Pension reform in Europe: make way for the 4th Pillar?

...article by Simon Colboc, FEPI Secretary General, as published in March 2021 by www.fecif.org

A wide-ranging study on retirement across Europe conducted in 2020 by the FECIF European Pensions Institute (FEPI) shows that current pension reforms, however ambitious, are far from enough to address the scale of the issue.

Fortunately, European households have accumulated considerable reserves in savings and investments not identified by retirement finance statistics. This 'invisible' wealth of assets represents the hidden '4th pillar' of retirement systems.

However, these investments need to be managed in a completely different way to address the retirement gap – this requires considerable advances in advice and technology.

We generally see pensions and retirement systems as resting on three pillars

The first one is mandatory, a state-run pay-as-you-go system in which contributions from the productive sectors of the economy are redistributed to pensioners. This represents today the bulk of pensions in many European countries, contributing over 70% of pensioners' income in countries like Germany, France, Italy and Spain.

The second pillar is made up of employer-managed funded pension schemes, whether 'Defined Benefits' (guaranteeing a lifetime income in relation to salary and years of service) or 'Defined Contributions' (accumulating a pension pot made available to the participant at retirement). These represent a very significant proportion of pensioners' income in countries like the Netherlands, Denmark and the UK.

The third pillar consists of individual retirement savings made by households to supplement 1st and 2nd pillar provisions. This pillar is the focus of the European Union's effort to boost retirement savings via the creation of the Pan European Personal Pension (PEPP) products, and also local initiatives like the French PER.

This pension structure can no longer be reformed

Maintaining the long-term balance of contributions while avoiding civic unrest on pensions is not easy for governments. Most countries across Europe have been tinkering with Pension reforms for over 30 years now, and it seems they have stretched current efforts about as far as they can go. Demographic changes and worsening dependency ratios (number of pensioners vs. active population) are putting untenable pressure on the pension systems.

So-called 'parametric' reforms, adjusting the parameters without changing the overall structure of retirement systems have reached their limits, as people are not ready to work longer even though we live far older than our grandparents, pension contributions are increasing labour costs and the purchasing power of pensions is worsening.

Recent reforms (from NEST in the UK to the launch of PEPPs) have integrated the learnings of the past and the advances of behavioural finance to develop better and targeted solutions, yet even in the most optimistic projections, the assets accumulated by such products will only address a limited part of the pension gap.

The solution might well lie outside the box, but it still needs considerable work

In reality, there is a lot of room to manoeuvre – provided we accept the need to look outside the box. Current pension systems (both first, second and third pillar) might have reached their limits, but there is an alternative.

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European households are sitting on a massive amount of savings, over €30tn in financial savings. These assets are not usually considered when analysing the pension gap, because they sit in life insurance, savings accounts or other forms of financial investments not usually associated with pensions.

However, providing for retirement is one of the key reasons why households have built such savings. If we consider that about a third of these assets are earmarked towards retirement, the assets represent some €10tn aimed at providing long-term financial security to European households.

The good news is that these €10tn do go a long way towards bridging the pension funding gap. The not-so-good news is that this money is not invested in a way that would support the investors' goals. Most of it is parked in products providing liquidity and capital guarantees in the short term, at the expense of long-term returns. Therefore, it is very likely to provide disappointing returns over the long period of time during which it will be invested. The result is simple: households are losing massively in terms of long-term purchasing power, so they are not meeting their goals.

Getting on the right path

A significant shift in saving and investing behaviour needs to take place across Europe if we are to see the 4th pension pillar contribute meaningfully to the long-term financial security of households.

Beyond changes in legislation (e.g. no longer 'forcing' investments towards guaranteed products with poor long-term prospects) and product design, three changes need to take place:

1. Enabling consumers to go through a proper financial planning exercise, to define clearly their goals, priorities and time horizon.
2. Enabling savers to set up a risk-based investment approach to reach these goals.
3. Ensuring consumers can access IT-augmented advice to prepare and implement their financial planning.

These changes were supposed to be helped by MiFID II, IDD and other European regulations, but we have to admit there is still a lot of work to do.

This article is largely inspired by the research conducted on retirement savings in Europe by FECIF and CMI strategies for FEPI in 2020. A full Executive Summary can be found here.

FECIF European Pensions Institute

Retirement Planning in Europe

Executive Summary