# A Blueprint for Pensions

*Saving enough, saving well, saving wisely*

February 2017

## About Insurance Europe

Insurance Europe is the European insurance and reinsurance federation. Through its 35 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 200bn, directly employ 985 000 people and invest nearly €9 900bn in the economy.

# Contents

# Executive summary

Europe is ageing, adding to the huge challenge for its governments of making sure that people have an adequate retirement income. This Blueprint sets out the extent of this challenge and proposes ways to help ensure that European citizens can save enough, save well and save wisely for their retirement.

### The challenge

Effective, affordable and sustainable pension systems are a cornerstone of a successful modern society and economy. The fact that Europeans are living longer is putting increasing pressure on pension systems at a time when public finances are already under strain. The number of people aged 65 or above relative to those aged 15 to 64 is expected to double between 2013 and 2060. As a result, many European states have already started reforming their pension systems, but that is not enough. As the Organisation for Economic Co-operation and Development (OECD) reiterated in December 2016, citizens also need to take personal responsibility and contribute more and for longer periods if they are to have an adequate income in retirement.

### The role of the insurance industry

Multi-pillar pension systems are widely seen as the most effective way to ensure the sustainability and adequacy of retirement provision. As major providers of a wide variety of occupational and personal pensions, insurers are a key part of any multi-pillar system. An effectively regulated and well performing insurance industry has much to contribute to tackling Europe’s pension challenge.

### Ways to save enough

As individual responsibility becomes ever more vital, policymakers must raise public awareness of the need to make adequate provision for retirement. There are a number of ways policymakers can motivate people to save more for retirement. These include:

- raising awareness of the need to save, notably by promoting tracking services through which citizens can view their expected future pension entitlements;
- stimulating the widest possible uptake of supplementary pension arrangements through the most appropriate enrolment systems; and
- introducing or maintaining stable, effective tax incentives for supplementary pensions.

### Ways to save well

Future pension adequacy depends not only on how much individuals save and how early they start saving, but also their asset mix. Investing in a range of assets that includes equities and property can be as important as saving enough because of the very different long-term returns and diversification that are offered by the different asset classes. The long-term nature of insurance savings products also allows insurers to invest in illiquid and long-term assets, such as infrastructure and green projects. The natural and legitimate concerns many individuals have over the risks and volatility of certain asset classes can be overcome by taking a long-term approach, together with the traditional insurance techniques of collective pooling of risks and providing customers with the option to have minimum returns guaranteed.

Savers should be informed of the importance of the right asset mix in achieving their investment goals, and policymakers and insurers should work together to ensure regulation does not prevent insurers from offering well-designed, long-term, collective pension products.

**Ways to save wisely**

The level of financial literacy is still low in most countries in Europe. Policymakers must ensure that there is sufficient financial education to empower individuals to plan and manage their financial future. National strategies are needed to promote financial education and literacy from a young age and to support the work being done by insurers in this area.

Citizens must also have access to information about the products and services available to them. Policymakers have a role to play in ensuring that pension and savings information is clear and consumer-friendly.

If citizens are saving enough through long-term savings products channelled into a wide range of asset classes, this also provides a major source of long-term funding for growth in Europe and acts as a stabilising force in financial markets.

There is no single policy measure or solution that will fix Europe's pension crisis but — implemented widely and consistently — the proposals in this Blueprint could help to significantly reduce the pension savings gap.

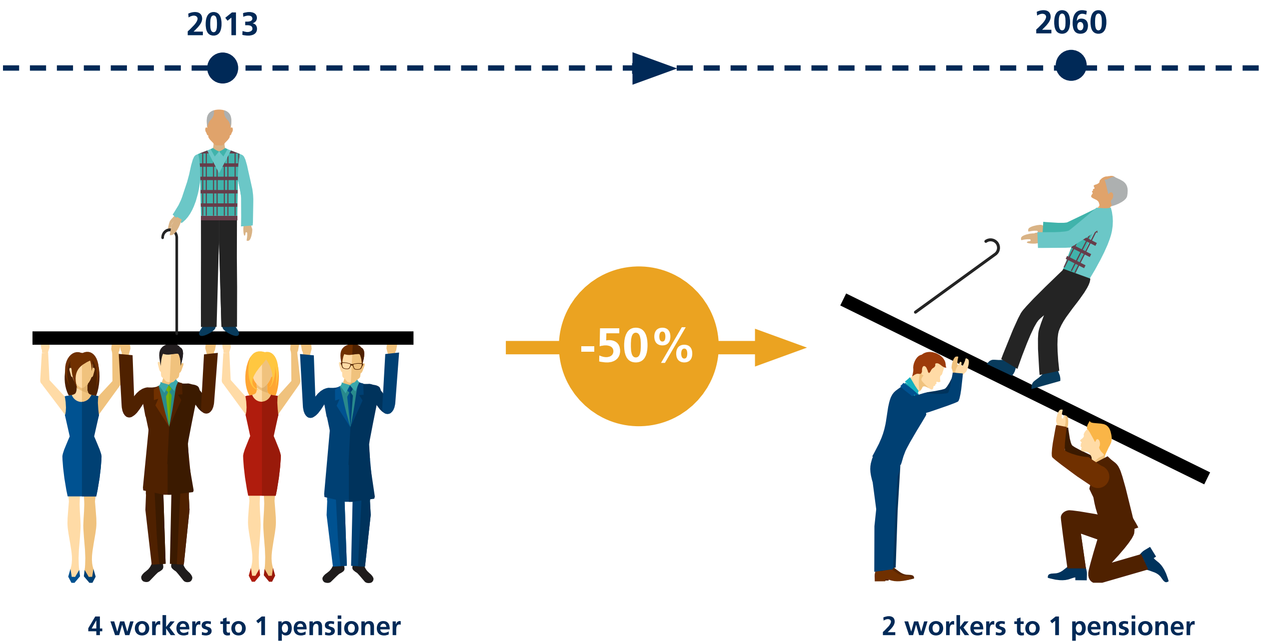
# 1. Setting the scene: Europe’s pension gap

Europe faces an unprecedented pension challenge, as the so-called "baby boomers" approach retirement and life expectancy increases.

Europe's old-age dependency ratio — the number of people aged 65 or above relative to those aged 15 to 64 — is expected to double between 2013 and 2060[1]. While today there are four workers per retired person, in the future there will be just two.

This will have profound implications on the sustainability of national statutory pension systems, which are traditionally funded on a pay-as-you-go (PAYG) basis. PAYG systems divert social-security contributions from workers to pensioners and are therefore highly exposed to demographic changes.

