

# **European Commission's Green Paper - Towards adequate, sustainable and safe European pension systems – UK Government response**

12 November 2010

## **Q1. How can the EU support Member States' efforts to strengthen the adequacy of pension systems? Should the EU seek to define better what an adequate retirement income might entail?**

The UK Government believes that the definition of an adequate retirement income is a national prerogative and depends on the political choices made in each Member State. In the UK the State Pension is meant to help alleviate poverty – providing high replacement rates only for those on low earnings. For those on median-to-high earnings, the State Pension is meant to provide a solid foundation for private savings.

Adequacy is very hard to define. The Commission has already tried to develop the statistical means to monitor levels of relative poverty and material deprivation among pensioners on a cross-country basis. This has revealed the difficulty of arriving at any objective EU-wide adequacy measure; as rankings based on relative poverty tend to be the opposite of those based on material deprivation.

In its June Budget 2010, the UK Government pledged that “pensioners will have the income to live with dignity in retirement”. From April 2011 onwards, the basic State Pension will be uprated by a triple guarantee of average earnings, prices or 2.5 per cent, whichever is highest. This year, the Government has further strengthened crediting arrangements allowing carers to build State Pension entitlement, and changed qualifying conditions for the basic State Pension to make it fairer and more accessible.

Under the Open Method of Co-ordination, Member States have already agreed to common objectives on pension policy, the achievement of which is monitored through a number of agreed indicators – including on adequacy. Rather than moving away from these agreed indicators – on which there has been considerable work by the Commission and Member States since 2001 – the Commission should focus on improving existing indicators and strengthen joint analysis and policy exchanges between countries.

## **Q2. Is the existing pension framework at the EU level sufficient to ensure sustainable public finances?**

At present the EU monitors the financial impact of ageing through its Ageing and its Sustainability reports. These reports based on an agreed methodology present very useful cross-country comparisons and are sufficient to help countries compare their policies. Member States are best placed to decide what level of GDP spent on pensions is sustainable or not.

Assessments of sustainability of fiscal policy are already conducted by the EU. It is unclear whether changes to the existing pension framework at EU level would add any additional benefits.

Moreover the sustainability of pension policy goes beyond fiscal considerations. Private savings ratios, employment rates, and projected demographic developments also play considerable parts in ensuring sustainability. This is captured by the broader set of indicators monitored under the existing Open Method of Co-ordination in pensions. The cost of pensions is only part of the parcel of public finances, and the Commission should integrate the pension framework with the wider work of the ECOFIN Council on economic policy.

The UK economy is recovering from the longest and deepest recession since official records began. This has had a significant impact on public finances. In its June Budget 2010, the UK Government announced a major programme of fiscal consolidation to reduce borrowing.

The UK Government also reaffirmed its belief in the need to ensure fiscal sustainability over a longer time frame. In order to achieve this, the UK Government is identifying future fiscal pressures and taking action to alleviate them. A certain source of future pressure will arise from an ageing population. Given the challenges posed by the rapid increase in longevity, the UK Government has reviewed when the State Pension age will rise to 66, and has decided to bring forward the increase to 2020. The UK Government is also reviewing ways to deal with the future cost of public sector pensions.

### **Q3. How can higher effective retirement ages best be achieved and how could increases in pensionable ages contribute? Should automatic adjustment mechanisms related to demographic changes be introduced in pension systems in order to balance the time spent in work and in retirement? What role could the EU level play in this regard?**

The UK Government believes that the setting of pensionable ages is a national prerogative and depends on the political choices made in each Member State. However, the EU has an important role to play in serving as a forum where policy experiences are exchanged.

The UK Government strongly supports the Commission's position on extending working lives. Over recent years, the UK has pursued several policies, such as putting in place age discrimination legislation, adopting active labour market policies and helping create a positive culture towards older workers among businesses. To ensure that those who wish to work beyond 65 are able to, the Government will phase out the Default Retirement Age from April 2011.

In 2007, the UK legislated for a gradual increase in the State Pension age to 68 by 2046, to follow the equalisation of the pensionable age for women with that for men starting in 2010. However, given the challenges posed by ageing, the Government has reviewed the timing of the rise to 66, after carrying out a call for evidence among stakeholders. The timing of further increases and how best to manage the challenge posed by rising longevity will also be looked at.

