Tackling EU pension gaps

1. Current challenges faced by pension systems

1.1 The current structure of European pension systems

The Chair outlined the three pillar structure of European pension systems. Pillar 1, the state pension system, is funded on a pay as you go basis. Pillar 2 covers employment related pensions and Pillar 3 is based on individual pension savings. Only a few European countries, such as Sweden, Denmark and the Netherlands, have successfully implemented Pillar 2 and 3 schemes. In the Netherlands for example, 80% of workers participate in these systems. However, the full potential of Pillars 2 and 3 remains largely untapped at EU level, as the direct competences in this area, such as pension legislation, taxation and labour market policies rest with member states rather than the EU.

An official explained that Sweden's public pension system was reformed in the 1990s. One of the specificities of the Pillar 1 system is that it does not rely solely on the pay as you go model. A small portion of mandatory contributions (2.5%) is invested in investment funds via the premium pension component. Sweden also has a strong tradition of unions and employee organisations administering Pillar 2 schemes through collective agreements, but there are also privately managed pension funds. Approximately 90% of Swedes have an occupational pension. Swedish savers hold assets worth nearly 140% of Swedish GDP in Pillars 1 and 2, with additional significant savings in Pillar 3. The capital invested in Pillar 1 alone equals 40% of Sweden's GDP, which contributes significantly to the depth of the Swedish capital market.

A regulator emphasized the need for a holistic approach to pensions that considers all three pillars. Pillar 1 is mainly about redistribution and ensuring minimum pensions for all individuals including those who might not have had a continuous working career. Many EU member states are yet to develop Pillar 2 and 3 schemes to deal with the future pension gap. There are also indirect benefits from these schemes, such as a higher level of financial literacy and a higher trust in the future, which drives savings and spending.

1.2 Demographic and economic pressures

The Chair noted that Pillar 1 is under significant pressure due to demographic changes. As populations age, there are fewer workers to support the growing number of retirees and the capacity for state budgets to compensate is limited. It is uncertain whether Pillar 1 pensions can be sustained at their present levels in the future.

A regulator illustrated the demographic challenges that Pillar 1 pension systems are facing. Currently, there are three working Europeans for every pensioner, but this ratio is expected to drop to 1.5 in the future. Some member states are already fairly close to reaching this level. On average, Pillar 1 pensions cover 47% of people's pension needs, but this will decline to the low 30%s over the next 30 to 40 years. Only 47% of EU citizens believe they will live comfortably in retirement. The reality is that 20% of people will not.

A policy maker stated that the issue with pensions is relatively simple. It boils down to a trade off between pension adequacy and financial sustainability. For many years the adjustment variable was financial sustainability, but now this has become the constraint and pension adequacy has become the adjustment variable. This change is concerning for future pensioners. Every year until 2050, 1 million European workers will stop working and become pensioners. The macroeconomic situation with regard to pensions differs greatly across different member states. Ireland, the youngest country in Europe, spends just 3.8% of its GDP on pensions; Italy, the oldest country, spends 15.6%. Despite these challenges, pension systems across Europe have generally performed well, even during critical moments like the Covid 19 pandemic.

A consumer representative agreed that Pillar 1 pensions are not sustainable in their present state, but many EU citizens cannot afford to save sufficiently for retirement, and their ability to save is only declining. As a result, many of these people will continue to depend on Pillar 1, making reform critical.

An official noted that the European Commission's 2024 Ageing Report shows that the old-age dependency ratio will rise to 59% in the coming decades in Europe (versus 36% today). The overall population of the EU is expected to slightly decrease, while the proportion of elderly people will rise significantly. In 50 years, one third of the population over 20 will be older than 65. This will put immense pressure on Pillar 1 pensions and increase GDP related pension expenditure in the majority of member states. Currently, 80% of pension expenditure happens via Pillar 1, which urgently needs reform.

The official added that ultimately, the size and age profile of a society is determined by factors such as fertility rates, life expectancy and migration. Fertility rates across the EU are well below the natural replacement rate of 2.1, currently averaging around 1.5. No European country reaches 2 and even optimistic forecasts predict only a slight increase to 1.6 in the future. Life expectancy is also expected to increase by six to eight years over the next 50 years, which will further strain the public pension system and also health systems, as the number of years that people spend in good health does not increase in parallel. This demography shift, which is common to all EU member states, is a critical issue that needs urgent attention.

1.3 Gender inequality

A regulator stressed that women face higher pension gap issues in the current system. The percentage of EU citizens expected to not be able to live comfortably in retirement is 20%, but for women this risk is 35% higher. Even in the Netherlands, which is often seen as a leader in pensions, 40% of women face a significant pension gap, highlighting the vulnerability of women to poverty in retirement. Increasing the participation of women in the workforce is often seen as a solution to demographic and economic challenges, but this should not be seen as a panacea.

