

EU-25 PENSION TERMINOLOGY MODEL – EFRP WORKING PAPER



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THE NEED FOR AN EU-25 PENSION TERMINOLOGY MODEL

EXECUTIVE SUMMARY

This paper sets out EFRPs proposal for an EU-25 terminology model, in response to the *EU Commission Document “The three pillars terminology – information note”*.

We believe that our terminology model is **comprehensive** by taking into account the various structures that already exist within the EU-25, as well as being ‘benefit’ **focussed** to differentiate between the three pillars. These in turn result in a **consistent** approach to terminology which will support a greater understanding across the EU and prevent unnecessary misunderstandings and confusion.

Variations of multi-pension pillar models are used in the EU-25 to describe the national pension systems. There is currently no generally accepted EU-25 pension pillar terminology in existence. The EFRP believes it is now the time to forge the three pillar pension terminology into a useful EU-25 instrument to enable mutual learning amongst the Member States within the Open-Method-of-Coordination for pensions.

Any proposed EU-25 structure should, as far as possible be consistent with the different multi-pillars models which exist within the EU-25. We feel that a complete overhaul of existing terminology should be avoided. The EFRP believes that the existing EU-15 three pillar pension terminology, is a valid starting point for building the EU-25 pension pillar terminology model. However, it needs to be adapted to take into account two fundamental and recent developments namely enlargement and pension reform.

The EFRP proposes a comprehensive three pillar pension terminology model, structured around benefits for the EU-25. Upon retirement, pensioners should receive an income in a number of ways:

- they are entitled to the social security state pension – **first pillar**
- they have worked and gained access to a private workplace pension scheme – **second pillar**
- they deliberately have decided as an individual to save for retirement – **third pillar**.

In our opinion, the mandatory / voluntary aspect of second pillar is not a decisive factor for distinguishing between pension pillars.

Consistent labelling and recognising the diversity that exists in second pillar is in our view the key to describe the EU-25 pension landscape.

Our call for more consistent labelling of second pillar pension schemes will not only kill the out-dated split between the EU-15 and EU-10 models. It will also act as an incentive:

- to better identify pension responsibility
- to promote the appropriate supervisory framework for – workplace or not - private pension provision
- to acknowledge (national) pension reforms
- to reinforce the EU policy priority to build up pension income through employment.

1. WHY HAVE AN EU-25 PENSION TERMINOLOGY MODEL ?

The EFRP believes that there are a number of important reasons to agree on an EU-25 terminology pension pillar system:

- In the framework of EU Social Protection policies it is important that the EU can use its own agreed pension pillar terminology.
- A European pension model will provide Member States with a framework to build their own modernised pension system, which will in turn provide pensioners with the opportunity to benefit from an adequate, affordable, and well diversified income upon retirement.
- Common pension pillar terminology will allow benchmarking and mutual learning to take place at European level within the Open-Method-of-Coordination for pensions. It needs to be said that until now the Open-Method-of-Coordination for pensions has only been limited to a descriptive analysis of national pension systems and reforms. Without any common language in the field of EU pensions unnecessary misunderstandings and confusion can arise.
- A common understanding of EU pension terminology is a pre-requisite for:
 - avoiding confusion and encouraging industrious discussion
 - identifying and analysing more easily quantitative and qualitative information in the European pension landscape.

The EFRP is convinced that an EU-25 pension pillar terminology model should be as simple as possible. The pillar terminology is an instrument to understand the main structures of the national pension systems. In designing the EU-25 pension pillar terminology we should avoid a complete overhaul of existing terminology. The proposed structure should be as much as possible consistent with the current multi-pillar pension models already used in Europe.

2. WHAT ARE THE BUILDING BLOCKS OF THE EU-25 PENSION TERMINOLOGY MODEL ?

The EFRP believes that the EU-15 pension pillar model is a good starting point. However, the model needs to be adapted to take into account two fundamental and recent developments - enlargement and pension reform. This effectively means that the model must include:

- the characteristics of the EU-10 (NMS) pension systems
- the implemented pension reforms that have taken place in many Member States.

It is important to understand the differences between the EU-15 and EU-10 NMS models that are currently operating and we demonstrate this below.

2.1. WHAT IS THE CURRENT EU-15 MODEL ?

The logic behind the EU-15 pension model is that an individual can draw **retirement income** in a number of ways:

- a **State pension**, accessed through social security
- an **occupational pension**, accessed through paid work
- **individual pension savings**, accessed through an individual decision independent from occupational position.