**Figure 1: The ratio of workers to pensioners will decrease**



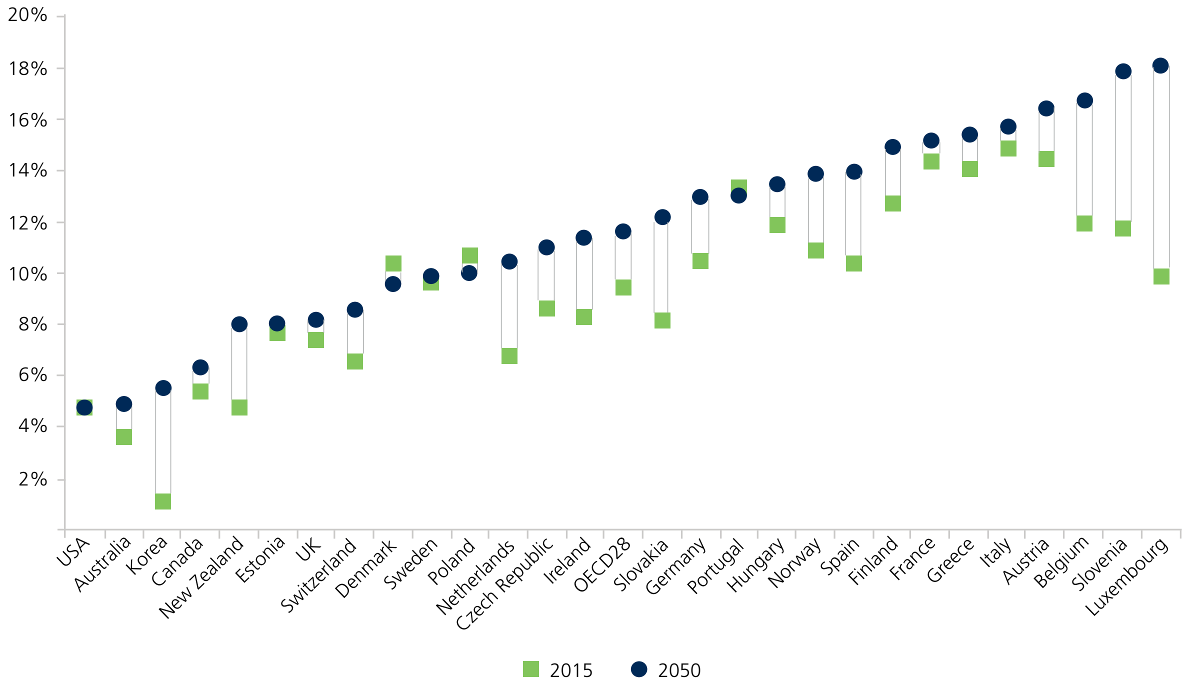

1 European Commission 2015 Ageing Report

## Impact on public finances

If nothing is done about it, the "greying" of the population across Europe will lead to a widening gap between the social-security contributions that European Union member states collect and the pension payments they make, increasing the burden on public finances.

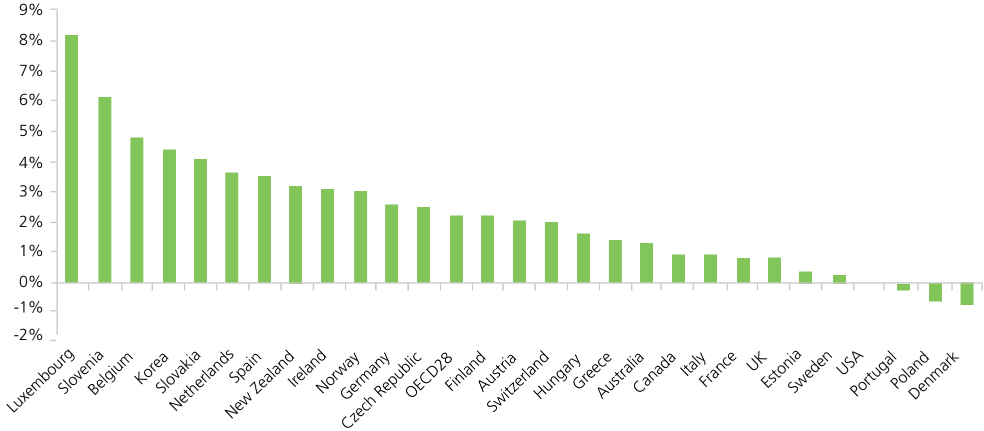
Figure 2 shows that public pension expenditure — even taking into account the impact of the most recent reforms — is expected to rise substantially in developed countries, with the Organisation for Economic Co-operation and Development (OECD) average increasing from 9.5% to 12% of gross domestic product (GDP) between 2015 and 2050.

**Figure 2: Estimated government pension payments as a % of GDP — 2015 to 2050**




*Source: "The Coming Pensions Crisis", Citi, March 2016 (OECD and Citi research)*

**Figure 3: Estimated increase in government pension expenditure as a % of GDP — 2015 to 2050**
Some countries will be in a better position than others to control demographic pressures on costs




*Source: "The Coming Pensions Crisis", Citi, March 2016 (OECD and Citi research)*

The challenge posed by shifting demographics comes at a time when many EU member states already have a high level of public indebtedness, which has risen in recent years. In the euro area, for example, the average public debt to GDP ratio rose from 65% in 2007 to 92% in 2014. This means that most EU member states will face difficulties maintaining the financial sustainability of their PAYG systems.

Against this background, many EU states have started reforming their pension systems to make them more sustainable. The statutory retirement age has been raised across Europe, and in some countries a link has been made between retirement age and life expectancy. In a number of countries, access to early retirement has been curtailed, while accrual and indexation rules have been revised to reduce the generosity of future pension benefits.

The efforts of European member states to adjust their pension systems prompted the informal Eurogroup of euro-area ministers to comment officially on this topic in June 2016[2]. The group outlined four principles to guide pension reforms:

- safeguarding against demographic and macroeconomic risks
- complementing reforms with flanking policies to improve the sustainability of the pension system
- broader reforms to strengthen growth and employment
- anchoring political and societal support for reforms

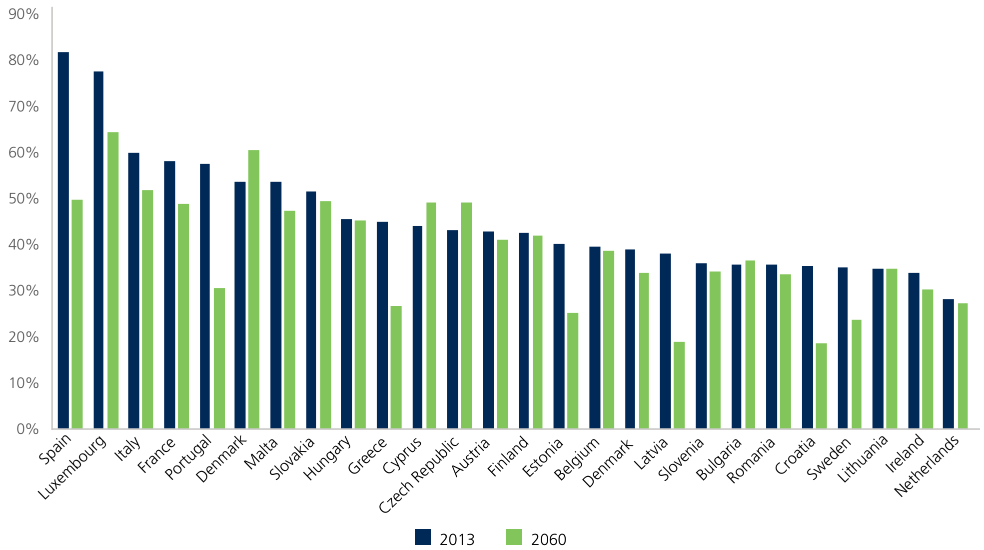
2 Eurogroup statement on common principles for strengthening pension sustainability: www.consilium.europa.eu/en/press/press-releases/2016/06/16-eurogroup-pension-sustainability/

The Eurogroup states that: "[Pension] reforms should focus on systematically increasing the resilience of public pension systems against risks from demographic change or macroeconomic shocks. In particular, the introduction of automatic mechanisms appropriately designed at Member State level has been shown to be an effective tool for dealing with the effects of demographic change, specifically the slow-moving but significant increases in life expectancy."

