An Insight of the Future - Pan European Pension Product

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Abstract: The problems of aging population, the funding of adequate pensions, and increasing mobility of workers have been recognized for decades and EU institutions have now with pan-European personal pension product, a significant opportunity to offer to EU citizens a portable and practical tool to supplement the funding of their pension. The pan-European personal pension product, PEPP for short, is especially pertinent, as it will allow to pair long-term savings with long-term assets, such as bonds, stocks, private equity, and contribute to the financing and the development of the real economy. The objective of this article, in the context of the dynamic of the EU population, is to explain the need for such product, the potential of the PEPP from consumers of financial services perspective, by determining those specific features that could be incorporated into a PEPP framework. Because it addresses a significant number of people across the EU, consumer protection is the key of the topic of financial innovation, so transparency, simplicity and fairness in the market for consumer financial products and services are issues that must prevail. On the other hand simplicity of the PEPP products is no guarantee for pension safety and adequacy of this pensions plans. Supplementary, the PEPP should have sufficiently attractive characteristic to entice prospective consumers.

Key-Words: pension, retirement, pension plans, consumer, investor, consumer protection, pan-European personal pension product, financial product, demography

1. Introduction

According to wikipedia.org, a pension is ”a fund into which a sum of money is added during an employee's employment years, and from which payments are drawn to support the person's retirement from work in the form of periodic payments. A pension may be a "defined benefit plan" where a fixed sum is paid regularly to a person, or a "defined contribution plan" under which a fixed sum is invested and then becomes available at retirement age.[1] ” Also, wikipedia.org explains: „Pensions should not be confused with severance pay; the former is usually paid in regular instalments for life after retirement, while the latter is typically paid as a fixed amount after involuntary termination of employment prior to retirement.”

There had been a long practice starting in the Roman Empire to the modern nation states of providing pension to those who had served in the military (https://en.wikipedia.org/wiki/History_of_retirement#cite_note-8). Cotton Mather, the 18th century New England Puritan minister and author, proposed that elderly people should "[b]e pleased with the retirement which you are dismissed into".

A European comparison of the financial systems for social insurance reveals considerable differences, but a general classification into two basic systems is still possible. What we may call the Bismarck system is based primarily on social insurance contributions; the financing of the other system, the Beveridge system, is from taxes. In other words, an optimal Bismarck system leads to no redistribution between various income groups, but the Beveridge system does contain a redistribution. There is, however, a trend in Europe for the two financing systems to converge.

The Beveridge vs Bismarck pension model

European countries have quite different pension systems regarding the funding methods but fundamentally are based on two models, Bismarck model and Beveridge mode. The first is based on contributions with the express purpose of social protection, the second is based on general taxes collected.The Bismarck system goes back to German Chancellor Otto von Bismarck, who with the introduction of a statutory health insurance (1883) in Germany paved the way for a comprehensive social insurance system. In 1884 an Accident Insurance law was introduced to compensate workers injured at work. In 1889 an Old Age Pension scheme was introduced for workers over seventy. Bismarck's goal was to thwart, social agitation and socialism and also to undermine economically the voluntary social insurance of the trade unions and church-run labour federations. However Bismarck understood that socialism could not be overpowered by harsh measures alone. He realised that policies were needed to meliorate the situation of workers in Germany so as to erode advocacy for the socialists.

The Bismarck system is represented by the following three characteristics:

• The insured persons are employees or gainfully employed;
• The contributions to be paid are based on wages or salaries;
• The financing is via contributions, graduated according to income;

The Beveridge system is named after William Henry Beveridge, who in 1942 presented an extensive report to the British Parliament on social policy. The report contained concrete proposals for the creation of a comprehensive social insurance system which included the integration of social insurance forms, the creation of a general health service including workplace accident insurance, the introduction of family assistance, the maintenance of a high and stable employment rate as well as protection against mass unemployment (Franke 2004). These proposals were the foundation for the post-war British social insurance scheme. The Beveridge system is marked by the following:

• It comprise the entire population;
• It is principally financed from the state budget;
• It calls for uniform, lump-sum contributions.

