PENSION WEALTH IN THE EUROPEAN UNION – TENDENCIES, PROBLEMS AND SOLUTIONS

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Abstract

Pension wealth in the European Union member states differs vastly among countries. Elderly in most Member States are growing as proportion in the population. This is combined with the different design of pension systems, increase in the number of years after retirement, limited abilities to raise pension expenditure and economic environment with low interest rates. As a consequence, there is a pension gap, deep problems emerge and market risks are created. European citizens need to have more and safe opportunities for long-term saving and investment. At the same time, market players expect clear rules and predictive framework. For long time adequate and sustainable pensions are mainstream of policymakers but it is time to set another focus. This focus could be the pension wealth and its development. The tendencies and problems concerning the wealth of elderly are analyzed and some solutions are presented.

Keywords: *pension wealth, old-age income, statutory pensions, supplementary pensions, adequate pensions, sustainable pensions*

INTRODUCTION

The income of the older people in the European Union (EU) is in jeopardy to decrease. Factors that drives this are the longer life, the increase of the population over 65 (65+) in most EU countries and the limited ability of the governments to raise the pension expenditure.

It is of scientific interest how to preserve and even increase the income after retirement. That is why the paper examines the pension wealth of the older people in the EU, which factors are influencing its change, what are the tendencies, problems and possible solutions.

The paper starts with analysis why are pensions important and what constitutes the pension wealth of the elderly. Examined are the current pension systems, including the expenditure from the government. Compared is the size of the expected pension with the working income prior retirement. Searched is the role of the supplementary pensions.

Some of the conclusions are that pensions across EU are very diverse. No matter that pension policy is within responsibility of each Member State future steps have to be undertaken to close the differences and to improve the results for the beneficiaries. Another conclusion is that for the same income one need more working years or higher contributions compared to current pensioners. This requires more information to the public, more active role of state, employers, labour unions and pension administrators. The targeted results could be reached through shifting the mainstream from adequate and sustainable pensions to improved pension wealth.

The thesis of the study is that focus on pension wealth could lead to improved savings, increased awareness for proactive investment decisions among savers and more sophisticated regulations to help for development of long-term products markets.

1. THE IMPORTANCE OF PENSION WEALTH

Approximately 20 years is the duration of life after retirement. This is huge part of our life and logical question is what is the income during these years. Other relevant questions are what are the different sources of the income and how this income can be influenced. Such questions lead to the concept of pension wealth of the older people.

The pension wealth is important because of the adequacy of old-age income. Pension wealth is defined (according to the classification of the Organisation for Economic Cooperation and Development) as the present value of the flow of pension benefits. The indicator is measured as a multiple of annual earnings. It is relevant to know how pensions maintain the income for the duration of retirement. Pensions are considered [1] as "…both the main source of income for older Europeans and an important component of public expenditure." In the paper it is analyzed the income mix of the elderly. Also, attention is given to the expenditure allocated from the Member states. Nevertheless, the pension reforms and the efforts from the governments, 17.3 million or 18.2% of older people aged 65 and over in the EU remain at risk of poverty or social exclusion as of 2016, according to the European Commission (EC). Furthermore, low percent from the working income is replaced by pensions at the moment - pensions in the early years after retirement amount to more than half of late-career work income (58% in the EU, Eurostat). In the paper is analyzed this ratio for each Member State. At the same time, the retirement years are huge part of the total life of a person: it is about half (51%) of that spent in employment. EC is projecting that the ratio will increase to 53% by 2060. Based on these tendencies public pension systems in EU is facing financial and social risks that with less money has to finance increased pension obligations. At the same time, supplementary pensions are still not mature and in many countries are in early stages of development. The authorities in the EU are admitting that people retiring in 2056 will have lower pensions compared to their work income than a similar career would have earned them in 2016.

The Figure 1 shows the people at risk of poverty or social exclusion in % of the population in the EU, according to Eurostat. A comparison is made between two years - 2009 and 2017.