## Impact on individuals

The reforms to statutory pension systems will result in lower expected replacement rates[3] and therefore in less adequate future pensions. In 16 member states, the European Commission[4] estimates that for a full career (from the age of 25 to a statutory pension age above 65) net replacement rates will be lower in 2060 than in 2013. In the 11 countries where replacement rates will remain similar or slightly higher, it should be noted that the current replacement rate is already relatively

**Figure 4: Earnings-related public pension replacement rate — 2013 and 2060 (%)**

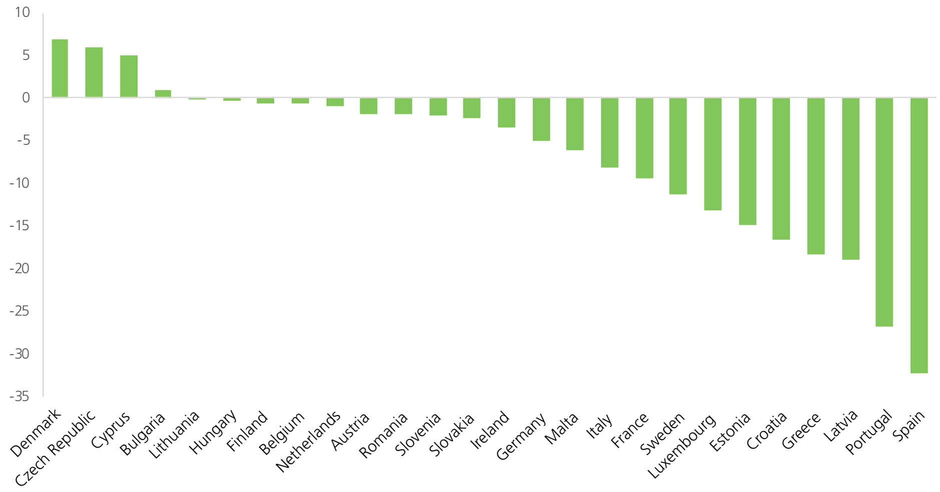



*Source: European Commission 2015 Ageing Report*

3 The average first pension as a share of the economy-wide average wage at retirement (European Commission definition)

4 European Commission 2015 Pension Adequacy Report

**Figure 5: Earnings-related public pension replacement rate — 2013–2060 (percentage point change)**




*Source: European Commission 2015 Ageing Report*

low. Overall, almost no country will be able to provide a replacement rate higher than 50% This evolution highlights the need for people to save (more) for their retirement through private, funded-pension schemes.

## Need to promote private savings

Multi-pillar pension systems are widely regarded as the most effective way to cope with the demographic challenges faced by pension systems and to meet the dual objective of the sustainability of systems and the adequacy of pension revenues.

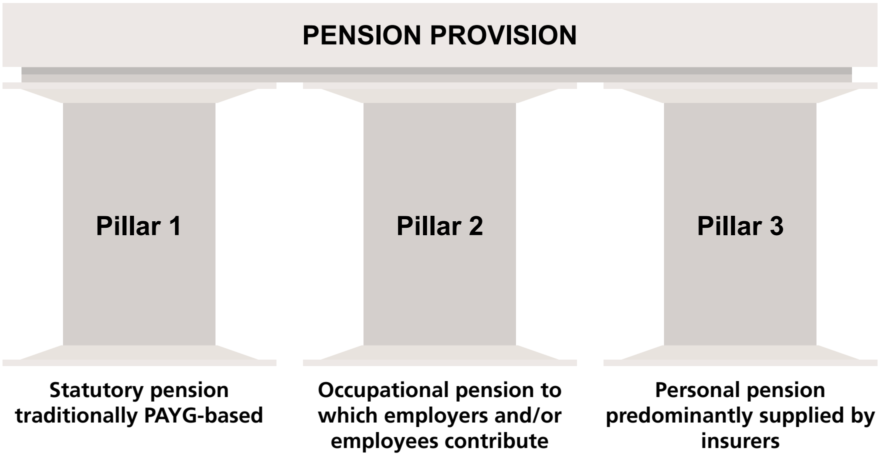
Multi-pillar systems involve complementing state retirement income (generally referred to as "first pillar") with two other, funded pension pillars:

- A second pillar, or "occupational pensions", consisting of funded pension arrangements (schemes) linked to a work contract or an occupational activity. These are generally set up by employers at either company or sector level, often with some involvement of employees or employees' representatives. In some countries, the self-employed can access this type of product. Occupational pensions are mostly provided by financial institutions such as life insurers or pension funds.

- A third pillar, or "personal pensions", consisting of voluntary retirement savings. These are products that individuals can access on a voluntary basis. Life insurers are by far the largest providers of these in Europe.

Multi-pillar pension systems have the significant advantage of diversifying risks, since the factors that mostly affect the first pillar (labour market dynamics, demographic change, public finances) are not fully correlated with those that affect the second and third pillars (changing financial returns, market volatility, inflation).

**Figure 6: The three pension pillars**




## Role of life insurers

As major providers of occupational and personal pensions, insurers are an integral part of any multi-pillar system. What marks insurers out is their ability to provide protection for very different life risks. These include provision for dependants if a saver or beneficiary dies prematurely (mortality risk), protection if savers are unable to pay contributions due to invalidity (morbidity risk) and protection against outliving assets (longevity risk). Risks can be covered in both the accumulation phase and — through annuities — the pay-out phase.

The flexibility and responsiveness of the insurance sector means that insurers offer a wide range of pension and insurance products tailored to the cultures and needs of different markets.

These can cover pension accumulation and/or decumulation and include:

- **Annuities and other products where the pay-outs to the policyholder are fixed and guaranteed.** The investment returns available when the customer buys the annuity will, together with life expectancy, determine the pay-outs that the insurer is able to provide to the customer.
- **Products with guaranteed returns.** The customer does not bear an investment risk, but has the certainty of a predetermined, guaranteed return.
- **Products with profit-sharing provisions.** These products may include guaranteed minimum payments and top-ups through profit-sharing mechanisms. The level of guarantee that can be offered is affected by the expected performance of investments. The pay-outs from profit-sharing depend on the excess of the actual over expected performance of investments and on the difference between expected and actual mortality rates.
- **Life products with investment features.** In addition to risk cover, investment returns are an integral part of the products themselves.
- **Protection products**. These products primarily cover risks.

Policy measures to protect retirement savers should be suitably balanced, proportionate and — importantly — stable. Otherwise, the availability of retirement savings products can be adversely affected. It is only in an environment that provides regulatory and policy stability and the flexibility to innovate that insurers can develop and maintain the products that consumers seek.

Chapter 2 addresses the challenges policymakers face when setting up multi-pillar pension systems. Chapters 3 to 5 offer a series of practical recommendations on how to address these challenges and ultimately ensure EU citizens have access to adequate and sustainable pensions.

## How can we cope with Europe's demographic challenge?

**Insurance Europe recommendations:**

1. Governments should introduce (or enhance) funded pension pillars (ie occupational and personal pensions) alongside the traditional PAYG statutory pension systems to improve their sustainability and the adequacy of retirement incomes.

2. The design of the multi-pillar system is key. To be successful, pension pillars must be mutually reinforcing and have clear roles and objectives (eg poverty prevention, income replacement).

# 2. Three challenges

Chapter 1 set out why multi-pillar pension systems that include both occupational and personal pensions are the best way to address the pension challenge in Europe and achieve adequate living standards for retirees. To unlock the full potential of multi-pillar systems, policymakers must ensure that European citizens save enough, save well and save wisely.

## Challenge 1: saving enough

Financial planning is something that is very easy to put off. There are always more enjoyable or urgent things to do. Research shows that large numbers of people lack awareness of the importance of savings and investments, debt management and insurance.

**Figure 7: Financial behaviour by country**

| | Sets long-term financial goals | Active saver |
|---|---|---|
| Austria | 65% | 69% |
| Belgium | 62% | 75% |
| Croatia | 45% | 63% |
| Czech Republic | 39% | 59% |
| Estonia | 40% | 40% |
| France | 61% | 83% |
| Hungary | 43% | 27% |
| Latvia | 44% | 36% |
| Netherlands | 39% | 71% |
| Norway | 44% | 84% |
| Poland | 32% | 34% |
| Portugal | 52% | 37% |
| Turkey | 44% | 51% |
| UK | 45% | 72% |

*Source: OECD/INFE 2015 measurement exercise, "Financial education in Europe. Trends and recent developments", OECD, April 2016*

Getting people to think far ahead about their retirement pension needs is even harder. Many young — and not so young — people believe that pensions are something to think about in later life and they postpone pension-related decisions.

Yet demographic challenges and the resulting reforms to statutory pension systems make individual responsibility more vital. It is more important than ever before that citizens understand their responsibility to save more and make plans for their income in retirement — and that they do so from an early age.

Individuals are often not sufficiently aware of how the pension system works. Many are at significant risk of realising too late that their statutory pension will not be enough to ensure an adequate standard of living. It is therefore imperative that people are made aware that they need to start saving early and that they need to save enough. Unfortunately, if investment returns are low, the amounts that need to be saved increase significantly. There is a clear need to raise public awareness about the need to save enough.