The purpose of the Bismarck system is thus to assure a standard of living, while the Beveridge system aims on assuring a subsistence level. The result is that the Bismarck model tends to limit the redistribution of benefits between different categories of citizens' incomes, while the Beveridge model contains a redistribution of collected funds. Technically, first aimed to preserve the living standards of those who contribute on the basis of the principle of contributory, while the second seeks to provide support after a uniform standard. In fact, no country has a pure Bismarck or pure Beveridge system, and over time there have been changes from one pattern to another, and the deviations among individual benefits can be significant. The Bismarck system purpose is to tackle the problems of poverty and income inequality, to foster social solidarity and to increase the efficiency of the economy .The Beveridge system goal is to improve individual security and attenuate unknown social risks. This was to be achieved by unemployment, health and old-age insurance. Since the inception of the systems, the economic and social climate in Europe has changed. This also includes demographic changes. An increase in life expectancy has led to an extension of periods of non-employment and dependency. Moreover, changes in fertility rates have also impacted the financing of the social insurance system. This has been accompanied by a shift in the age structure of the population: the share of people above 65 years has increased and the share of younger cohorts has declined.

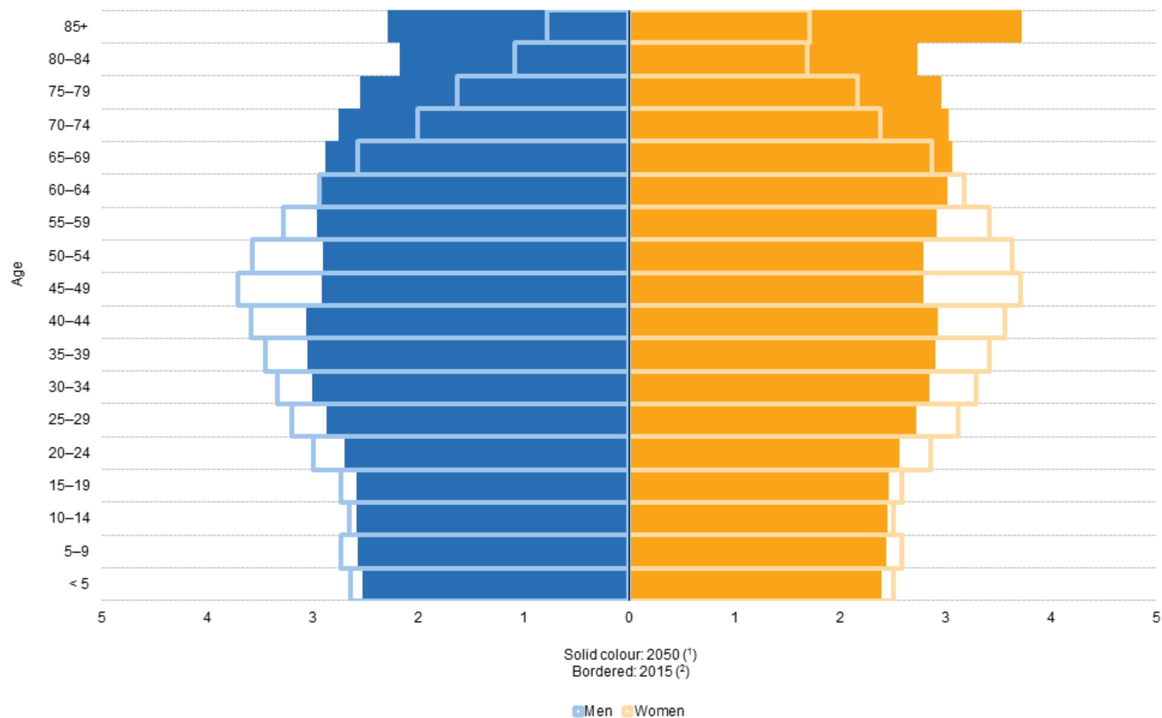
2. An ageing society in the EU

Nowadays, Europe faces an unprecedented demographic challenge that will increase the pressure on social services systems and public finances across EU. In the next 50 years, the share of the retirement age population compared to the share of working age will double (from four to one, two to one, i.e. two working-age people to a retired person). This situation demands reforms in national pension systems, which some EU Member States have already started. Part of the solution resides in occupational and personal pensions systems that supplement state-based pensions.