The boundaries between each of these three pillars may not always be clear, but we are of the view, that broad agreement already exists on this model and the main characteristics of each of the three pillars.

However, it should be noted that some of the EU-15 Members States have introduced **funded elements** in the State PAYG pension to face the consequences of demographic change. Member States have set up demographic reserve funds¹ and/or introduced mandatory privately managed occupational pension schemes². Except for France, all these mandatory schemes are pre-funded.

¹ For example: Belgium (Zilverfonds), Spain (Fondo de Reserva), France (Fonds de Réserve pour des Retraites), Ireland (National Pensions Reserve Fund), Netherlands, Portugal (Social Security Stabilisation Fund)

² For example: Denmark (ATP, SP), Finland (TEL), France (AGIRC-ARRCO), Portugal (to be implemented), Sweden (AP), United Kingdom (S2P)

2.2. WHAT IS THE CURRENT EU-10 NMS MODEL ?

The **EU-10 NMS**³ have also introduced a three pillar pension model. The logic of this model is different to that of the EU-15 and inspired by the World Bank pension model. The mandatory social security contribution is split up into two parts. The bulk of the contribution goes into the PAYG State pension. The rest of the contribution is put into a funded pension pillar which is managed on an individual basis by the private sector. On top of these two pension pillars a third pension pillar covers **voluntary** pension provision that can be workplace based or purely individual.

2.3. Summary Tables

The tables below summarise the main characteristics of the EU-15 pension model and the EU-10 NMS pension model.

EU-15	Pillar I – State pension	Pillar II – Occupational pension	Pillar III – Individual pension
Type	Basic	Supplementary	Supplementary
Access	Mandatory	Collective bargaining / Voluntary by employer	Voluntary by individual
Nature	Social security	Paid work	Individual decision
Financing method	PAYG / notional + Pre-funded	Pre-funded	Pre-funded
Management	State run	Private sector	Private sector
Ownership assets	State	Pension provider	Pension provider/ individual

Table 1: EU-15 Pension descriptive model

EU-10 NMS	Pillar I – State pension	Pillar II – Mandatory private pension	Pillar III – Voluntary private pension
Type	Basic	Supplementary	Supplementary
Access	Mandatory	Mandatory	Voluntary by employer/ individual
Nature	Social security	Paid work	Individual decision
Financing method	PAYG / notional	Pre-funded	Pre-funded
Management	State run	Private sector	Private sector
Ownership assets	State	Pension provider	Pension provider /individual

Table 2: EU-10 (NMS) Pension descriptive model

³ Czech Republic, Slovenia, Cyprus and Malta have a variant on the NMS pension model

2.4. IMPORTANT QUESTION FOR CONSIDERATION

'Do we see a possibility to merge these two pension pillar models into one EU-25 pension pillar model?'

Yes, by taking the EU-15 pension model as a starting point we can fit-in:

- the EU-10 NMS first pillar
- the EU-10 NMS third pillar, which could be spilt up functionally between, on the one hand **voluntary privately managed occupational** pension schemes accessed through paid work and on the other hand **voluntary privately managed individual** pension schemes accessed through an **individual decision** independent from an occupational position. The private pensions accessed through paid work would then fit into the second pillar, work place pensions. The private pensions accessed through individuals' decisions independent from professional occupation would then fit into the third pillar, individual pensions.

We now have to decide where we classify:

- **PRIVATELY MANAGED FUNDED ELEMENTS OF THE EU-15 FIRST PILLAR -**
It occurs to us that the classification of the **demographic reserve funds** is simple. Member States have set up these reserve funds to partly relieve the budgetary consequence of ageing on the PAYG pension system. As these funds are dedicated to pay-out first pillar pension benefits and the central State holds the ownership of the assets, we should consider them as belonging to the first pillar. In some Member States these demographic reserve funds are competitively managed by private industry operators and consist of real assets.
- **MANDATORY PRIVATE PENSION SCHEMES**
To ensure understanding we highlight the following points as the main characteristics of mandatory occupational private pension schemes:
 - These pension schemes are considered as providing **supplementary** pension benefits, a top-up for the first pillar, the social security system.

- Access to these pension schemes is made **mandatory** for individuals who participate in the labour market.
- Individuals' access to these pension schemes is through **paid work**. If the individual does not work he/she is not building up pension rights in these schemes.
- These pension schemes are mostly **pre-funded**.
- They are **privately managed** by specific pension fund management companies.
- Until retirement of the individual, the **pension provider is the direct owner** of the pension assets.