A number of solutions to this problem are presented in Chapter 3.

**Figure 8: Investment impact on long-term savings (25-year-old saving for retirement at 65)**

| Investment returns | % of salary to save for 50% of salary at retirement |
|---|---|
| 5% | ~10% |
| 3% | ~19% |
| 1% | ~33% |

*Calculations based on an expected inflation rate of 2%*
*Source: Pre-retirement calculator: https://www.calcxml.com/calculators/retirement-calculator?skn=*

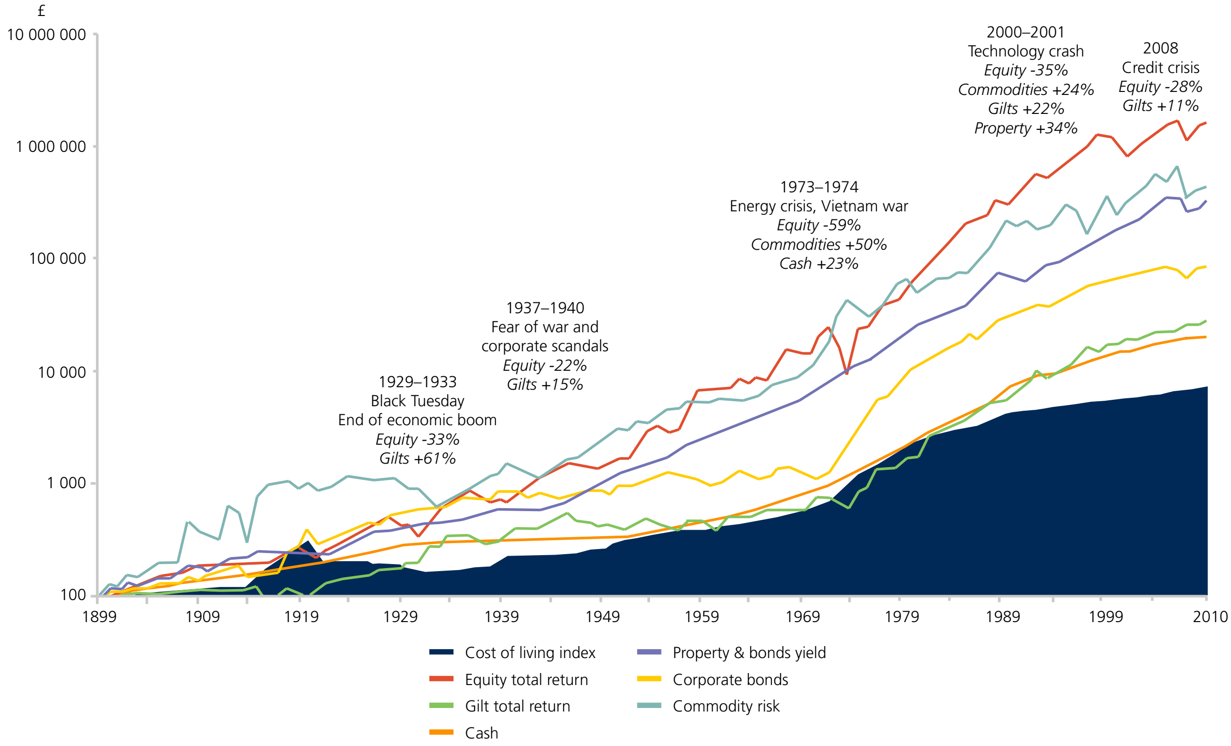
## Challenge 2: saving well

Future pension adequacy depends not only on how much people save and for how long. The asset mix and timing of investment plays a very important role in delivering adequate retirement income.

Figure 9 shows the very significant variation in long-term average returns across different asset classes and in particular how much better equities and property perform on average over the long-term than other major asset classes. This is why it is so vital that pension savers can enjoy returns generated by long-term investments in such asset classes.

In practice, there are a number of barriers preventing optimal asset allocation strategies for long-term pensions. Firstly, people's natural aversion to risk can put them off investing sufficiently in asset classes with higher returns. Average returns

**Figure 9: UK historic returns of asset classes and inflation — 1899–2010 (£)**




*Source: AIM, Barclays Capital, Deutsche Bank, Credit Suisse. All assets rebased on 100 31/12/1899. Equity total return is UK equities (Barclays Equity Gilt Study)*

from equities and property are higher than other asset classes, but the risk of poor or even negative returns for individual savers is also greater because the timing of the investment has a huge impact.

Behavioural research shows that generally individuals tend to be risk-averse and are not very good at making rational long-term investment decisions. People's decisions are subject to particular biases and their decisions about pension investment are no different. Some may not have the skills to make appropriate decisions or rely on indicators that are not meaningful on their own, eg recent past performance. Some may be overconfident and invest or sell at the wrong moment. And others may tend to postpone key decisions and miss good opportunities.

This leads to less investment overall, less investment in the right assets or badly timed decisions.

Secondly, investments in certain illiquid assets like infrastructure are — for good reasons — often restricted to institutional investors. Therefore individual savers, particularly if they are less affluent, have no access to those assets.

A simple and less risky way for individuals to gain exposure to a wide range of assets is through traditional insurance products, which play an important role in providing guarantees and smoothing returns. However, insurers in turn are facing challenges that may limit their ability to offer such products and this brings us to a further barrier; Solvency II — the EU regulation governing insurers' capital requirements — has made the cost to insurers of investing in the assets that can provide reasonable returns for policyholders very expensive due to high capital charges and exaggerated balance-sheet volatility. Such volatility in financial-reporting results can create difficulties for long-term investments. Furthermore, management concern over the impact on their company's reported solvency of investing in these assets has contributed to a reduction in investments in higher performing assets such as equities and infrastructures.

Overall, the Solvency II measures are exaggerating balance-sheet volatility and the capital insurers need to hold, potentially causing unnecessary damage to pension returns. Adjustments are needed if these measures are to capture accurately the true risks and nature of the life insurance business model.

A number of solutions to this problem are presented in Chapter 4.

## Challenge 3: saving wisely

The level of financial literacy is low in most countries, including developed ones[5]. Individuals generally lack an adequate understanding of finance and financial products, yet some believe themselves to be far more financially literate than they actually are. A crucial element in equipping people with the skills to make informed pension decisions is thus to ensure that there is sufficient financial education.

A better understanding of general economics and finance empowers individuals. They become capable of taking responsibility for the planning and management of their financial future, they are more likely to act in a rational manner during times of financial difficulty and they better understand the effect of financial decisions on their daily lives.

Only once consumers are equipped with the necessary financial skills — and the confidence to use them — will they be in

5 "Financial education in Europe. Trends and recent developments", OECD, April 2016

a position to seek out and understand the information that enables them to make better decisions about investment and retirement planning, and to reassure themselves that they will have an income in retirement that meets their needs and expectations.

Together with adequate financial literacy, it is essential to have a product disclosure regime that makes it possible for individuals to make those informed pension decisions. The information provided about pension products needs to be appropriate to citizens' abilities and needs, and — most importantly — has to be designed specifically to suit pensions.

One example where this is not the case is the suggestions[6] by the European Insurance and Occupational Pensions Authority (EIOPA) in the debate on the possibility of creating a pan-European pension product (PEPP). EIOPA proposes to use the key information document (KID) required under the EU Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation as the starting point for pre-contractual disclosures for pension products. The PRIIPs Regulation specifically excludes pension products.

While the insurance sector supports the overall objective of the PRIIPs Regulation, particularly greater transparency, the methods of calculation of the main PRIIPs KID indicators (the risk indicator, performance scenarios and cost indicator) are currently inappropriate for insurance products and are even more inappropriate for pension products because they will mislead pension savers. Not only is it now highly unlikely that the KID will be a concise tool that enables consumers to compare products effectively, but pension products also require different information to that in the PRIIPs KID, eg information about the pay-out phase and tax treatment. Moreover, pension products are inextricably linked to member states' social policies and taxation rules, which necessitates a different information approach.