A policy maker agreed that women face specific disadvantages due to interrupted careers, extended periods of part time work, lower contributions and the underutilisation of pension care credits that need considering.

2. Solutions to address the pension gap

2.1 Addressing the demographic challenge

An official emphasized that demographic issues should be a central focus of the discussions on reforming the pension system. If nothing is done to correct Europe's very low fertility ratios, member states will have to further reform Pillar 1 pension systems. Economic growth is also necessary to sustain the income from Pillar 2 and 3 pension schemes, which in turn requires a stable workforce. Increasing the birth rate is essential to solving these problems. Hungary has been successful in increasing fertility rates from 1.2 to 1.6 over the past 14 years by increasing the amount of state support available to families.

A policy maker remarked that legal migration offers a potential solution. The recently adopted European Migration Pact aims to bring in 500,000 workers each year, which will partially offset the 1 million workers leaving the labour market.

An industry speaker agreed that immigration can contribute to addressing the pension challenges, but it cannot be the sole solution.

2.2 Pillar 1 reforms

The Chair noted that solutions to reform Pillar 1 pensions exist. They typically involve raising contributions, increasing the retirement age or cutting benefits. The problem is that they are unpopular with voters, as demonstrated by the experiences of member states that have attempted to introduce such reforms recently.

A policy maker pointed out that many countries have successfully introduced incentives for older workers to continue working, particularly those over 55, whose employment rates have seen the largest increase in recent years.

An official agreed that fixing the pay as you go Pillar 1 pension system is challenging, One potential solution might be to follow Sweden's premium pension model, which requires individuals to invest a small proportion of their Pillar 1 contributions in investment funds.

Another official stated that if fertility rates cannot be sufficiently increased in the EU, three other responses will have to be considered: raising the retirement age further, although some countries are already moving toward a retirement age of 70; reducing pension benefits, which would undermine pension adequacy; or increasing taxes, which would harm economic growth and competitiveness.

2.3 Auto enrolment in Pillar 2 pensions

A regulator emphasised that addressing the pension gap should not stop at Pillar 1; it must include Pillars 2 and 3. Implementing auto enrolment in Pillar 2 pensions will help people to save. Some people have argued that this is difficult to implement in countries with lower GDPs, but the Dutch pension system was established in the 1960s when the country's GDP was relatively low. Politicians and policy makers need to take a long term view to solutions to solve the pension gap. One challenge however is that this involves asking individuals to transfer money from guaranteed bank accounts into riskier pension products without guarantees.

An official noted that one way to encourage occupational pension savings is to use a gradual approach taking small contributions from individuals' salaries. Sweden's pension reforms included auto enrolment in Pillar 2 schemes through collective agreements. Today, 90% of Swedes have an occupational pension.

An industry speaker agreed that auto enrolment will be crucial to ensure that everyone is included in the system. In the Dutch market, about 90% of people are covered by the Pillar 2 system, which is not the case in most EU countries. Without auto enrolment into supplementary pension schemes, many individuals will face severe financial difficulties in 20 years. However, with auto enrolment comes responsibility. There will have to be strong governance to ensure that individuals have access to the right financial products.

A consumer representative concurred that auto enrolment is an adequate solution, as seen in Sweden and the UK. Product performance must be a key focus if an auto enrolment approach is taken, however. Pension products must be cost efficient and deliver good returns.

2.4 Enhancing long term investment products

A consumer representative highlighted the significant disparity in returns from Pillar 2 pensions across Europe. According to a Better Finance report, some countries have experienced very low returns in Pillar 2 products, ranging from just 1% to 3% over the past decade, while Sweden achieved a 9.4% return after inflation correction and the UK's Nest product delivered 7.3%. These differences emphasize the need to reduce costs, which directly impact performance and to implement regulatory and supervisory measures to enhance value-for-money in pension products, including possible market interventions. Simplifying pension products is also crucial. Distribution is another key factor, as people need access to suitable and simpler products. Swift action is necessary to encourage citizens to save for retirement, and regulators and supervisors must have the powers and resources to enforce these changes effectively.

An industry speaker emphasized that the key factors for developing an effective Pillar 2 pension system are governance and risk-return, which countries like the Netherlands and Sweden have managed successfully. Political motivation is also essential to develop such systems and ensure that no one is left behind, but the objective of developing Pillar 2 systems is not yet shared by all member states. The financial industry is ready to implement supplementary pension solutions, as evidenced by successes in certain countries. Products such as European Long-Term Investment Funds (ELTIFs) should play a role in these solutions. Regarding costs, the industry speaker warned that if Europe's asset management industry continues to face cost compression, it risks becoming dominated by large, US-style exchange-traded funds (ETFs). The ultimate goal should be to achieve an attractive balance between risk and return.