The number of people aged 65 or above relative to those aged 15 to 64 is expected to double between 2013 and 2060. As a result, many European states have already started reforming their pension systems, but that is not enough. As the Organisation for Economic Co-operation and Development (OECD) reiterated in December 2016, citizens also need to take personal responsibility and contribute more and for longer periods if they are to have an adequate income in retirement (https://ec.europa.eu/epsc/publications/strategic-notes/pan-european-pension-product_en).

The size of a population changes in a dynamic over time, depending of three demographic factors: births, deaths and migratory flows. The main result of the current low levels of fertility and mortality in the EU is a progressive ageing of the population. If the already low number of births is projected to continue, there will be little or no natural population growth and the working-age population is projected to decrease considerably between 2015 and 2050, thus further increasing the weight on those of working-age to sustain the dependent population. The rate of elderly persons is projected to grow much larger — as shown by the broadening at the top of the pyramid — reflecting the ageing of the EU's population as a result of small mortality rates. The number of women aged 85 and over is projected to be considerably higher than the number of men in the same age range (Figure 1).

Figure 1



Source: http://ec.europa.eu/eurostat/statistics-explained/index.php?title=File:Population_pyramids,_EU-28,_2015_and_2050_(%25_of_the_total_population)_RYB2016.png

In European Union, one of three pension formats as outlined by the World Bank in 1998 has since been adopted by many economically reforming countries in Central and Eastern Europe. The aims of the three-pillar system is to separate the major objectives of pension (retirement) schemes into the following pillars:

Pillar 1 – A standardized, state-run pension system, which offers basic coverage and is primarily focused on reducing poverty.

Pillar 2 – A funded system that recipients and employers pay into; this includes pension funds and defined-contribution accounts/plans.

Pillar 3 – Voluntary private funded accounts, including individual savings plans, insurance etc.

Voluntary personal pension plans are already in existence and each country in the European Union has their own system of pension, state-run or private, designed to help people save for their retirement years. A pan-European personal pension product, PEPP for short, will definitely increase pension funds, on a continent where pension products have a low priority for many citizens. According to the Commission, only 27% of Europeans between the ages of 25 and 59 have enrolled themselves in a pension product (http://europa.eu/rapid/press-release_MEMO-17-1798_en.pdf). The EU is currently facing an unprecedented demographic transformation brought about by declining birth rates and rising life expectancy, so Europe faces a major challenge in ensuring adequate retirement income for its citizens. Personal, or "third pillar" pensions play a key role in today's pension

landscape. This role is likely to become increasingly important, as multi-pillar pension systems are the most effective way to ensure the sustainability and adequacy of retirement provision. Voluntary personal pension plans are already in existence. Each country in the European Union has their own system of pension, state-run or private, designed to help people save for their retirement years. Indeed, the industry is believed to be worth about €700bn.

With a long track record of tackling demographic challenges, life insurers are major providers of personal pension products that consumers can trust.

3. The pan-European Personal Pension Product (PEPP)

A pan-European personal pension product, PEPP, certainly will enlarge pension provision on a continent where pension schemes are a low priority for many citizens. One of the stipulations of the proposed pension plan is that PEPPs will have the same standard features wherever they are sold in the EU and can be offered by a wide range of providers, such as insurance companies, occupational pension funds, investment institutions, banks and asset managers. The proposed pan-European Personal Pension Product (PEPP) is a standardized personal pension product that allows citizens to save money in addition to their state- and occupational pensions. PEPP will be offered alongside existing national third pillar products. Another stipulation is the portability of the PEPP, the notion of "portability" meaning possibility for the consumer to remain with and continue to pay contributions to the existing provider, regardless of where the consumer chooses to live in the EU. As personal pensions are contracts concluded between customers and providers, no limitations apply to the place of residence. For instance, a customer moving to another member state can continue to accumulate capital and receive the returns covered by the contract. However, the customer may be subject to national rules (e.g. taxation) over which PEPPs providers have no command. Portability at EU level is currently not allowed for any pension pillar. For pillar I, a coordination of statutory pension systems is provided through Regulation 883/04. For pillar II, Directive EC/2014/50 requires preservation and fair treatment of occupational pension rights for workers moving across border. Both pieces of legislation entail no actual transfer of pension contributions.