A number of ways to ensure the appropriate pre-contractual pension information and high standards of financial literacy that are the prerequisites to people making informed pension decisions are presented in Chapter 5.

6 EIOPA advice to the European Commission on the development of an EU single market for personal pension products (EIOPA-CP-16/001)

# 3. Saving enough: the solutions

There are a number of ways in which policymakers can motivate people to save more for retirement. These include:

- raising awareness of the need to save
- stimulating uptake of supplementary pension arrangements
- taxing supplementary pensions appropriately (including tax incentives)
- easing online access to pensions

## Raising awareness

Promoting the need for citizens to save is first and foremost the responsibility of each EU member state. The European Commission could nevertheless add real value by organising the exchange of information between states about effective financial awareness initiatives that help people to better understand the long-term nature of pensions and the need to provide for an income in retirement.

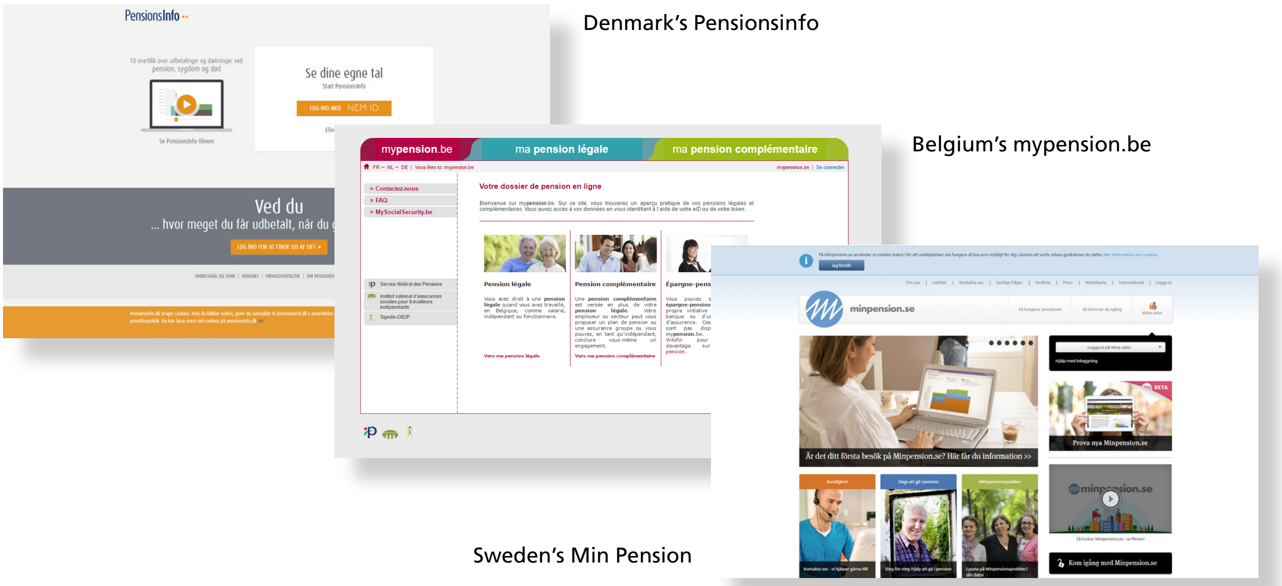
National governments should be encouraged, for example, to provide every citizen with clear and accurate information about the expected value of their state pension benefits. It is particular important to demonstrate the effects of decreasing state pension levels on individual retirement income. Life insurers are keen to work with national governments to draw people's attention to the fact that they need to save (more) for their retirement and need to take responsibility for financing that retirement.

Examples of national initiatives aimed at raising pension awareness include:

- "PensionsInfo"[7], for which the Danish insurance association (F&P) has been running the secretariat since it was launched in 1999. This is a comprehensive tracking tool allowing each Dane to access an overview of their entire pension entitlement in all pillars. Through this service, pension providers can also flag dormant pension rights to individuals and prompt them to check whether it would be profitable to transfer the funds to a new scheme. The tool also shows related insurance covers.
- The Belgian pension tracking system, "mypension.be". This provides information on all statutory and occupational pension arrangements in Belgium.
- The Swedish pension tracking system, "Min Pension"[8] (My Pension). Established in 2004 as a subsidiary of insurance association Insurance Sweden, this gives individuals a full picture of their current total pension rights and savings in all three pillars. They can also receive a free estimate of their total future pension.

7 https://www.pensionsinfo.dk/Borgerservice/velkommen.html
8 https://www.minpension.se/

**Figure 10: Examples of initiatives aimed at raising pension awareness**




Insurance Europe would welcome initiatives from the Commission to promote tracking services, which show individuals their entitlements accrued in the different pension pillars. Showing someone what they can expect in retirement — and so clearly demonstrating their own potential pension gap — can encourage them to save more for their retirement.

## Stimulating uptake of supplementary pension arrangements

As we saw in Chapter 1, state pension systems alone cannot adequately provide for the retirement income of their citizens. To improve the sustainability of pension systems and the adequacy of pension revenues, more people need to make supplementary pension arrangements. Different models for this exist in Europe:

- **Hard compulsion**, or mandatory participation for all or some categories of people. This model obviously guarantees the highest uptake, since it overcomes people's inertia and tendency to procrastinate about retirement-related decisions. However, it generally needs to be introduced in a work setting, for example at company or industry level. It is therefore more common in countries where there is a strong tradition of social dialogue. According to the OECD[9], this model also has certain disadvantages: setting one contribution rate for all may be inefficient for some; it may be perceived as a tax; and it does not adequately take into account the differing needs of people with higher or lower incomes.

- **Soft compulsion**, such as auto-enrolment. This model encourages participation, but still allows individuals to make choices, such as opting out. it aims to overcome people's inertia and make it possible to achieve the critical mass necessary for economies of scale, while avoiding the constraints of hard compulsion. Adequate information plays a key role in such a model, so that people who decide to opt out are well informed. An example of introducing soft compulsion is the 2012 UK auto-enrolment reform, as a result of which 66% of all employees were active members of a pension scheme by April 2016, compared with 47% in 2012[10].
- **Voluntary participation**, based on individual choice.

EU member states should choose enrolment systems that ensure the widest possible uptake, taking into account the design and role of their statutory pension system (eg primarily poverty relief or income replacement).

## Appropriate taxation and tax incentives

Tax incentives are an essential tool for encouraging the necessary transition from a pension system featuring exclusively a pay-as-you-go, statutory pension system to a multi-pillar arrangement based in part or entirely on occupational and personal pensions. The tax regime is one of the key ways in which countries can incentivise citizens to save for their retirement. It is also fundamental to the design of any pension product, eg by requiring particular product features or discouraging early surrender.

Saving through a funded pension scheme entails three stages that can be subject to taxation:

- contribution — the money paid to the funding institution by the individual or their employer
- investment — the capital gains accruing to the pension pot
- benefits — the regular payments or lump sum on retirement

This means that the taxation of funded pension schemes can take any of eight different configurations, depending on whether each of these transactions is subject to taxation (T) or exempt from it (E).

9 "Coverage of private pension systems: evidence and policy options", Antolin P., Payet S., Yermo J., OECD, 2012
10 "Automatic enrolment: Commentary and analysis, April 2015–March 2016", The Pensions Regulator, UK, July 2016

So, an EET configuration means that contributions and investment income are exempt from tax, but benefits are taxed. This means that the income that is taken from the pension is taxed, but the portion saved for future consumption is not. An EET tax configuration aims to encourage the early engagement of pension subscribers. It will typically have the net effect of lowering average taxation over the course of a lifetime, as people will usually pay a lower marginal rate of taxation in retirement than they do when they are working. Younger savers, in particular, benefit from EET because of the non-taxation of accrued interests (investment income). Last but not least, EET has the advantage of providing the state with tax revenue when it needs it most, ie when people also start to claim their state pension.

EU countries have generally opted for some variant of an EET taxation regime. This is the case, for example, in France, Germany, the Netherlands, Spain, the UK and Belgium. A number of EU countries have opted for an ETT regime, including Italy, Denmark and, currently within Pillar 2, Sweden.