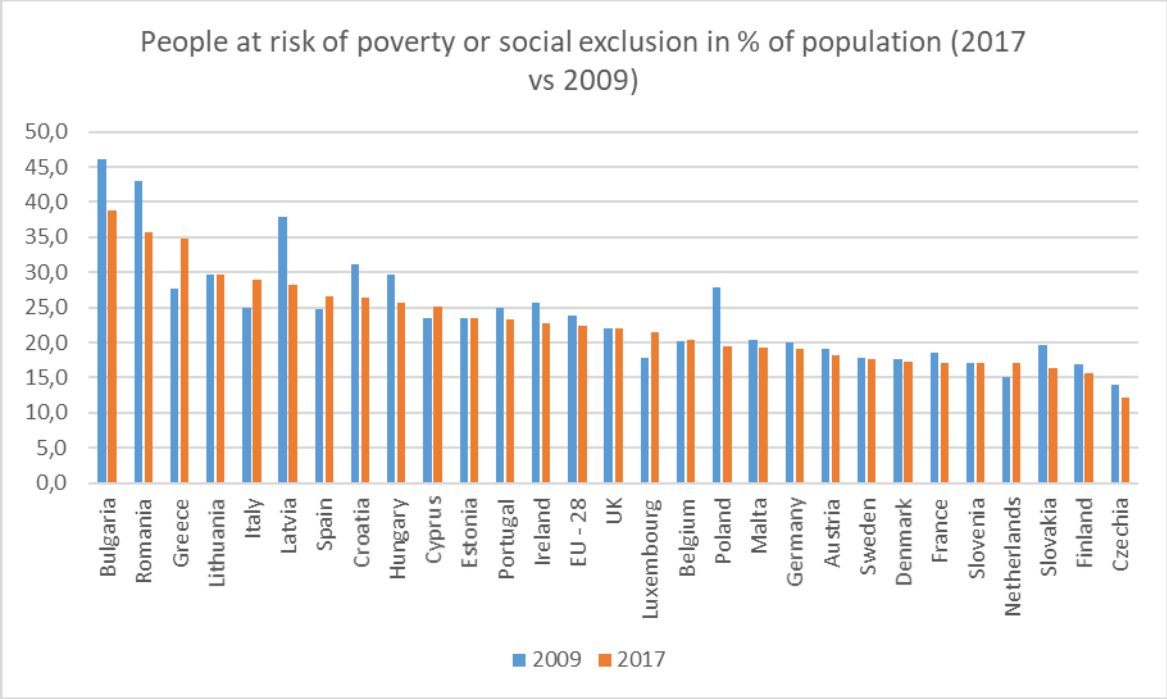


Figure 1

Source: Eurostat, https://ec.europa.eu/eurostat/web/income-and-living-conditions/data/database

The figure shows that the risk of poverty is the highest in countries in Central and Eastern Europe region (CEE) – Bulgaria, Romania, Lithuania and Latvia (above 27%). Greece and Italy are entering the top six in 2017 compared to relatively lower risk in 2009. The last could be explained with the problems in the two countries with the high level of the government debt and the limited abilities to increase state expenditures. People 60+ is the largest part of the group in risk. Still in many countries the level of the people at risk is very high. For Bulgaria this is particularly evident throughout the so-called transition

period and its economic impacts in the following decades [2]. The good news is that the ratio is decreasing as a whole in the EU – average 22% from 24% eight years earlier. The highest steep decrease is registered in Poland and Latvia due to measures to increase the income of elderly. We are analyzing the people at risk of poverty and social exclusion because pensions play important role in social policy. From the figures we can conclude that still pensions are not at the required level both in terms of size and coverage.

The problem of the income of the older people is very complex because it interrelates different sections such as social factors, labour factors, economic factors, personal initiative and public policy, environmental policy to protect the life, health and working capacity of the population [3]. That is why identifying as many more of those factors as possible is instrumental to achieving the desired return on investment portfolios aiming at ensuring required levels of pensions when the point in time for them arrives. As Kitanov stresses, "Many oftentimes random factors influence investment activity. These factors could be identified both at macro and at micro level." and should be properly taken care of [4].

The structure of pension wealth is also important for each country itself. It could encourage personal initiative, business endeavors, and saving with increased added value for the country. The greater role of private sources in the income mix could lead to capital market development and diversify sources of financing. Here we are talking of more efficient and productive long-term saving.

When analyzing income sources mix in addition to pensions it has to be taken in mind also homes, securities, bank deposits, other social benefits and work income, as well as social policy of employers as part of corporate risk management [5].

The figure 2 shows the proportion (in %) of various income (gross income) sources for a household that consists of a couple with at least one member aged 65+. The data is for the EU 28 for the year of 2015.

