3 QUESTIONS 2

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on rethinking our pension system sustainability and adequacy

Q #1 *Why should pension systems be rethought?*

Pension systems in many European countries should be rethought for two main reasons. The first is the financial sustainability challenge. Pay-as-you-go pension systems are under strain because the population aged 60+ is growing. Consequently, as the number of workers per retiree is declining, tax rates required to finance first pillar pensions will have to be increased, the level of pensions will have to be reduced, and/or people will have to work longer before retiring. Governments will need to take these kinds of measures to ensure the sustainability of their pension systems, especially in countries with large projected increases in pension expenditure and high government debt.

> *"If nothing is done, a growing number of people will face poverty risks when they retire"*

The second reason is the pension adequacy challenge. If nothing is done, a growing number of people will face poverty risks when they retire because of the expected decline in pay-as-you-go pension benefits and the limited coverage of occupational and personal pension plans. This is especially true among women because, on top of often having worked in lower paid jobs, the older generation of women are more likely to have worked part-time and to have had longer career breaks to care for children or relatives.[1]

Q #2 *What are potential solutions to address the pension adequacy challenge?*

The goal should be to ensure that people save enough to secure an adequate income in retirement. Five types of measures have proved particularly effective in many countries, starting with tax advantages and other financial incentives such as matching contributions from the government or from the employer. Most OECD countries rely on these measures to promote participation in funded private pensions.[2]

Occupational defined-contribution (DC) plans and personal pension products are also very effective tools. A key feature of occupational pension plans is that they tend to charge low fees because they benefit from economies of scale and low cost of distribution.

[1] See related data from the OECD.
[2] The OECD publishes regular reports with annual overviews of the tax treatment and non-tax financial incentives provided to encourage individuals to save for retirement in funded private pension plans in OECD countries. See also the report published by the International Investment Funds Association, entitled 'Better Pensions, Better Lives: How investment funds can help individuals save for retirement and reduce fiscal pressures on governments'.

We also strongly believe in the power of auto-enrolment. The secret behind this power is the ability to overcome the inertia that prevents many people from taking the leap to start saving for retirement on their own initiative.

More radical, but of course also very powerful, are mandatory pension programs like the national pension system (PPM) in Sweden. One of the features of this system, which came into effect in 1999, is that 2.5% of the pensionable salary is to be invested in investment funds. The first selection of PPM funds was made in 2000. This was not the best time for launching such an initiative because of the dotcom crash, the September 11 attacks, and a few years later the global financial crisis. And yet, despite these events, the PPM returned an average (capital weighted) of 9% per year in the 2000-2021 period, according to the Swedish Pension Agency.[3]

Last but not least, governments, regulators, fund managers, other financial services providers, and trade associations should undertake investor education initiatives to increase people's awareness about the need to save for retirement.

EFAMA took the step of reaching out to Insurance Europe and PensionsEurope to launch the European Retirement Week. Since then, eleven other European associations have joined this initiative. This year's edition will start on 28 November with the participation of two European Commissioners, Mairead McGuinness and Nicolas Schmit, and of the Chairperson of EIOPA, Petra Hielkema. On 1 December, EFAMA will organize an event on the contribution of capital markets and asset managers to good outcomes for DC pensions.

Q #3 *What are the obstacles to overcome?*

Numerous obstacles deter governments from taking the measures that are needed to limit the growth of pension costs in the public expenditure, primary among these is the lack of public support for pension reforms. Indeed, older people want to keep their acquired state pension rights whereas the younger generations don't want to pay higher taxes to finance the pensions of new retirees, while facing themselves the prospect of low pensions. Many governments also lack the political courage to acknowledge the negative impact an ageing population will necessarily have on the future level of public pension benefits by fear of provoking widespread social unrest.

Governments also have difficulties in addressing the trade-offs between different policy options: pay-as-you-go vs funded pensions, occupational vs personal pensions, collective vs personal solutions, and voluntary vs mandatory measures.

> *“A change in mindset is required”*

There are additional obstacles that hamper the willingness of governments to promote complementary retirement savings. One of them is that Covid-related expenditure, and the support provided to alleviate the current energy crisis, have drastically reduced the available fiscal room to provide tax incentives and have shifted policy priorities to more immediate concerns. Another reason is a lack of trust in capital markets and fears of market downturns.

To overcome this obstacle, a shift in mindset is required to take into account the following realities. Firstly, the market is not evil, investing is helping your money to work harder and grow. Secondly, volatility is less of an issue for long-term pension products, what matters is the amount of assets at retirement. And thirdly, since young people will not be able to rely on the State for an adequate pension, they should be encouraged to take control of their future pension and start saving accordingly.

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[3] See page 62 of the Orange Report 2020 (Annual Report of the Swedish Pension System).

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages over EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

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