The importance of tax incentives during the build-up phase of adequate pension capital is key to the uptake of private pensions. That is why it is so concerning that some EU countries have recently decided to remove them. This is the case in Sweden, for example. Such a short-sighted decision may make it harder for a country to bridge its pension savings gap.

It is vitally important that tax incentives:

- remain stable over time and in value to reassure citizens about the fiscal treatment of their pensions savings and to build trust in the pension system;
- incentivise citizens to save for the long-term, thus postponing consumption; and
- are clear and easy to understand.

Finally, it is important to avoid disincentivising citizens from saving for their retirement by inappropriately linking the level of statutory pension received and the level of an individual's second- or third-pillar pension savings.

## Easing online access to pensions

It must be as easy as possible for individuals to access long-term savings products to fund their retirement. Without hindering or incentivising one channel more than another, all ways of distributing pension products should be possible, providing convenience and freedom of choice. In particular, people should be able to purchase products online as easily as by other means.

New or existing legislation, rules or guidelines relating to pension products should:

- be digital-friendly and appropriately designed so that both consumers and providers benefit from the opportunities offered by digitalisation;
- be technologically neutral and sufficiently future-proof to be fit for the digital age; and
- not give more favourable or preferential treatment to existing distribution channels over new and emerging digital channels that would create barriers to development or stifle innovation.

## How can we get people to save enough?

**Insurance Europe recommendations:**

1. Policymakers should ensure that European citizens are informed about their expected future statutory pension entitlements.

2. Member states should take action to increase the uptake of supplementary pensions, introducing enrolment systems suited to local circumstances.

3. Member states should adopt tax configurations that incentivise citizens to save for the long-term, eg by deferring the point of taxation.

4. Member states should introduce or maintain tax incentives for supplementary pensions. These should be simple, stable over time and incentivise adequate saving over the long-term, eg by penalising early exit/surrender.

5. Digital distribution can increase private pension coverage and should not be hindered.

# 4. Saving well: the solutions

Chapter 2 showed why investing in a range of assets that includes equities and property can be as important as saving enough. This is because of the very different levels of long-term returns offered by different asset classes. However, we also saw that there are reasons why many people across Europe cannot follow optimal strategies for allocating assets over the long term.

The first reason is the natural and legitimate concern many individuals have over the risks and volatility of investing in equities and property. While some people, particularly those who are wealthier or protected by generous pension arrangements, may be comfortable taking risk in order to get better returns, the majority of people may not be able to cope with drops in the value of their investments, especially close to retirement. For some, investing in equities may feel like playing roulette and if we look at the variation in returns around the attractive long-term average we can understand why:

**Figure 11: US equity investments — 1900–2012**

| Average return on a one-year investment was **11.7%** | |
|---|---|
| In the worst year | investors lost **63%** |
| In the worst 10% of years | investors lost **13%** or more |
| In the best 10% of years | investors gained **36%** or more |
| In the best year | investors gained **143%** |

*Source: S&P 500 Index/Insurance Europe analysis*

Therefore, although on average it makes sense for savers to allocate a significant portion of their pension savings to equities, on an individual basis it could be best to choose to avoid them. Across Europe there are many customers who would only feel confident investing in pension products that limit or eliminate their risk of losses in order to accept exposure to assets such as equities.

## The benefits of insurance savings products

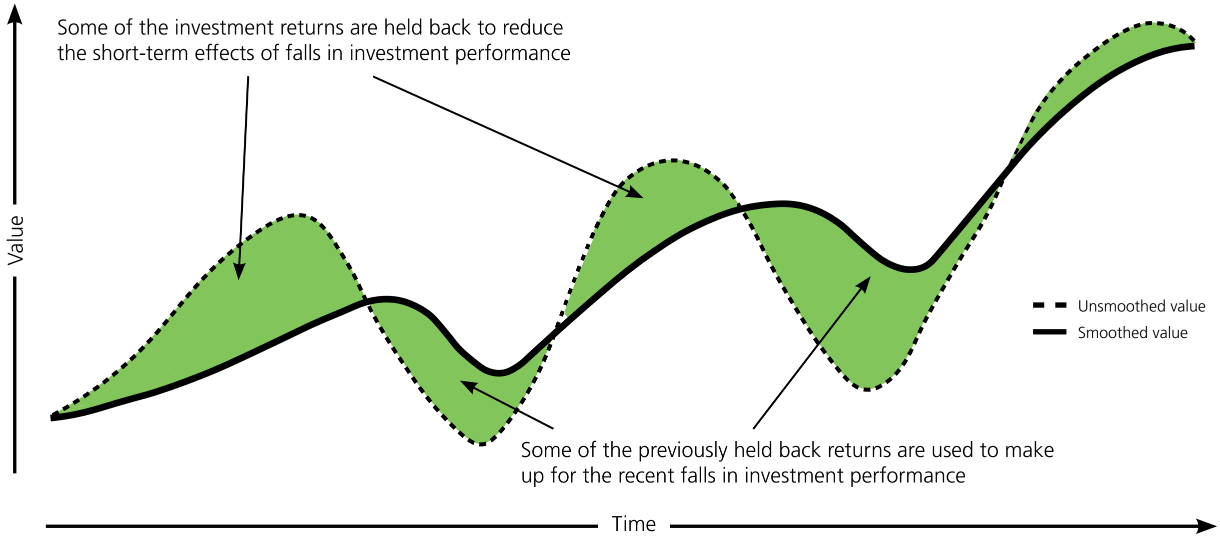
European savers should have access to the types of pension products that suit them best. Different types of insurance savings products enable individuals to gain exposure to a well-diversified, long-term investment portfolio, without them having to take investment decisions. These products often entail guarantees, smoothing or specific investment strategies[11].

11 For instance, life-cycle investment strategies that reduce individuals' exposure to market risk as they age.

The current calibrations of the Solvency II regulatory regime, however, cause difficulties for traditional insurance products that provide smoothing and guarantees. This is a serious problem that must be addressed.

Traditional insurance savings products can play a key role in pension provision because they are based around the principle of providing a minimum return guarantee and/or using risk-sharing mechanisms such as collective pooling. In addition, there are restrictions on early surrender or adequate mechanisms to balance the interests of the remaining insurance collective and early leavers. This allows insurers to invest long-term and spread the risks across many different investors and across time. In doing so, they can smooth the investment returns and aim to provide all savers with something in line with long-term average market returns.

**Figure 12: Return smoothing through collective mutualised investment products**




*Source: Legal & General*

Collective mutualised investment products, or profit-sharing products as they are sometimes called, can therefore allow many more consumers to save adequately for their long-term pension needs. Figure 12 illustrates how such products work.

Traditional insurance pension products also pool biometric risks, in particular longevity risk, which is the risk that pensioners live longer than expected and use up all their savings before they die. Through pooling, the risk is shared across those who live longer than expected and those who die earlier than expected, so everyone gets an income for their entire lives. Illness or death benefits are other risks that can be covered by such products, either as a standard feature or optional additional cover.

Traditional insurance products can also help address other behavioural issues that prevent savers from saving well for retirement. They generally offer a simple and fully managed product so that the saver has exposure to a well-diversified mix of assets, with the company experts taking charge of decisions about which individual assets to hold and when to adjust the asset mix to take advantage of developments within industries and markets.

Such products tend to be used in the accumulation phase of savings, but the collective mutualisation approach can also help investors to maintain exposure to the right asset mix during decumulation, for example as a lifetime annuity.

Traditional insurance products have, in some cases, been criticised for a lack of transparency or high charges. However, these are issues that can be addressed and already have been in many markets. Given the potential for such products to provide pension savers with simple and less risky access to an appropriate asset mix, policymakers should support industry efforts to make wider use of these products.

## Solvency II needs adjusting

As highlighted in Chapter 2, the current calibrations of the EU's Solvency II regulatory regime make it difficult for insurers to offer good-value products that provide smoothing and guarantees. While there is strong support in the insurance industry for key elements of Solvency II, which is a very holistic, risk-based regime setting extremely high standards of risk management, reporting and levels of capital, its treatment of long-term investment can be flawed. This is because Solvency II generally assumes that insurers are trading all their assets and are therefore exposed to having to sell the entirety of their portfolios at any moment.

