

Brussels, 6 March 2009

## The economic crisis and pensions in the EU

### How does the EU improve pension systems in Europe?

The EU seeks to assist Member States in developing their pension systems towards the shared goal of providing adequate and sustainable pensions for all, through its Open Method of Coordination (OMC). The Commission's role in this is to highlight issues of common concern across Europe and to assist and encourage the sharing of data and best practice between countries. A major output of this process is the annual Joint Report on Social Protection and Social Inclusion (see [IP/09/360](#) and [MEMO/09/96](#)).

There are many other ad hoc outputs such as the October 2008 report "Privately managed funded pension provision and their contribution to adequate and sustainable pensions" ([IP/08/1551](#)). The report points out variations between Member States in approaches to private pension provision and the need to ensure that where funded private provision exists, its coverage and adequacy match its intended role.

Although pensions are primarily the responsibility of Member States, there is also some EU level framework legislation, notably a directive on occupational pensions. This directive<sup>1</sup>, whilst leaving the detailed rules to Member States, establishes prudential standards for occupational pension schemes. In addition, the Insolvency Directive provides protection in the case of insolvency of a company which sponsors an occupational pension scheme.

### What impact is the financial crisis having on pension schemes in the EU?

Pensions are not immune from the financial crisis. But the long term nature of pensions gives some natural protection. It is important to distinguish between the different types of pension schemes used as the precise impact will depend on the specific mix of schemes in place in any particular Member State.

- **Pay-as-you-go (PAYG)** pensions are statutory state schemes largely paid from current contributions of workers and remain important in all Member States. A serious economic downturn and larger national debt may increase the need for policy adjustments to secure the long term sustainability of such schemes in some countries. But in the shorter term, people will get the pension they expect and any adjustments for the longer term can be gradually phased in.

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<sup>1</sup> Directive 2003/41/EC on the activities and supervision of institutions of occupational retirement provision. Commonly known as the IORP Directive.

- In general, funded pensions will see more direct impacts from their investments falling in value. **Defined Benefit (DB)** occupational pension schemes take on the investment risk, so again people in general will get the pension they expect. Going forward there will be challenges as funded DB pension schemes, in deficit as a result of falls in investments, seek to restore their funding balance. Impacts on individuals may come from formalised or ad hoc adjustments to indexation or contributions and the crisis may also accelerate the long term trend for DB schemes to close to new members or even accruals to control costs. Beyond this we cannot completely rule out more serious impacts, though the Insolvency Directive and measures Member States have put in place provides a further layer of protection.
- **Defined Contribution (DC)** pension schemes leave the investment risk entirely with the scheme member so the impact will be felt directly. But for those some way from retirement, there is time for investments to recover. For those close to retirement they may nonetheless be protected – for instance in some occupational schemes in countries such as the UK – by being in funds which operate so-called 'lifestyle' or 'lifecycle' investment strategies. These take most investment risk when the scheme member is young and gradually move to safer, less volatile investments like cash and bonds as retirement approaches. But those close to retirement and not in lifestyle funds who are relying heavily on DC schemes in their overall pension income will face less well paid or later retirements. But this is an atypical scenario for most European citizens, as DC schemes are usually a small or negligible element of overall retirement income for most people retiring today.
- For the future, DC pensions are expected to play a bigger role in overall pension income, notably in a number of the new Member States where statutory funded DC pensions have been set up in recent years. However, the financial crisis has led to some Member States looking again at some aspects of these systems.

### **Are Member States pension systems differently affected by the crisis?**

It is still too early to predict precise impacts, but given the severity of the financial crisis, all Member States' pension systems will be impacted to some extent.

The effects on any particular Member State will depend on a number of factors, including the differing impacts of the financial crisis on their individual economies, how their pensions systems measured up against the EU aims of adequacy, sustainability and transparency to begin with and the precise mix of schemes in place in the national context.

### **Why are pension funds not affected by the crisis in a similar way to banks and other financial institutions?**

Funded, defined benefit pension schemes have a number of features that make them more resilient to current market events than some other financial institutions. For instance,

- Much of a pension funds liabilities are *very* long term (an existing pension liability may not be due to *start* to be paid for up to 40 years and then continue as a regular payment for 30 or more years).
- So assets held in pension funds today may relate to a liability (promise to pay a pension) several decades away.

- Hence pension funds take a very long term approach to much of their investment portfolio and they can afford to ride out even severe market turbulence as the long term assets they hold relate to liabilities that will not fall due for payment for many years yet.
- We have seen no evidence that pension funds have significant direct investments in the kind of toxic assets that have caused problems for banks and others. Typically pension funds are conservative investors who hold a well diversified range of mainstream assets. Asset types held by pension funds are primarily shares and bonds (eg accounting for about 90% between them in UK, 75% in the biggest NL pension fund).
- Pension funds invest their own money only, so they are not geared. In other words they do not borrow money to invest alongside their own money in order to magnify gains (and if things go wrong, losses) as many other financial institutions often do such as hedge funds, private equity companies and investments banks.
- So pension funds do not have loans to repay or refinance and so they do not rely on the availability of credit, unlike banks and others who have had difficulties refinancing credit because of the credit crunch.
- This means pension funds are not forced sellers of assets (i.e. they do not have to sell assets at the bottom of the market in order to pay debts that have fallen due).

All this means that typically a pension fund's liabilities falling due today are a small proportion of their total assets and they still have income both from active members (workers) who are contributing to the scheme and from investment income. The latter is not all dependent on the capital value of the investment. For instance bonds pay a set percentage yield or 'coupon' throughout their term, and despite the current difficulties some companies will still be paying shareholders dividend payments and property holdings will still yield rents.

Of course pension funds may need to take action in the short term to continue to safeguard their long term health and national supervisory bodies operating within the European and national regulatory framework should ensure that they do.

### **What lessons can we draw from the crisis on current pension systems in Europe?**

No system is perfect and there is room for improvement in the EU's current pensions framework. However, despite the severity of recent market turbulence, European pensions have not experienced problems to the same degree as other types of financial institutions nor those of pension systems in some other countries outside the EU. So clearly the system is relatively robust, at least over the short term for those retiring today.

### **What about lessons for the future?**

The Open Method of Co-ordination (OMC) process provides a tool for the European Commission to explore with Member States where there may be weaknesses in pension systems that could need addressing in the future.

For instance, one early lesson is around the importance of ensuring that investment frameworks for DC pension schemes are designed to encourage the right choices and that the 'lifecycling' or 'lifestyling' of asset allocation is the mainstream option for everyone. This was a point highlighted in the report "Privately managed funded pension provision and their contribution to adequate and sustainable pensions" published on 20 October 2008 as part of our OMC work.

Another is that Member States should give careful consideration to the appropriate maximum proportion of overall pension income expected to come from DC pensions, particularly for the less well off who may be less able to absorb the inherent risks.

The financial crisis may also have put into sharper focus underlying structural issues regarding the sustainability of pension systems. These issues may previously have been masked to some extent by expectations of returns in funded pension schemes which now seem over optimistic. Adjustments may therefore be necessary to ensure the long term health of pension systems.

**Further information:**

<http://ec.europa.eu/social/main.jsp?catId=443&langId=en>