Automatic mechanisms linked to demographic changes may be considered. The UK Government believes Member States should determine the most appropriate form any such mechanism should take with due regard to their individual schemes. It is also aware that any policy developed in this area needs to be considered in the context of factors such as the degree of variation in life expectancy between different socio-economic groups.

Addressing demographic change is crucial to ensure pension systems are sustainable and contribute to intergenerational fairness. Increases in pensionable ages can help send a clear signal to individuals that life expectancy has increased and that therefore to enjoy their desired retirement income, they need to have longer working careers.

## **Q4. How can the implementation of the EU 2020 strategy be used to promote longer employment, its benefits to business and to address age discrimination in the labour market?**

To counteract demographic change the EU2020 strategy explicitly promotes the inclusion of older workers in the labour market. This can be achieved by promoting extended working lives, using flexible working and discouraging early retirement. An older labour force and longer working lives need not imply less productive labour or less innovation. The promotion of life-long learning schemes, preventative health care coupled with the experience and knowledge that older workers hold will positively contribute to the recovery and the future growth of the EU.

Member States have the responsibility of implementing the EU2020 strategy and the UK has already begun to put reforms in place to encourage older workers to stay in the work place. These include gradually increasing State Pension Age women to 65, and then for both men and women to 68. However, given the challenges posed by ageing, the UK Government has reviewed the timing of the rise to 66, after carrying out a call for evidence among stakeholders

The UK is also committed to phasing out the Default Retirement Age, the age at which an employee can be made to retire. This will result in more people above retirement age working if they want to and will increase the number of older people in the work place. Encouraging people to work longer will have financial benefits for both the individual and the wider economy.

These reforms will enable and encourage more people to work longer and promote longer employment as well as bringing benefits to business.

## **Q5. In which ways should the IORP Directive be amended to improve the conditions for cross-border activity?**

The considerable divergence in the approaches Member States have taken in their treatment of institutions wishing to undertake cross-border activity remains a very significant barrier in enabling such schemes to operate appropriately and effectively.

The UK Government welcomes the important work the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) has undertaken in highlighting both the theoretical and practical difficulties of cross-border arrangements. For example, competing views as to who the host state is.

Greater consistency in the approach Member States take in the identification and treatment of institutions wishing to operate across borders is a prerequisite in strengthening the internal market for private pensions, whilst ensuring adequate member protection.

In the first instance, the Open-Method of Coordination provides a suitable instrument for achieving the consistency needed. In addition, given the European Insurance and Occupational Pensions Authority (EIOPA), the new European supervisory authority, will have powers to set binding guidance, it may be that better consistency and improved conditions for cross-border schemes could arise from their work in the future.

## **Q6. What should be the scope of schemes covered by EU level action on removing obstacles for mobility?**

The scope of schemes covered by the IORP directive is satisfactory and should not be extended to other pension schemes.

The UK remains committed to the free movement of workers. That is why the UK Government, when transposing the IORP Directive, in support of the overall objective to remove barriers to a European internal market, ensured that members' rights remain properly protected, particularly important given that members of schemes based in other States are not afforded the protection of the Pension Protection Fund. The protection of members' rights is the real issue. The UK also recognises that pensions remain a Member State competence and further European legislation may have adverse impacts on some pensioners or place onerous requirements on certain, particularly small, schemes.

The UK would also be concerned about the impact any new legislation in this area may have on its new National Employment Savings Trust (NEST). This is part of the UK's wider pension reforms and is designed to ensure people who are not saving for their retirement can do so. NEST is specifically designed to focus on a target market of low to moderate earners and compliment, rather than compete with, existing provision. In order to achieve this it will operate a ban on transfers until at least 2017.

Any action to facilitate pension mobility must also pay due regard to the risks associated with it. For example, the UK has additional rules around the quality of advice on personal pensions and pension transfers, which are essential to the delivery of acceptable outcomes for consumers in the UK pensions market.

## **Q7. Should the EU look again at the issue of transfers or would minimum standards on acquisition and preservation plus a tracking service for all types of pension rights be a better solution?**

The UK Government is keen to ensure that individuals can move their pensions within and between Member States and supports the Commission in examining how this can be made easier.