This is far from the economic reality. For these types of products in particular, insurers are long-term investors, matching assets with liabilities. The current Solvency II approach can lead to an exaggeration of capital charges and volatility for long-term guarantees and investments, which in turn can make these products unnecessarily expensive and restrict their asset mix or even make them unviable.

Figure 13 shows how the real risk of investing in equities is fundamentally different between a short-term trading approach and the long-term way in which insurers can invest in such products.

**Figure 13: Real risk of investing in equities — preliminary analysis based on 100 years of US stock market data***

| Market participant | 1 in 200 shock | Comment |
| --- | --- | --- |
| "Trader"— who can be forced to sell entire portfolio after worst-case 1-year price fall | -43% | Close to Solvency II calibration |
| "Insurer"— who can invest for 10 years and absorb shorter-term losses | -26% | 10-year holding reduces the risk of loss due mainly to impact of dividends, also to some extent tendency for market to recover over long term |
| "Insurer"— who can invest for 10 years and can "pool/ smooth" returns across portfolios offered to consecutive cohorts | +9% | Pooling appears potentially very effective |

** Insurance Europe looked at the 1 in 200 level of worst-case outcome for investing in the S&P 500 Index over the last 100 years for three different approaches: a one-year investment, a 10-year investment and a 10-year investment assuming "smoothing". The smoothing mechanism in this example pays out the average return of 10-year investments that matured over the previous five years. Monthly US stock market index and dividend yields were used to give total return indices from 1900 to 2012. It is assumed that the insurer has no early surrender risk, either because the product has no option or any losses from early surrender are passed on to the customer.*

*Note that, in practice, insurers may be even less exposed to share price volatility because they can usually choose whether to sell equities or other assets, or indeed use new premiums to fund claim payments, but in this simple modelling the benefits of this additional flexibility have been ignored.*

*Source: Insurance Europe*

The analysis indicates that an insurer investing 100% in the US stock market and operating a very simple collective mutualised product over the last century would have needed far less capital for a longer-term product than a shorter-term one. Indeed, with a very simple smoothing rule added, the company would not have needed any solvency capital at any point during the entire period if its promise to customers was simply to always provide a positive return.

We do not advocate zero capital solvency requirements, but the analysis shows that the differences between the current Solvency II approach and how insurers are really exposed to investment risks cannot be ignored. Refining Solvency II requirements, so that they recognise — rather than ignore — the very real difference in risk that long-term investment brings, would help collective mutualised products play an active role in supporting the right asset mix for many savers.

## Appropriate decumulation

While building adequate pension capital is crucial, the design of the pay-out phase likewise plays a key role in ensuring individuals enjoy an adequate standard of living in retirement. Pension decumulation needs to balance the right level of protection against longevity risk and the flexibility to allow access to funds if needed.

Retirement benefits can be paid in a number of ways:

- life annuities (a stream of payments for as long as the pensioner lives);
- programmed withdrawals (a series of fixed or variable payments, generally calculated by dividing the accumulated assets by a fixed number or by the expected life expectancy in each period);
- lump sums (ie a single payment); or
- a mix of these.

Pension decumulation practices and rules vary substantially in Europe. For instance, some countries require individuals to purchase lifetime annuities, while others allow other options such as lump sums, or even a combination of different products.

## How can we get people to save well?

**Insurance Europe recommendations:**

1. Savers should be informed about the importance of the asset mix in achieving their goals for income in retirement.

2. Policymakers and the insurance industry should work together to facilitate the availability of well-designed collective mutualised investment products for those savers that need them.

3. Solvency II's treatment of long-term investments should move from a trading to a long-term approach, so that solvency capital charges are appropriate and not unnecessarily excessive.

4. Against the background of increasing longevity risk, policymakers must ensure that consumers can access decumulation products that best suit their needs, while reflecting national practices (eg life-long annuities, drawdowns, lump sums).

# 5. Saving wisely: the solutions

To be able to make informed financial decisions, individuals need two things: to be financially literate and to have access to information about the products and services available to them. So, high-quality financial education and pre-contractual product information are essential and complementary in ensuring that people save for retirement.

## Financial education

As the European Commission has rightly acknowledged, financial education can help people make informed choices. The Commission has stressed the importance of individuals being properly equipped with economic literacy and planning skills so that they can adequately assess their need for financial and social protection and has noted that informed decision-making goes hand-in-hand with adequate pension provision. When it comes to pensions, financial education not only helps to raise awareness of the pension gap but also helps people make informed and appropriate decisions about making provision for their retirement.

The European insurance industry shares the Commission's view and is actively engaged in increasing financial education and raising financial literacy levels across the continent. Here are just three examples of its many pension-related initiatives that span all life stages from childhood to retirement:

- In Germany, the "Safety 1st" tool/website[12], a joint venture by the German insurance association (GDV) and Stiftung Jugend und Bildung, a youth foundation, is aimed at young adults and their teachers, providing them with an accessible introduction to social insurance and private pensions. The GDV also provides a pension calculator on its website. Users can check their individual pension status in a few easy steps.
- Finance Norway has developed a training programme in personal finance for 30 000 lower secondary school students. Questions about pensions feature in the programme.
- The Austrian insurance association (VVO) has developed a board game "Less risk more fun" that has been distributed in schools all over Austria. Young people learn through play to assess and be aware of different risks at different stages in their life and of how to minimise them. Raising awareness of the need for private pension provision is included.
- In 2016, the Spanish insurance association (UNESPA) launched a four-year campaign called "estamos seguros" (we are insured/safe/sure) comprising a broad range of actions to raise public awareness and understanding of insurance and retirement saving. It includes an online tool for pupils and teachers[13].

12 www.safety1st.de
13 www.estamos-seguros.es and www.aprendoseguro.es

One challenge is to convert raised awareness of financial issues into actual change in citizens' behaviour. If financial literacy components are incorporated into school curricula, financial capabilities and responsibility are developed early by the entire population, making it more likely that behaviour changes.

Education is, of course, a matter for national governments and the fact that many countries have already recognised the importance of financial education by incorporating it into their school curricula is to be welcomed. We would encourage all national governments and other relevant institutions to do the same. The European Commission's role is to encourage states to tackle financial education issues and to facilitate the exchange of best practices. Insurance Europe would support a Commission Recommendation to encourage the adoption of national financial education strategies and their inclusion in school curricula. In relation to insurance, this should ideally give young people a grounding in the risks encountered in everyday life, such as accidents and illness, and in long-term issues such as retirement provision, as well as ways to deal with them.

The Commission could also introduce a European Day of Financial Education that would allow policymakers, citizens, the financial sector, education providers, social partners and the media to focus on best practice and new approaches to financial education at national and EU level.

EIOPA should do more to fulfil the obligations set out in its founding Regulation to review and coordinate financial literacy and education initiatives by national authorities.

Internationally, Insurance Europe welcomes the work done by the OECD on financial literacy, such as that under its Programme for International Student Assessment (PISA), which not only aims to measure students' financial literacy levels but also provides impetus to governments to introduce financial education into their school curricula.

## Pre-contractual information

However financially literate they are, people cannot make informed decisions unless they have sufficient, high-quality and appropriate information to enable them to compare and choose products. Ensuring the effectiveness of product information by simplifying disclosure requirements is vital if consumers are to compare products and select the ones that meet their needs. In the same way as for other insurance products, pre-contractual information about pension products should be fair, clear and not misleading:

- Better information does not mean more information. To have a clear and demonstrable benefit to consumers, pre-contractual information requirements should focus on quality rather than quantity. Too much information may actually prevent consumers from making good assessments and appropriate choices.