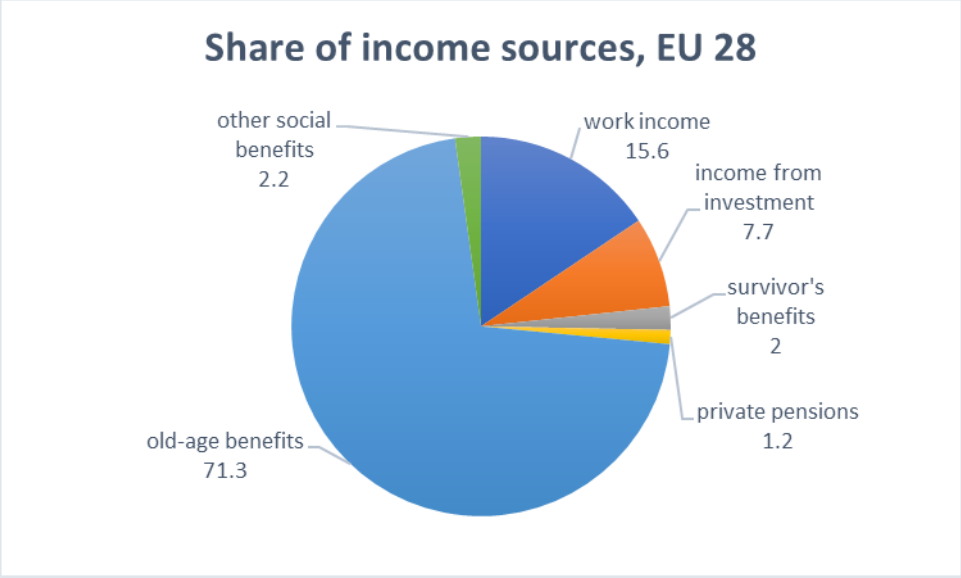


Figure 2

Source: European Commission, "Pension Adequacy Report 2018: current and future income adequacy in old age in the EU", Volume 1, p. 29

The figure shows that old-age benefits (pensions) are the main source of income for old people with share of 72.5%. When analyzing the living standards of older people, we have to take into account other sources and factors – the household composition, duration of working life, living conditions, personal wealth and service accessibility. Other important income sources are from work – 15.6% and from alternative forms of investments – 7.7%.

In our opinion the share of other forms of investments seems very low. Shares, bonds, deposits, real estate income are elements of this group. The low proportion is an evidence for relatively low investment culture and that these forms of income are not well used from savers. This group can expand its share with the help of the state and market players. Apart from that, it should not be forgotten, that even government bonds, which are traditionally considered risk-free, are not exactly such in reality. Kitanov points to the multiple issues related to the rates of return of these instruments, emphasizing that "Contrary to the common understanding that government bonds are risk-free, they are not. They are exposed to at least three types of risks: 1) risk of default (credit risk), 2) inflation risk, and 3) currency risk. It is correct to consider that they are guaranteed in terms of nominal value but since risk of default exists, this means that they are actually not guaranteed even in terms of nominal value." [6]. That might be a possible reason for people abstaining from investing in bonds, especially in underdeveloped markets such as Bulgaria. Apart from that, as Zhelyazkova points out, in the recent years, a number of new investment types and vehicles have been gathering momentum, such as the so-called socially-responsible investments, or SRI [7].

At the same time, home ownership among elderly is relatively common in the EU. Average for the EU 28 76% of older people live in their own homes (Eurostat, 2016). We are bringing attention to the home ownership because household residential property could be converted to cash in order to supplement the pensions. There are various schemes that encourage such conversion, for example equity-release schemes. This element of income also has room to expand its share and governments have to undertake measures that will create friendly environment for market players to develop the product niche.

The term pension wealth has to be regarded not only in short meaning (pensions) but also in broad meaning – the total wealth of elderly. It is interesting to see what is the size of wealth by age. The average net wealth by age for the EU 19 can be seen in the following figure.