The switching feature, meaning the possibility to turn between providers or between products. For personal pension products which are typically very long-term products, it is important to offer consumers the flexibility to change between products as well as providers. Switching permits investors a choice between products and providers, and could be a measure to encourage competition and keep levels of costs (commissions, fees) under control. Being locked into in a product or with a provider for a long time as until reaching retirement age, regardless of whether the performance of the product is satisfactory or not, could be very prejudicial for the consumers.

Due to demographic challenges, state-based benefits are expected to decrease with the consequences that people will have to voluntarily save for their retirement. Facts that should favor consumer who wish to save for their retirement to use a PEPP could be:

Disposable income – It is known people with low incomes are often more affected by the decrease in state benefits. For this group will be a problem to have the income or the access to invest in a PEPP. Middle and high earning households in countries with reduced offer of personal pension products will be able to benefit from PEPP.

Confidence: the trust in the financial sector differs between countries. Also it should be considered that the overall confidence in the sector has been smitten during the 2008 financial crisis and a lot of consumers become reluctant to conclude long term investing contracts. Moreover, if no domestic PEPP provider is available in a country, will a consumer have the trust to place his spare income with a PEPP supplier from another state? A consumer from for example Romania might be interested to invest in a PEPP of a German bank but we question whether a consumer from Germany will invest in a PEPP of a Romanian bank

Tax exemption: the tax exempt policies will incentivise the choice of investing in PEPPs. If there will no be a tax exemption offered, we expect there will be limited interest in the PEPP. Tax incentives have a significant role in an individual's resolution to postpone consumption and instead save for golden age. For this reason, tax incentives or tax exemption could lead to success or fiasco of a PEPP framework. Economization through a funded pension plan can be taxed at three possible moments: when money is paid in, on capital revenues and on the pension payouts or lump sums. But, exempting pension contributions from taxation is crucial to incentivise saving.

The proposed pan-European Personal Pension Product (PEPP) must be designed to ensure a high level of protection for customers of insurers, who are the main providers of personal pensions. This protection is ensured through a range of measures, including stringent capital requirements. A poorly designed regulatory

initiative could bring benefits to neither consumers nor the EU economy. Consumers find it difficult to assess and make decisions about their future retirement income needs. However financially literate they are, people must be given sufficient, high-quality and appropriate information to enable them to compare and choose products. Precontractual information requirements must be tailored to the specific nature of the PEPP. Consumers could benefit from simpler, more innovative and more efficient personal pensions to supplement their retirement. On the other hand simplicity of the PEPP products is no guarantee for pension safety and adequacy of this pensions plans. A simple pension product design would not necessarily offer more adequate pensions.

From a consumer protection perspective, the PEPP should entail an appropriate level of security for policyholders. In past years, a lot of initiatives have been enforced or still are being implemented for the insurance sector (Solvency II, Insurance Distribution Directive IDD - Directive 2016/97). These rules are meant to ensure a high level of protection for consumers who purchase personal pension products from providers.

The key features of an EU personal pension framework will be trustworthiness, transparency, cost effectiveness.

Regarding the transparency, in order to determine which personal pension products best match their needs, consumers should be suitably informed of the key aspects of such products, especially in character of the products' long-term kind and intrinsic complexity. There are recent examples in EU financial services legislation about information disclosure requirements, such as in the Regulation on Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs), in the Markets in Financial Instruments Directive (MiFID II) and in the Insurance Distribution Directive (IDD) which could be background basis for constituting the adequate disclosure requirements for personal pension products.

Consumers should be informed about: age and pay-out options, minimum investment required period(s), conditions for partial withdrawal, risk coverage where provided (e.g. sickness, death, disability, longevity risk), consequences of early termination.

Cost-effective products could be offered by a well- functioning Single Market for personal pension products, without barriers to cross border activities, helping financial innovation and a healthy competition. Factors that would encourage competition to offer high quality, affordable personal pension products are: consumer awareness of the availability of retirement products and ease of distribution, transparency on fees and costs, tax and other financial incentives to personal pension savings, level of fees and returns.