- The EU regulatory framework for distribution — updated recently by the Solvency II and Insurance Distribution Directives — contains sophisticated information requirements for all insurance products, including pensions offered by insurers. Behavioural economic research shows that constant changes in regulation may negatively affect consumers understanding of disclosures. EU policymakers should bear this in mind before introducing any additional requirements, as well as assessing their coherence and added value.
- EU member states are responsible for the design of pension products, so the EU may not be the most appropriate level at which to take any initiative on information requirements, given the diversity of products due to different EU citizens' needs, demands, cultures and financial education levels. Any EU requirements must be sufficiently flexible to cater for different national systems, be non-exhaustive, be principle-based and provide legal certainty.
- Any product information requirements must be future-proof and suitable for all current and future distribution modes, be they on paper or digital. This would be in line with the EU's objectives for a digital single market. The provision of information in a digital format, for example, offers the possibility to layer the information and enable consumers to access further information about the product if they so wish. Consumers should be able to freely decide in which format they wish to receive information and should have equal access to both digital and paper means. This is not the case with the EU's Insurance Distribution Directive (IDD) and Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation, which require pre-contractual information to be provided on paper. It is only by way of derogation and under certain conditions that this information can be provided through a website.
- Pension disclosures must be consumer-friendly and engaging. Any regulatory initiative on product information should go through rigorous consumer-testing. This is the only way to ensure that requirements benefit consumers and match their actual, not perceived, information needs.

The choice of whether to seek advice when buying a pension product should be left to the individual, as long as this is in accordance with national rules. Even where sales are made without advice, all relevant information should still be provided in a clear and easily accessible manner.

## A possible pan-European personal pension product

As well as common features, pension products obviously have features that make them distinct from one another. Consumers therefore need to be informed of the specific characteristics and functions of products, as well as their risks and rewards, in order to make informed decisions about and have confidence in pension products.

The European Commission is working on a pan-European pension product (PEPP). Unlike pension products currently available at national level, this is expected to be a standardised EU-wide product. Taking product specifics into account, Insurance Europe has identified some elements for a key information checklist for a PEPP (see Figure 14). The objective is to provide consumers — clearly and concisely — with the information they need to be able to understand and compare PEPPs and, ultimately, make informed pension decisions.

The checklist is a minimum list; national standards may require further information. While standardisation aids comparison, too high a level of prescriptiveness would not allow adaptation to local consumers' needs and expectations and would interfere with existing, national self- or co-regulatory models that have been proven to work effectively.

Pensions are a cornerstone of the European economy. Europe's future competitiveness, standard of living and ability to advance and grow depend in great part on its capacity to build up effective, affordable and sustainable pension systems, as these represent a significant portion of the public finances in all EU member states.

## How can we get people to save wisely?

**Insurance Europe recommendations:**

1. Financial education and awareness

    a) The European Commission and member states should favour the adoption of national strategies for financial education and their inclusion in school curricula in order to develop financial literacy and responsibility from an early age.

    b) A Commission-led European Day of Financial Education for sharing best practice and new approaches to financial education at national and EU level should be introduced.

    c) EIOPA should review and coordinate financial literacy and education initiatives by national authorities.

2. Any EU initiative on pension product information should respect local market characteristics, be suitable for current and future distribution channels and be thoroughly tested with consumers. Consumers should be able to freely decide in which format they wish to receive the information and have equal access to both digital and paper means.

3. When envisaging the introduction of a pan-European personal pension product (PEPP), EU policymakers should consider the elements in Figure 14 for a PEPP's standardised pre-contractual information.

### Figure 14: Elements for a key information checklist for a PEPP

**Name of product**

**Name of insurance undertaking** May also include company head office address and legal form

**Type of product** Summary of product

**Insurance cover**
- Risk coverage description (death, disability, sickness, etc.)
- Related biometric risk premium

**Target retirement age** Indication of target retirement age, according to national rules, if applicable

**Pension benefits/decumulation** Description of pay-out option(s)

**Objectives and investment policy**
General description of investment objectives of:
- PEPP
- default investment option
- other investment option(s), if applicable

**Risk and reward profile**
- Narrative explanation describing risks, risk mitigation elements, guarantees and existence of Solvency II requirements
- Possible maximum loss
- Smoothing rules, if applicable
- Reward description

**Investment charges**
- Description of investment costs and charges

**Access to pension pot**
- Minimum investment period(s)
- Special conditions for partial withdrawal (eg medical expenses), if applicable according to national law

**Fiscal treatment**
- Description of tax treatment, including relevant tax incentives (rationale, amounts, eligibility, etc.), if applicable
- Link to national law granting the incentive, if applicable

**Consequences of early termination** General warning (if consequences of early termination are too long to be detailed). The general warning can consist of a reference to the general policy conditions for further information.

**Mediation mechanisms** Information about how and to whom a retail investor can make a complaint about the product or the conduct of the manufacturer

**Date of publication** [day/month/year]

## 6. A win-win-win situation

In this Blueprint, we have advanced a number of recommendations to unlock the full potential of multi-pillar pension systems, highlighting how insurance can support governments' efforts to deliver adequate pensions to EU citizens.

The insurance sector is a key source of the investment needed to restore growth to the economy and to fund the retirement of present and future generations. The sector is therefore a major asset for the EU as it faces the challenges of the next decades.

If insurers can fulfil their role in the right conditions, there is clear potential for a "win-win-win" situation:

- **A win for European citizens**, who will benefit from adequate retirement income and biometric risk protection, even in times of major demographic challenges and less generous statutory pensions.
- **A win for European governments**, who can ensure the sustainability of their long-term budgets and at the same time make sure that their citizens enjoy decent living standards in old age.
- **A win for European growth**, which will be significantly strengthened by the long-term investments in the real economy that will be facilitated by insurers.

An effectively regulated and well performing insurance industry has much to contribute to European society. It is therefore crucial that regulators and policymakers work collaboratively with insurers in order to create an environment in which citizens' interests are safeguarded and economic growth can be achieved.

We hope that this Blueprint makes a useful contribution to the debates on how to tackle Europe's pension challenge and that it contributes to the general understanding of the role and benefit of insurance in pension provision. The insurance industry will continue to support efforts at EU and national level to ensure that European citizens can enjoy an adequate income in retirement.

# 7. Insurance Europe recommendations

## Summary of recommendations

### How can we cope with Europe's demographic challenge?

1. Governments should introduce (or enhance) funded pension pillars (ie occupational and personal pensions) alongside the traditional PAYG statutory pension systems to improve their sustainability and the adequacy of retirement incomes.

2. The design of the multi-pillar system is key. To be successful, pension pillars must be mutually reinforcing and have clear roles and objectives (eg poverty prevention, income replacement).

### How can we get people to save enough?

1. Policymakers should ensure that European citizens are informed about their expected future statutory pension entitlements.

2. Member states should take action to increase the uptake of supplementary pensions, introducing enrolment systems suited to local circumstances.

3. Member states should adopt tax configurations that incentivise citizens to save for the long-term, eg by deferring the point of taxation.

4. Member states should introduce or maintain tax incentives for supplementary pensions. These should be simple, stable over time and incentivise adequate saving over the long-term, eg by penalising early exit/surrender.

5. Digital distribution can increase private pension coverage and should not be hindered.

### How can we get people to save well?

1. Savers should be informed about the importance of the asset mix in achieving their goals for income in retirement.

2. Policymakers and the insurance industry should work together to facilitate the offering by insurers of well-designed collective mutualised investment products for those savers that need them.

3. Solvency II's treatment of long-term investments should move from a trading to a long-term approach, so that measurements are appropriate and not unnecessarily excessive.

4. Against the background of increasing longevity risk, policymakers must ensure that consumers can access decumulation products that best suit their needs, while reflecting national practices (eg life-long annuities, drawdowns, lump sums).

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    a) The European Commission and member states should favour the adoption of national strategies for financial education and their inclusion in school curricula in order to develop financial literacy and responsibility from an early age.

    b) A Commission-led European Day of Financial Education for sharing best practice and new approaches to financial education at national and EU level should be introduced.

    c) EIOPA should review and coordinate financial literacy and education initiatives by national authorities.

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3. When envisaging the introduction of a pan-European personal pension product (PEPP), EU policymakers should consider the elements in Figure 14 for a PEPP's standardised pre-contractual information.

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