Revisiting Pension Privatization in Europe

Bernhard Ebbinghaus

School of Social Sciences & Mannheim Centre for European Social Research (MZES), University of Mannheim, Germany

Bernhard Ebbinghaus (Ed.): Varieties of Pension Governance: The Privatization of Pensions in Europe
1. Introduction: Privatization of pension responsibility

Global paradigm shift:
„Reforming pensions is one of the biggest challenges of the 21st century!“ (OECD)
• Demographic ‘time-bomb’ of ageing societies
• High expenditure, partly due to early exit from work
• Demographic problem of pay-as-you-go pensions!
→ Shift toward (pre)funded pensions (II-III pillar)
  Goal: fiscal and economic sustainability!

But: post-crash financial crisis (2007/08-)
• I: Sovereign debt crisis: more pressures on PAYG
• II: DB pension: underfunded firm-sponsored funds
• II/III: DC pension: lower returns → later retirement?
→ Individualized risks: increase in poverty & inequality

Puzzle: How to square financial, social & political sustainability?
2. Challenges to multipillar strategy

- Ageing: Problem for pay-as-you-go financing → shift to funded systems
- Globalization: economic competitiveness → limiting labour costs
- Marketization: high public debt & liabilities → reduce public expenditure
- Financial crisis: negative and low returns → is funded system still better?

→ Goal: financial sustainability

But further social challenges („new social risks“):
- Flexibilization: non-standard employment → access / coverage?
- Reconciliation of work and family care → social care credits?
- Plural family & household patterns → individualised pensions?

→ Goal: social sustainability

Consequences for political legitimation?
- Increase in old age poverty → return of the state via minimum income
- Increase in insecurity & inequality → state regulation of private pensions
- Post-2007 crisis: low trust in public (PAYG) & private (funded) pensions

→ Goal: political sustainability
3. Public-private pension mix in Europe before the crisis

Public and private pension expenditure (% GDP), OECD 2006

- Public expenditure
- Private expenditure

<table>
<thead>
<tr>
<th>Country</th>
<th>Public Expenditure</th>
<th>Private Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>12.0</td>
<td>12.2</td>
</tr>
<tr>
<td>France**</td>
<td>11.9</td>
<td>12.2</td>
</tr>
<tr>
<td>Germany*</td>
<td>11.7</td>
<td>11.9</td>
</tr>
<tr>
<td>Belgium</td>
<td>8.1</td>
<td>9.5</td>
</tr>
<tr>
<td>Sweden</td>
<td>7.7</td>
<td>8.9</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>7.5</td>
<td>10.5</td>
</tr>
<tr>
<td>Switzerland</td>
<td>6.7</td>
<td>5.5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5.4</td>
<td>9.0</td>
</tr>
<tr>
<td>Denmark</td>
<td>4.8</td>
<td>9.0</td>
</tr>
<tr>
<td>Finland</td>
<td>1.1</td>
<td>10.3</td>
</tr>
</tbody>
</table>

Total private pension assets (% GDP), OECD 2007

<table>
<thead>
<tr>
<th>Country</th>
<th>State Pensions Crowded Out Private Funded Pensions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>4</td>
</tr>
<tr>
<td>France</td>
<td>7</td>
</tr>
<tr>
<td>Germany</td>
<td>18</td>
</tr>
<tr>
<td>Belgium</td>
<td>14</td>
</tr>
<tr>
<td>Sweden</td>
<td>57</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>96</td>
</tr>
<tr>
<td>Switzerland</td>
<td>152</td>
</tr>
<tr>
<td>Netherlands</td>
<td>149</td>
</tr>
<tr>
<td>Denmark</td>
<td>141</td>
</tr>
<tr>
<td>Finland</td>
<td>78</td>
</tr>
</tbody>
</table>

### 4. Paradigm shifts in pension policies

<table>
<thead>
<tr>
<th>Process</th>
<th>Marketization</th>
<th>Privatization</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Principle</strong></td>
<td>Increasing the <em>market-logic</em> and market-dependency <em>(commodification)</em></td>
<td>Shifting responsibility to <em>non-state actors</em> <em>(risk privatization)</em></td>
</tr>
<tr>
<td><strong>Aims</strong></td>
<td>Financial sustainability, reducing public expenditure</td>
<td>Retreat of the state, self-regulation / choice</td>
</tr>
</tbody>
</table>
| **Instruments** | • Employment-related pensions  
  • Longer working life  
  • Actuarial treatment of benefits  
  • Pre-funded pensions | • Mandate for private actors  
  • Collective bargaining  
  • Employers commitment  
  • Voluntary/individual choice |

5. Private pension governance: actors & interests

Conflicts of interests in supplementary pensions:
- **Vertical conflicts** = principal-agent problem (sponsor/financial agent)
- **Horizontal conflicts**: sponsor (employer) vs. beneficiary (worker)
  - employer commitment: employer sponsors ‘trust’ fund, implicit contract
  - collective agreement: delegated to employer/union negotiations