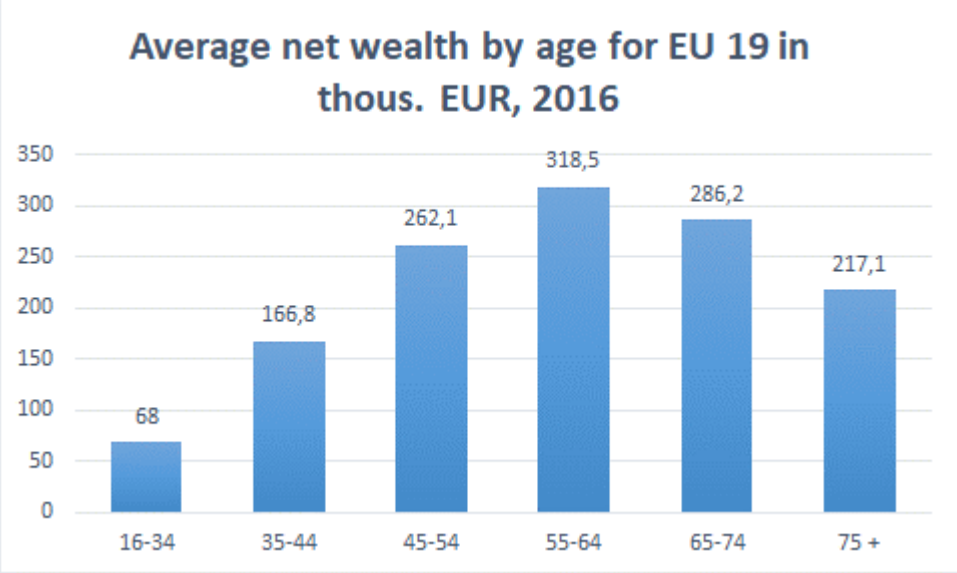


Figure 3

Source: European Central Bank Household Finance and Consumption Survey, 2016

The data shows that older people have wealth higher than young persons which is logical taking into account consumption, wealth accumulation and inheritance. One conclusion from the relatively good results is that the period 1945 – 2016 is the time of the baby-boomers in Europe. This is a period during which the accumulating of wealth was easier than previous, and potentially later generations, according to the Pension Adequacy Report 2018 from the EC. The data encompasses EU 19 and does not include Member States with low pension replacement ratios like Bulgaria, Romania, Czech Republic and

Croatia.

The increasing difficulties in maintaining the size of pensions are stemming from the fact that the public pension systems depend on the incoming contributions. These contributions tend to decrease. There are tendencies for ageing of the population and increasing longevity (20 years is the life expectancy at age of 65 in EU average as of the end of 2016 which is more than one year higher compared to a decade earlier – 18.7 in 2006) [8].

The two trends are increasing the period of receiving pension. According to the World Health Organization [9] between 2015 and 2050, the proportion of the world's population over 60 years will nearly double from 12% to 22%. By 2050, the world's population aged 60 years and older is expected to total 2 billion, up from 900 million in 2015.

The ageing in the Europe is in worse condition compared to Asia and Africa. As a consequence of these trends there is a threat the pension expenditure to increase. The figure 4 shows the pension expenditure in Member States per beneficiary in thousands EUR as of 2015.

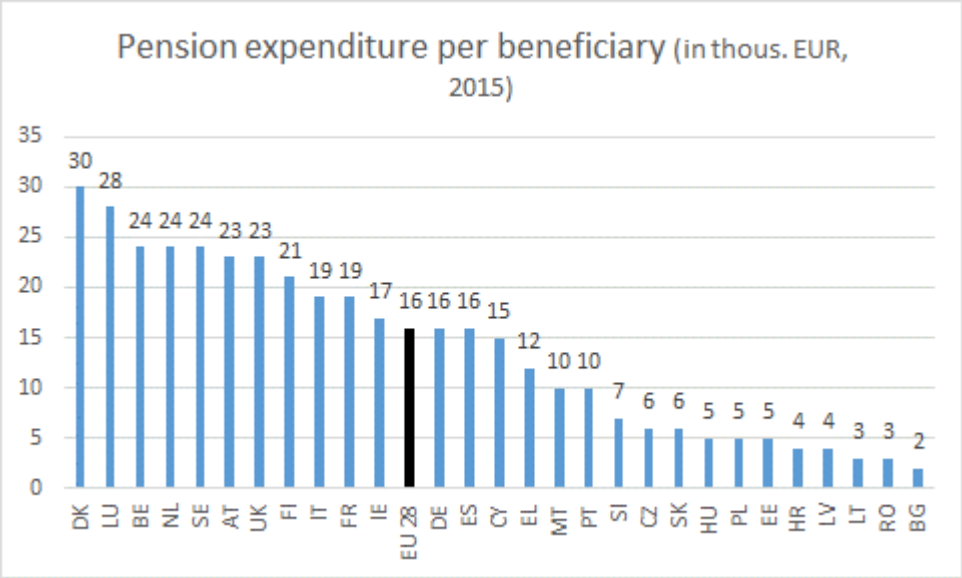


Figure 4

Source: European Commission, "Pension Adequacy Report 2018: current and future income adequacy in old age in the EU", Volume 1, p. 35

The figure shows the pension expenditure per beneficiary for old-age and survivor's pensions. The value is calculated as total expenditures for pensions is divided by total beneficiaries for each Member State. From the data we can derive a conclusion that the pension expenditure is very diverse across Member States. The highest value is in Denmark (30 thousand EUR per beneficiary per year) and lowest in Bulgaria (2 thousand EUR) with 16 thous. EUR average for EU.

From the above analysis can be drawn conclusion that pensions are the main source of income of elderly. Governments have to address the relatively low financial culture and to establish framework for products that could increase the pension wealth of the elderly.