In summing up the six essential characteristics above, we notice that most of these characteristics are the same for the voluntary agreement based second pillar occupational pension schemes, which are widespread in the EU-15. The only difference being the way in which individuals access the pension scheme i.e. in **mandatory schemes**, the individual is automatically enrolled by participating to the labour market. Whereas in a **voluntary** occupational scheme the individual is automatically enrolled on the basis of a collective bargaining agreement or on the basis of an voluntary decision of the employer to offer an occupational pension scheme as part of the employment conditions.

The mandatory / voluntary aspect of a second pillar pension scheme is not the decisive factor for distinguishing between pension pillars. Consistent labelling and recognising the diversity that exists in the second pillar is in our view the key to describe the EU-25 pension landscape. The table below illustrates the extent of the diversity within the second pillar which comes down to variation in access

EU-25	Pillar II – Occupational pension		
Type	Supplementary	Supplementary	Supplementary
Access	Mandatory	Collective Bargaining	Voluntary by employer
Nature	Paid work	Paid work	Paid work
Financing method	Pre-funded	Pre-funded	Pre-funded
Management	Private sector	Private sector	Private sector
Ownership assets	Pension provider	Pension provider	Pension provider /

Table 3: Pillar II – diversity

3. EU-25 PROPOSED PENSION TERMINOLOGY MODEL – STRUCTURE

Taking all the aforementioned considerations into account, it is our opinion that the EU-25 pension pillar terminology model should be structured as follows:

3.1. THE FIRST PILLAR

The first pillar should provide a **basic State pension** financed on a PAYG basis through social security and/or taxation. It is up to the Member States to decide whether the State pension is organised according to a Bismarck or a Beveridge approach. The State pension should allow pensioners to cover basic living costs upon retirement. To enhance the transparency of the public pension system, some Member States have introduced notional funded pension accounts⁴.

In order to avoid old-age poverty risk and moral hazard risk, one of the roles of the basic State pension is to grant pension benefits to individuals who have made no or insufficient social security contributions due to unemployment, sickness, etc.

3.2. THE SECOND PILLAR

The second pillar should contain all private pension schemes with a link to employment or a professional occupation and which are financed through employer and/or employee contributions or through contributions paid by self-employed workers and professionals. By way of paid work, the individual participates and builds up pension rights into those supplementary privately managed pension schemes. The occupational pension should allow pensioners to maintain life standards upon retirement.

3.3. THE THIRD PILLAR

The **THIRD PILLAR** provides an individual pension. The individual **deliberately** purchases specific retirement savings products to top up second pillar provision. The Governments can also provide fiscal incentives for these retirement products, sometimes those incentives are different from second pillar tax incentives; and sometimes they have been made equal with second pillar.

⁴ A bookkeeping method to keep track of pension contributions over the working career. However, those contributions are not accumulated on individual accounts.

4. CONCLUSIONS

The EFRP is convinced that a consistent EU-25 labelling of work place pension schemes would at least allow policymakers to understand the pension systems throughout the EU and to communicate on them effectively and unequivocally. Obviously there are many different approaches to organising private work place pension provision and it is vital that these differences are captured and clarified.

Probably the most important advantages of our EU-25 pension pillar terminology proposal is that it kills the use of the out-dated split between EU-15 and EU-10 Member States and promotes consistency and lucidity not just for those in the EU pension policy making but also for those who are affected by the EU pensions policy such as members and beneficiaries.

Diversity is the key word to characterise the European pension system. An important challenge for Europe is to learn to manage this diversity so as to reach unequivocal mutual understanding. Furthermore European citizens urgently need to be better educated in making appropriate decisions for their pension provision.

A summary table of EU-25 terminology model can be found at Annex I.

5. KEY OBSERVATIONS

- 5.1. The EU Commission should work on a practical and pragmatic approach for defining in a comprehensive manner the EU-25 pension system.
- 5.2. Enlargement was officially finalised on the 1 May 2004. So, now is the time for effective communication within the EU-25 on pension structures. This is long overdue.
- 5.3. A pension pillar terminology structured around benefits paid out by institutions is more comprehensible than a pension pillar terminology structured around contributions paid into institutions.
- 5.4. The link between paid work and the access to an occupational pension scheme should be strongly emphasised. This is in line with the EU objective of “Making work pay”. Supplementary pension provision is part of the work conditions.
- 5.5. The third pillar remains for those pension schemes where the decision to join remains entirely with the individual. It is also the individual who decides the amount of savings he/she want to put into it.
- 5.6. The private competitive management of the EU-10 NMS second pillar pension assets should be stressed. The provision of secure privately managed supplementary pensions in which individuals have trust over the long term, requires a sound regulatory and supervisory framework, in line with the “acquis communautaire” as to pension funds and life insurance.
- 5.7. In order to deliver pensions adequately both the mandatory and voluntary pension schemes have to benefit from the “prudent person” investment standard to maximise their performance. 1 % additional return during 40 year pension savings means a 30% higher pension capital. Moreover, we consider that barriers to capital movements are against the EU Treaty principles.