**Diagram:**
1) Individual decision
2) Employer commitment
3) Collective agreement

- Individual: mainly “exit” option
- Some “voice” less “exit” option
- “Voice” through collective action / institutionalized power
6. Private pension governance: pros & cons

**Collective** (= employer/unions co-manage collective scheme):
- **Pooling** of risks, broader coverage, lower administrative costs
- **Balancing** interests between sponsors & beneficiaries, informed decisions
  - But **less personal choice**, less attractive for higher income groups
  - Collective funds are more like public pensions, *consensus necessary*

**Employer-led** (= employer-sponsored pension fund or on the book reserves):
- **Limited representation** of beneficiary interests
- Risk of **bankruptcy** of firm: reinsurance needed
- **Underfunding** problem for sponsors but also who owns surpluses?
- Employer interest in **binding** employees but higher costs & lower mobility
  - Employer-funds can lead to **conflicts of interests**, thus requiring regulation

**Individual**:
- Individual decision to save for old age: **freedom of choice**
  - Individual savings depends on financial literacy, **foresight**, and liquidity
  - Individual responsibility but **individualization of risks**, regulation needed
7. Financial crisis and pension fund performance

- **Financial market crisis** 2007/08+ (worse than 2001)
- **Negative net returns**, decline in world assets
- **Risky** investment in equities (but later also Greek bonds)
- **Underfunding** of defined benefit (DB) pensions
- **Public reserve** funds are also affected
- **Sovereign debt crisis** will affect public PAYG pensions
- **Acute problems** particular for those close to retirement

Source: return on pension fund investment (%) in OECD Pensions in Focus, July 2010, Paris: 2010
8. Net return and equity investments during the crash (2007/08)

Pension funds

Equities 2007 (% of total portfolio)

Investment return 2008 (%)

Sources: OECD (2009): Pensions at a Glance

LMEs: Liberal Market Economies

- Mature pension fund capitalism
- More risky investments (equities, etc.)
- Less regulation (“prudent investor” rule)

CMEs: Coordinated Market Economies

- only NL, CH, DK mature pension fund capitalism
- More regulation than LME
- Less risky, more secure investments or insurances
- More buffer through DB schemes (firm, sector)
9. Net Annual Return (%) of Pension Funds, OECD 2003-12

[Diagram showing net annual return for various countries.]

9. Net Annual Return (%) of Pension Funds, OECD 2003-12

Rebounding?
## 10. Multipillar sustainability: Post-crisis consequences

<table>
<thead>
<tr>
<th></th>
<th>Private DB</th>
<th>Private / public DC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Problem:</strong></td>
<td>Underfunding</td>
<td>Lower returns</td>
</tr>
</tbody>
</table>
| **Short-term impact**| • Firm insolvencies  
• Higher reinsurance premiums  
• Easing funding rules?  
• Move to average-career DB  
• Conflicts between current and future members? | • Low/negative returns = lower savings  
• Higher individual contributions needed  
• Interruptions due to unemployment  
• Postponement of retirement? |
|                      | Higher **contributions** needed and / or lower benefits                     |                                                                                  |
| **Long-term impact** | • Coverage based on firm-attachment, mobility problem  
• Increased pressure on firms to move to DC  
• Reform of protection funds  
• Revised funding rules | • Labour market risks in voluntary schemes leads to gaps  
• Minimum statutory guarantees?  
• Mandatory annuities after retirement?  
• Nudging strategies |
|                      | Better supervision and stricter **regulations** of investments              |                                                                                  |
11. Social sustainability: inequality in coverage & benefits

- **Higher income** groups more likely to be covered by private pensions
- **Middle (}& lower) income** groups covered when (quasi)mandatory pensions

Source: SHARE (wave 2, 2006) ELSA (wave 3, 2006/07)

B. Ebbinghaus & J. Neugschwender, Ch. 14 in *The Varieties of Pension Governance*, OUP 2011
11. Social sustainability: inequality in coverage & benefits

- **Higher income** groups more likely to be covered by private pensions
- **Middle (and lower) income** groups covered when *(quasi)mandatory pensions*
- **Large income share** (50%) particularly for higher income groups
- **Private funded pensions** important in UK, CH, NL and Nordic countries

B. Ebbinghaus & J. Neugschwender, Ch. 14 in *The Varieties of Pension Governance*, OUP 2011
12. Reconsidering financial, social and political sustainability

Varieties of privatization in Europe:

• **State** retreats from direct financing but tax subsidies & negative externalities!

• **Marketization**: increased importance of funded pensions

• Cross-national diversity in private pension **governance**

• **Trend toward individualization** of financial risks (DB→DC)

• **Financial crisis** lead to declining trust in funded solutions

• Need for **better regulation** & good governance

• Danger of increasing old age **poverty** & inequality in future!
Further readings

**Monographs:**

**Journal publications:**

**Working papers:**