loss of 0.2 per cent a year in the 15 years to the end of 2017, according to the OECD. At the same time, management fees remain among the highest in the OECD's member countries.

In response, policymakers have proposed that the second-pillar system becomes voluntary, while the level of the state pension is increased. Those with savings in the second pillar will be able to suspend contributions and transfer out to a personal investment account.

Estonia's central bank and the International Monetary Fund have both warned that the system overhaul could mean lower pensions for future generations of retirees and have advised against the dismantling of the second pillar.

In Romania, meanwhile, a period of poor performance across the board from private-sector second-pillar providers resulted in the government pushing for reforms similar to those in Estonia. It also called for a 10-fold increase in the capital requirements for private-sector pension providers. This has since been revised – but providers must still come up with double the capital compared to existing rules.

According to Deloitte Romania partner, Alexandra Smediou, the collapse of the country's government in October means the controversial reforms are likely to be scaled back, if not scrapped altogether. Instead, a new government – likely to be led by Romania's Liberal Party – plans to list several government-owned companies such as utilities, introducing profit-making and successful companies into the investment universe of Romanian pension funds.

"If this happens it would be good news for pensions," Smediou says. "It would be a good use of money and a boost for the sector."

Broken promises

To understand why some governments have sought to effectively nationalise their supplementary systems, it is important to understand the history of those systems.

Former UK politician Gregg McClymont – now policy director at UK master trust The People's Pension – has co-authored two books about pension systems from around the world. He contends that the shift towards privatisation in eastern European countries after the fall of the Berlin Wall is seemingly reversing.

"Post the Berlin wall coming down there was a trend of moving from a first-pillar pension system to a first and second-pillar system," McClymont says. "Often the assets of the first pillar were to some extent lifted from the state system and dropped into the second pillar.

"In the past few years the second pillar has in some of those countries attenuated, and the balance has moved back towards a bigger first pillar."

Promises made by second pillar advocates in many cases have not been realised, he explains, with poor returns exacerbated by high costs, resulting in policymakers pushing for radical changes.

Pensions Europe general secretary and CEO, Matti Leppälä, adds that the creation of second pillars using assets from the first has made it "politically easier" for leaders to pull back from this policy and in part re-nationalise pensions.

Pensions Europe has been lobbying at an EU level for protections for supplementary pension systems, with some success. Recent amendments to the European Monetary Union's framework have made it less attractive for member states to use assets from the pension system to plug funding gaps elsewhere in their budgets.

Future challenges

Many of the policy ideas outlined above are short term in nature, focused on solving immediate problems such as pension cuts or public financing shortfalls. Longer term, however, European pension systems face challenges that short-term tinkering will not solve, whether with state pensions, supplementary systems, or both.

As McClymont explains, not only are demographics changing across Europe, but the nature of work is changing too. Increasing numbers of people are identifying as self-employed, and so are falling outside of the state and occupational pension systems in many countries. With fewer contributions coming in, first-pillar structures, particularly pay-as-you-go systems, are looking less affordable in the years to come.

Employers such as Uber and Deliveroo have also challenged the status quo. In Deliveroo's case, it has argued that it is a technology provider for independent delivery drivers, and so is not an employer. However, in the Netherlands, mandatory transport sector scheme Vervoer has taken the company to court in an effort to force it to enrol drivers into the second-pillar fund.

"It's really difficult to see a path to bring workers in the informal economy into the occupational pension system," McClymont says.

Reasons to be cheerful?

"There is no single system that can be transplanted from one country and applied, without change, to another country," writes Mercer partner David Knox in the 2019 edition of the *Melbourne Mercer Global Pension Index* (MMGPI) report.

Knox – the lead author of the report – adds: "However, there are certain features and characteristics across the range of systems that are likely to lead to improved financial benefits for the older members of society, an increased likelihood of future sustainability of the system, and a greater level of community trust and confidence."

He warns that effective policy reforms "are often not easy and may require long transition periods", particularly concepts such as raising the state pension age. But among the MMGPI report's recommendations there are less expensive or politically challenging options, including improving private-sector governance and introducing measures to "reduce the leakage from the retirement savings system prior to retirement".

The MMGPI report also highlights auto-enrolment or "an element of compulsion" as an important policy for governments to consider. Leppälä also cites the UK's introduction of auto-enrolment as an example that could be followed by other countries, as it has significantly increased coverage.

More than 76 per cent of the UK working population was enrolled in some form of second-pillar pension fund at the end of 2018, according to the country's Office for National Statistics, compared with 50.9 per cent a decade earlier.

In 2018, the European Commission appointed a High Level Expert Group (HLEG) of academics, industry organisations and practitioners to analyse the EU's pension landscape and make recommendations. A final report is expected late this year or early 2020.

Leppälä, a member of HLEG, is keen for the analysis to challenge the status quo. European pensions policy requires new thinking and new ideas, he says, and an acceptance that traditional structures in the first or second pillar will likely not be appropriate for younger generations of workers. He cites Latin American economies that have incentivised workers in the "informal economy" to save for retirement, and calls for lessons to be learned by European policymakers rather than "assume that the solutions we had for many years are the best solutions for these new situations". ■