At the same time there are problems to maintain the current levels of pension income. The pension income and the pension expenditure vary significantly between Member States. That is why in order to preserve the value of the pension income EU has to adapt long-term approach which to be implemented by Member States. An element of this approach is the concept of the pension wealth.

2. PENSION WEALTH IN EU

Among the principles of the European Pillar of Social Rights [10] is the one that the workers and the self-employed in retirement have the right to a pension commensurate to their contributions and ensuring an adequate income. The adequacy of the retirement income and the relation with the personal contribution lead to the concept of the pension wealth.

Because the social policy is within the discretion of each Member State and there is no harmonization in social security there are various pension system designs in EU. That leads to huge differences in pension replacement ratio among EU. The following figure displays comparison of the replacement ratio in the EU in 2005 and in 2017.

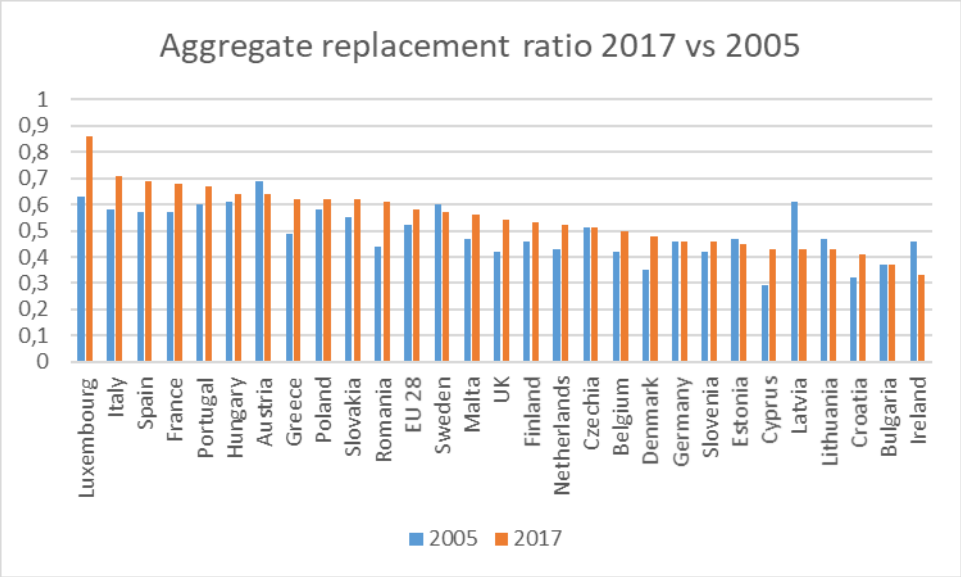


Figure 5

Source: Eurostat

The data from Figure 5 shows the aggregate replacement ratio which measures the income replacement capacity of pensions systems. Aggregate replacement ratio (ARR) compares the median individual gross pension income of people aged 65-74 to the median individual gross earnings of people aged 50-59. The ratio represents the difference in the income between late career and early retirement years. The value of the ratio varies from 86% to 33% for different EU Member States. The average for the EU-28 is 58%. During the analyzed period of 12 years for 9 countries there is considerable increase of 10% or more percent. In 6 countries there is a decline. Three countries are registering no change and in the others 10 Member States there is a moderate increase. When analyzing the ratio, it has to be taken into account that there could be different reasons for the value change. For example, higher ratio could stem from increased pension income or reduced preretirement earnings.

Another reason for the pressure on the PAYG pensions is the ageing population in many EU Member states [11]. The projected old-age dependency ratio in the EU is supposed to almost double from the current levels – from 28.8 for 2015 up to 51.6 in 2060 – now 100 persons aged between 15 and 64 have to support 28.8 people 65 and over 65 years and in 2060 100 persons in working age have to support 51.6 economically inactive persons aged over 65. This ratio shows that the people in working age who is paying contributions is decreasing compared to older people. At the same time the share of pension expenditure to GDP is 11.2% as of the end of 2015, according to Eurostat. It is expected to increase up to 12.9% in 2060.

The policymakers and the experts [12] are seeing solution the smaller replacement ratio from public

pensions to be compensated from supplementary pensions. These supplementary pensions constitute of occupational pensions, mandatory or quasi mandatory schemes and personal voluntary pensions. We support the view that improved savings for the households leads to better life during old age.

Often the expectations of the people for the size of the pension differs from the real situation. One explanation could be the difference between the ideal career path and the real working life. This can be measured by theoretical replacement rates. The figure 6 displays comparison between aggregate replacement ratio and theoretical replacement rate in Member States. Theoretical replacement rate (TRR) is calculated after taxes, for 40 years' uninterrupted career and standard pensionable age.