A regulator agreed that suitable long-term savings products that are simple and cost-effective are needed, as they encourage people to save for the future. Both the Letta and Draghi reports highlight the importance of creating adequate long-term retail savings products, but if meant as retirement products, they must be designed as products that people hold until retirement and include a structured payout phase. Revisiting the Pan European Pension Product (PEPP) is part of the solution. Regulators and supervisors also have an important role to play in this area by sharing data, ensuring value for money, and providing oversight to guarantee that pension products deliver adequate returns for consumers.

An industry representative remarked that a key issue for improving pensions in Europe is determining who will pay the costs of Pillar 2 and 3 products. Offering guaranteed pension products that satisfy both consumers and regulators is expensive because it requires hedging against a variety of risks. Some smaller businesses may face trade offs between contributing more to Pillar 2 pension structures for their employees and demonstrating profitability or financial resilience to investors. Additionally, if tax incentives are introduced to encourage savings, someone will have to pay for them. The US uses matching contributions, but this also carries a cost, with the government paying a portion for those earning below a certain threshold. Ultimately, economic growth and robust capital markets are the key to the viability of all three pension pillars. Much of the capital market investments in the US are controlled by the wealthiest 1%. It is also important to understand where the top 1% of Europeans have invested their assets.

2.5 Dashboards and pension tracking systems

A regulator explained that the European Insurance and Occupational Pensions Authority (EIOPA) has provided formal advice to the Commission on how to set up pension dashboards and tracking systems across the EU. Dashboards provide governments with a comprehensive overview on the national pension system and the different pillars. Tracking systems help individuals to understand their future pension revenues, identify potential gaps and make informed decisions. Currently, only seven member states have pension tracking systems in place.

An official agreed that pension tracking systems are important, as they foster awareness, transparency and credibility and can increase citizens' engagement. Such systems can be developed at national or EU level. In Sweden, the government, the Swedish Pension Agency and the insurance industry have cooperated to develop a national pension tracking system. This system provides clarity and transparency for citizens by projecting their expected pensions across all three pillars.

A consumer representative was in favour of behavioural measures such as pension tracking systems which aim to increase awareness, but highlighted that people will not be able to save if they lack the financial means to do so.

2.6 Improving communication and awareness around pension issues

An industry representative highlighted the need to improve communication around Pillar 1 pensions. There is inadequate communication on pensions from both member states and the EU. The lack of comprehensive information about the sustainability of pension systems and the state of the economy in general makes it hard for people to understand their overall pension situation and does not encourage them to take action. Citizens do not know what they need to do to prepare for retirement and many economic players are not sure who will bear the costs. Without clear information on what to expect from Pillar 1, people are unlikely to engage with Pillars 2 and 3. People need to understand that they must contribute more towards retirement alongside their other financial priorities.

The industry speaker noted that in the US, the Social Security Administration provides individuals with annual updates on their projected pension benefits, which help them to understand their pension situation. This kind of regular communication also needs to be implemented in Europe. However, the US model often uses fear tactics, warning people of the potential collapse of the social security system, which should be avoided. Developing financial literacy would be preferable, because people only save when they understand the context and the benefits.

A consumer representative commented that many people prioritise short term financial concerns, such as paying school fees, buying a home or simply making it to the end of the month. Both social and market interventions are therefore needed to help citizens balance these needs with a longer term focus on pension savings.

2.7 Connecting pensions with the Capital Markets Union (CMU)

The Chair observed that the discussion on pensions is linked to the CMU initiative. CMU requires risk bearing capital to function, and the long term investment horizons of pension funds are ideally suited to this role. A policy maker agreed that the issue of pensions is closely tied to both CMU and EU competitiveness.

A regulator agreed that retail pension savings could fuel the capital markets and support the EU's green and digital transitions. However, people might be reticent to transfer savings from guaranteed bank savings accounts into riskier pension products. What could help to build the trust of consumers is the introduction of an insurance guarantee scheme and better supervision at the EU level.

3. Conclusion

The Chair emphasised that trust, cost, and performance must be improved throughout all 3 pillars. This is an area where regulators and supervisors can contribute. There is also a clear need for political courage and a long-term view to make the right decisions about pensions and implement the adequate reforms. Countries like Sweden and the Netherlands have found an answer by forcing people to save for the longer term.