Regarding the safety of PEPPs, various types of protection should be attached to the implicit investment option, ensuring simplicity and reduced risks for investors in personal pensions such as guarantee on capital. Consumers should be conscious of the risks they bear and have the possibility to access some form of counsel.

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Since pension products are generally defined by their objective to provide an income in retirement, the protection of longevity risk should be considered among the options offered to consumers, in line with national rules. From a consumer protection perspective, the PEPP should entail an appropriate level of security for policyholders.

Romanian outlook

Romania adapted the World Bank's multi-pillar model, but, when it comes to pension reform, Romania is a late bloomer compared with other Eastern European countries. First pillar restructuring took place in 2000 and the launch of the private pension system took place in 2007 and 2008. The pension system in Romania has undergone numerous reforms over the past decade, aimed at improving the sustainability of the system confronted with structural changes of demographic nature in the sense of an increased share of the aged population. The modified system has three components – the three pillars. The main features of the new system are: the standard retirement age gradually increased by 2014 to 60 yrs. for women (from 57 yrs.) and to 65 yrs. for men (from 62). During the same period of time, the minimal contribution period went up for both men and women from 10 yrs. to 15 yrs. (https://www.cef-see.org/pension_reform/Romania.pdf).

In Romania, much attention has to be paid to the harmonisation of retirement conditions of men and women. Nevertheless, despite widely seen recent efforts for equalisation in, for example, Austria, the Czech Republic, Poland, Greece and Slovenia. Bulgaria and Romania – that have not yet induced the full harmonisation of retirement conditions between men and women (http://www.europarl.europa.eu/RegData/etudes/STUD/2014/536281/IPOL_STU(2014)536281_EN.pdf, page 13).

The changes introduced to the third pillar have mostly concerned conditions under which the private pension products are considered for a tax or other allowance. The most recent changes to pension systems have not concerned third-pillar schemes. In Romania, the state guaranteed the payment of benefits from private schemes to increase their attractiveness for citizens (http://www.europarl.europa.eu/RegData/etudes/STUD/2014/536281/IPOL_STU(2014)536281_EN.pdf, page 22). The voluntary scheme is also privately administered with defined contributions on individual accounts, whereas the contributions are deductible from gross wages up to an amount of the equivalent of 200 euros. No evidence is found that the third pillar directly influences reforms of Pillar 1 and 2, rather that changes to the third pillar are minor additions to large reforms, strengthening of Pillar 3 goes hand in hand with changes to Pillars 1 and 2.

The success of these schemes is, however, uncertain: while the number of people with bank accounts is steadily increasing, in June 2013 39 % of the accounts of the mandatory scheme and 50 % of the accounts of the voluntary scheme were empty. In particular a lack of financial literacy seems to be endemic. For example, 85 % of Romanians do not have any private insurance. Most are neither accustomed to taking care, nor educated enough to take care, of pension provision privately

The three-pillar system is fundamental taking into consideration the projections for Romania's demographic evolution in the following decades. Professional studies have al shown that starting with 2040 the demographic pyramid in Romania which is shaped in such a way that it will exercise immense pressure on the public pension fund. Fewer and fewer active persons will have to support an increasing number of inactive ones. Pillar 2, where money is being saved and invested, will be able to take on some of this financial burden. Additionally, an insurance system that proved its long-term sustainability and which represents a prerequisite for improving the living standards of the future Romanian retirees is needed and the Romanian consumers very much welcomes the launch of the pan-European personal pensions (PEPP) by the European Commission (EC).

4. Conclusion

PEPP is a possible solution to the serious demographic challenges the ageing population is facing. The PEPP will be more successful in some countries than others. Encouraging the supply of third pillar personal pensions by a wider range of financial institutions would maintain more competition and could offer more choice with more attractive prices to consumers The introduction of the PEPP can however benefit more persons, as mobile workers who work (temporarily) in other Member States, and freelancers as freelancers do not accumulate a pension with an employer so the introduction of the PEPP will offer them an alternative.

A dialogue between interested parties may have positive outcomes on personal pension products, (Member States, providers, consumers, consumer organizations). We need a common approach to providing personal pension products in order to create, together with the national authorities, pension industry and consumers – a series of recommendations which providers could follow when offering PEPPs.

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