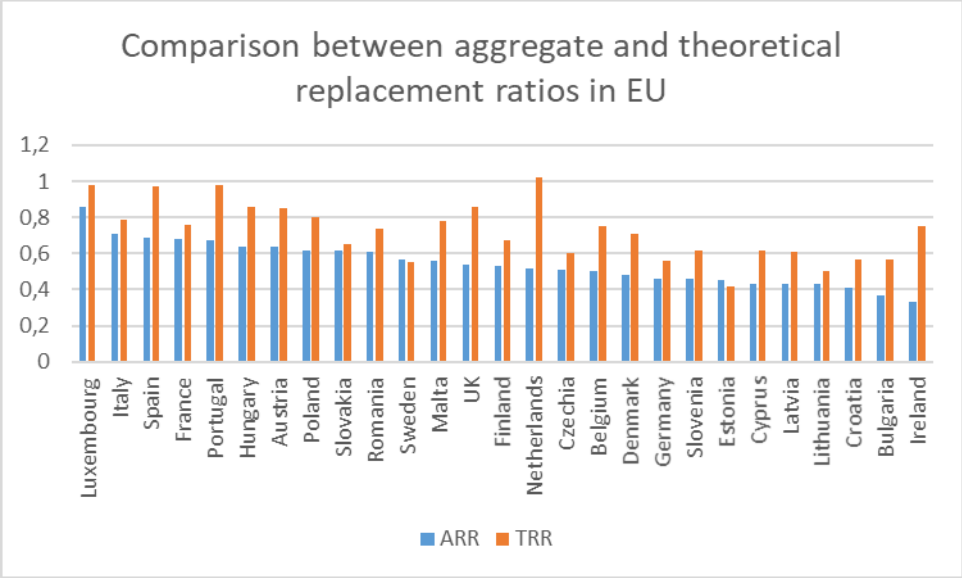


Figure 6

Source: Eurostat and European Commission, "Pension Adequacy Report 2018: current and future income adequacy in old age in the EU", Volume 1, p. 49

Theoretical replacement rate (TRR) measures pension income in the first year after retirement to earnings immediately before retirement. It is based on the scenario of specific career pattern – career length, earnings level and pension age. TRR is bigger than ARR because it takes into account ideal career path. The signal to young people is that it is good to start career as early as possible, to work longer and to insure on as high income as possible.

The pension wealth depends on the fact what the retirement income is supposed to cover. The covered costs spread to consumption of goods and services and essential care. It depends to the publicly provided services and goods. One example for such expenditure is the resources allocated for long-term care. Figure 7 displays the expenditure for long-term care in Member States as percent from the gross domestic product (GDP).

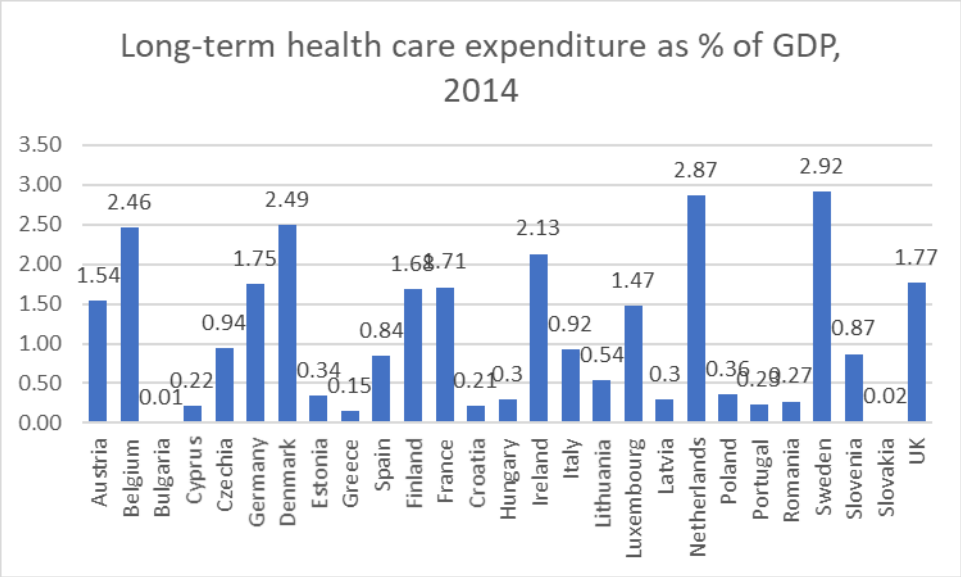


Figure 7

Source: Eurostat

The information from Figure 7 shows that countries with low pension expenditure add low levels of expenditure for long-term health care (Bulgaria, Romania and Latvia). This weakens additionally the pension adequacy of the old-age benefits.