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- 5.8. The State guarantee in some EU-10 NMS mandatory occupational pension system is a requirement put on the private pension provider rather than a guarantee delivered by the State itself. This must be clearly communicated to the beneficiaries. Including those systems in an EU-25 second pillar is just one indication on where the final obligation for pension delivery is situated.
- 5.9. Research suggests that collective schemes are more cost effective than individual schemes in occupational pension provision. European policy makers should consider a number of factors including costs (up front and accrual), risk sharing and governance in deciding which types of occupational pension schemes would best fit the objective to provide affordable, secure and cost-efficient workplace pensions.
- 5.10. Pension provision is much more than asset management. Pension providers not only collect lifetime contributions but also ensure the possibility of converting accrued pension capital into life time income for the member. Furthermore a collective system can rebalance the 'bad times' by sharing the risk between pensioners and active workers, by setting up buffers or by raising contributions from the sponsors.
- 5.11. We welcome Governments deciding to engage private sector managers for demographic reserve funds. Although these assets belong to the first pillar in our view, we believe that demographic reserve funds would greatly benefit from the prudent person investment rule which will enhance performance.

ANNEX I – EU -25 PENSION TERMINOLOGY MODEL

PILLAR I	
<i>Type</i>	- Basic pension benefit
<i>Access</i>	- Mandatory
<i>Nature</i>	- Social security
<i>Financing</i>	- PAYG / Notionally funded
<i>Management</i>	- State run
<i>Approach</i>	- Universal/ collective
<i>Ownership assets</i>	- State
DEMOGRAPHIC RESERVE FUNDS	
PILLAR II – MANDATORY	
<i>Type</i>	- Supplementary pension benefit
<i>Access</i>	- Mandatory
<i>Nature</i>	- Paid work
<i>Financing</i>	- Pre-funded ⁵
<i>Management</i>	- Private sector
<i>Approach</i>	- Collective/ individual
<i>Ownership assets</i>	- Pension Provider
PILLAR II – VOLUNTARY	
<i>Type</i>	- Supplementary pension benefit
<i>Access</i>	- Collective Bargaining / Voluntary
<i>Nature</i>	- Paid work
<i>Financing</i>	- Pre-funded
<i>Management</i>	- Private sector
<i>Approach</i>	- Collective/ individual
<i>Ownership assets</i>	- Pension provider
PILLAR III	
<i>Type</i>	- Supplementary pension benefit
<i>Access</i>	- Voluntary
<i>Nature</i>	- Individual decision
<i>Financing</i>	- Pre-funded
<i>Management</i>	- Private sector
<i>Approach</i>	- Individual
<i>Ownership assets</i>	- Individual directly / pension provider (life insurance)

Please note that Member States have the competence to determine pension plan design in all three pillars.

⁵ France: AGIRC and ARRCO are basically PAYG with very limited pre-funded elements.

ANNEX III - MANDATORY OCCUPATIONAL SCHEMES (2ND PILLAR)

DENMARK

- Labour Market Supplementary Pension Scheme (ATP)
- Special Pension Savings Scheme (SP)
- Supplementary Labour Market Pension Scheme for Recipients of Anticipatory Pension (SAP)

ESTONIA

- Mandatory funded pension pillar (EU-10 2nd pillar)

FINLAND

- TEL – Employees Pension Act

FRANCE

- AGIRC (for executives)
- ARRCO (for non executives)

HUNGARY

- Mandatory funded pension pillar (EU-10 2nd pillar)

LATVIA

- Mandatory funded pension pillar (EU-10 2nd pillar)

LITHUANIA

- Partial opt-out from the social security system (EU-10 2nd pillar)

POLAND

- Mandatory funded pension pillar (EU-10 2nd pillar) – Open Pension Funds (OFEs)

PORTUGAL

- The new legal framework, currently under study, will introduce mandatory occupational pension schemes

SWEDEN

- AP Pension Funds (2,5% contribution on pensionable income is paid to a pre-funded pension scheme)

UNITED KINGDOM

- State Second Pension (an employee with annual earnings above a certain amount can contract out the additional State Pension to an occupational pension scheme instead).
-