We saw that public pension systems have limited abilities to maintain adequate pensions. That is why official bodies propose private pensions to supplement PAYG (often referred to public systems where benefits are paid with the incoming contributions) pension income. For example, European Commissioner for Employment, Social Affairs, Skills and Labour Mobility Marianne Thyssen clearly puts two emphases on the development of pension protection in the Member States [13], namely a longer period of work and an increase in the role of supplementary, capital-based pensions. The EC places a mandate on governments and social partners to "actively promote" capital pensions by clearly demonstrating the "economic benefits of supplementary pensions". Supplementary pensions are regulated on EU level with various acts. Some of them are: Council Directive 98/49/EC of 29 June 1998 on safeguarding the supplementary pension rights of employed and self-employed persons moving within the Community, OJ L 209, 25.7.1998; Directive 2014/50/EU of the European Parliament and of the Council of 16 April 2014 on minimum requirements for enhancing worker mobility between Member States by improving the acquisition and preservation of supplementary pension rights, OJ L 128, 30.4.2014; Directive 2016/2341/EU of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs), OJ L 354, 23.12.2016 and Proposal for a Regulation of the European Parliament and of the Council on a pan-European Personal Pension Product (PEPP). Within the EC in 2018 was established High Level Group of Experts on Pensions which also focused the attention on the trust in pension products [14] "…the members highlighted such issues as the importance of viewing supplementary pensions in the context of overall pension system design and the importance of clear communication and trust in the pension system and of affordable pension saving options for different income groups".

One very important factor for the success of private pensions is their effectiveness which in turn depends vastly on the coverage. Figure 8 shows the coverage of supplementary pensions by type in Member States for 2016 in percent of the population aged 15-64.

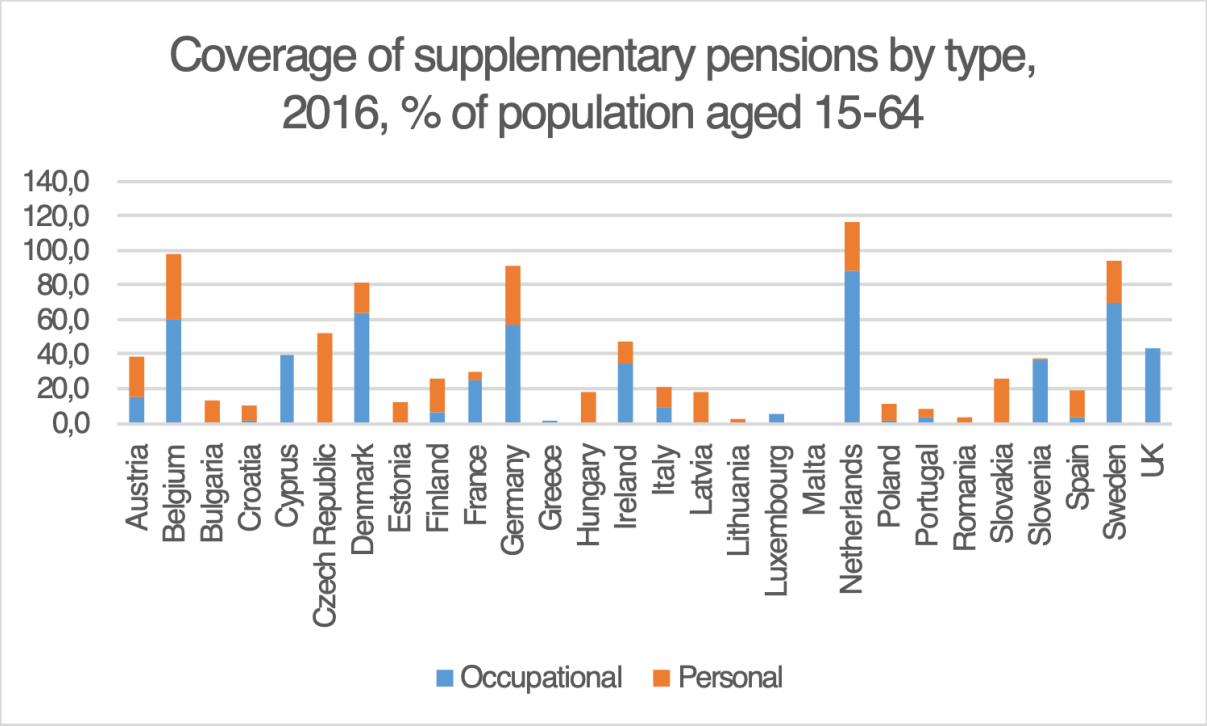


Figure 8

Source: European Commission, "Pension Adequacy Report 2018: current and future income adequacy in old age in the EU", Volume 1, p. 79-80

Figure 8 provides data for the coverage of supplementary pensions across EU of the working-age population by occupational and personal pensions. Occupational pension schemes are organized at the level of sector, professional group of companies or individual employer. The difference in the coverage and the distribution between the two types is explained by the different pension policy in each Member State, the role of the state in the overall pension security, the stage of the development of financial markets and the extent of participation of the social partners in the pension policy.

The countries which are "success stories" are Denmark, Netherlands, Sweden, Belgium, Germany, UK, Ireland, Czech Republic, Austria, Slovenia and Cyprus. Even in these countries the market mix between occupational and personal pensions varies significantly. In Denmark there is compulsory coverage for occupational private pensions and the contributions are high – 12%. The insurance in occupational pensions is quasi-mandatory in the Netherlands and there is close integration with the public old-age pension. Also, in Sweden the contributions in the supplementary pensions are related with the public system. Auto-enrolment in supplementary pensions is applied in UK and Ireland. In CEE Member States only Slovenia introduces occupational pension pillar. Poland also announced plans (in December 2018) to introduce such pillar. Occupational pensions are viewed as a product of industrial relations. Personal pensions are considered as a financial market product and it is retail-based - targeted to individuals.

While in some Member States maturing occupational pensions are expected to contribute more to old-age incomes, in many others, including those facing some of the biggest pension adequacy challenges, the coverage of any type of supplementary pensions remains very low. Some ways to boost supplementary pensions are mandating, auto-enrolment, collective bargaining, tax incentives, financial incentives, cost effective access for different income groups, promoting awareness of different saving options.

The development of personal pensions depends on various factors such as the role of the PAYG pension, the role of occupational pensions, the role of alternative savings and investment products, the development of financial markets, the history of providers, the regulatory environment, the fiscal

incentives, other forms of state incentives. In some Member States there are direct co-payment from the state (Germany, Czech Republic) and public subsidies (Austria).

The increased role of the private pensions in Western EU member countries compared to that in CEE states stems mainly from the historical development of Defined benefit (DB, occupational pensions) plans connected with the employers. Occupational pensions were considered as a good tool because of the solid economic development, the growing incomes of companies in Western Europe countries. All these processes enjoyed good times from 1960 till 1990. After 1990s there is a clear process of shift from DB plans to Defined contributions (DC) schemes. In simple, the main difference between DB and DC plans is how is defined the pension benefit – in DB schemes the pension is predefined (as a percentage from particular anchor or through formula) and in DC schemes the pension depends on the accumulated sum prior to retirement or defined are the contributions not the pension.

Most experts are seeing one of the advantages of the personal pensions for people with not straight career path, not regular incomes and self-employed. Such an example is Netherlands. Because of the limited access the participation of self-employed in the occupational pillar is very low. This create niche for personal pensions and 75% of self-employed is covered by personal pensions. So, the governments can think of incentives for these groups to increase the coverage of personal pensions among them. Supplementary pensions are an efficient tool for bridging benefit with a lower eligibility age. These schemes can fill the gap between labour market withdrawal and reaching statutory pensionable age. Another advantage of supplementary pensions could be more flexible pay-out options compared to statutory pensions. These are only part of the advantages of the private pensions.

One conclusion from the analysis is that in the future the individual has to make more decisions about financial and security matters like pensions, providers, products and others. There is a clear trend that greater responsibility (also often associated with risk) to be carried by the individuals. Another conclusion is that an individual has to save more and to start as early as possible.

Politicians, labour unions, employers' organizations, regulator and supervisory bodies have to follow clear communication strategy toward the society. Part of the strategy for development is the set of incentives for insurance. In our opinion the regulators have to create good environment for employer's plans and personal pensions. They have to send clear signals to the public about the role of the private pensions, the reasons for its development, the opportunities for the insured, about the risk, the problems and the potential solutions.

CONCLUSIONS

The current study leads to a conclusion that it is a time to put the problems of the elderly at the center of the EU authorities' priorities. One element of these problems is the income of the elderly. One way of improving the standard of living is to adopt the concept of increasing the pension wealth. Pension wealth has to be on the focus of the policymakers and the society.

Through this approach can be channeled additional assets in long-term investment projects, generated more value-added projects. The approach can trigger more active participation of the old people in the life of the EU and lead to healthier life.

Setting focus on pension wealth means to develop metrics, to channel the attention of the society, to develop policies, to set medium and long-term goals.

Pension wealth approach will lead to more informed decisions among elderly and will execute pressure to authorities for improved legislation and creation of better opportunities for savers.

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