However, as the UK already allows a scheme member to transfer (with, initially, the exception of NEST members) vested rights from an occupational scheme, and Council Directive 98/49/EC already provides an adequate framework for the preservation of vested pension rights, we see no need for further EU rules.

The UK recognises the benefits of national tracking services. We maintain a successful free Pension Tracing Service. The Service has experience in helping individuals locate schemes with which they have lost touch and has access to information on over 200,000 pension schemes. It has provided over 60,000 successful traces annually in each of the last 3 years.

We believe that other Member States might benefit from the UK example in setting up their own Pension Tracing Service, accessible from across the EU, with adjustments made for the nature of their pension systems and we would welcome the opportunity to share our experience with other Member States.

However, a single central, EU wide, register of all EU pensions would prove very unwieldy and could place an onerous bureaucratic burden on smaller schemes.

## **Q8. Does current EU legislation need reviewing to ensure a consistent regulation and supervision of funded (i.e. backed by a fund of assets) pension schemes and products? If so, which elements?**

The UK Government supports consistency in terms of the outcome that pension regulation and supervision should achieve: appropriate protections for members of all types of funded pension across the EU. However, member protection needs to take account of the specific features of a pension scheme, and, given the diversity of pensions and pension arrangements across Member States, and even within the Member States, different frameworks are required. The same framework cannot be applied to all pension schemes even within one country.

For example, the UK has different regulatory frameworks and different rules for occupational pensions (regulated by the Pensions Regulator) and personal pensions (regulated by the Financial Services Authority), as the risks associated with a trust-based scheme where the trustees have a legal duty to act in members' interests, are different from the risks associated with a personal pension offered by a firm on a commercial basis. These different arrangements are appropriate to achieve the same outcome for members in terms of pension safety.

With this in mind, the UK Government believes that current EU legislation is sufficient, striking the right balance between EU and national social and labour laws. It provides the necessary flexibility for Member States to respond in a timely and proportionate way to developments in their national pension systems, and has thus allowed the UK to develop a strong pension protection system for both occupational and personal pensions, both in terms of prudential rules and compensation arrangements. The UK would like to extend an invitation to the Commission and other Member States to visit the UK and to discuss in more detail the system we have in place.

## **Q9. How could European regulation or a code of good practice help Member States achieve a better balance for pension savers and pension providers between risks, security and affordability?**

It is important that pensions are secure and affordable to encourage individuals to save for retirement and promote sustainable public finances.

The UK provides security for members of both occupational and personal pension schemes. For occupational schemes the Pensions Regulator is responsible for ensuring good standards of administration and protecting the benefits of members in both DB and DC schemes. For DB, the Pension Protection Fund is available if the sponsor becomes insolvent. For personal pension policyholders, the Financial Services Authority Rules ensure proper management of schemes and the Financial Services Compensation Scheme (FSCS) is available. Any pension guarantee system needs to take account of the particular nature of a pension scheme and the risks it is appropriate to address in relation to that scheme, and any future EU proposals should reflect this.

The UK stakeholder pensions products, which must meet minimum standards including a charge cap, make pensions more affordable to those on lower incomes.

In terms of risks, the UK notes that pension risks depend on the features of a Member State's pension system and regulation needs to allow members to achieve their desired balance of risk and reward. We recognise the role of the market in providing products which allow savers to achieve this balance, but note that firms do not always design products appropriate to the needs of their intended target market. The Financial Services Authority is thus more actively scrutinising products and their governance to identify problems before they cause widespread detriment as part of its new Consumer Protection Strategy.

The UK welcomes the exchange of information about best practice between Member States in areas such as information disclosure and risk-sharing, in particular, striking the right balance between member protection and encouraging employer provision of pensions.

## **Q10. What should an equivalent solvency regime for pension funds look like?**

The UK supports the objectives of Solvency II for insurers. However, the application of a similar solvency regime for pension funds would raise funding requirements beyond those needed for financial stability and member security purposes. This would significantly raise the costs of Defined Benefit schemes to sponsoring employers, potentially reducing benefits for members of such schemes.

There are fundamental differences between occupational pension schemes and insurance products. For instance, UK law requires pension schemes to have a statutory funding objective so that assets cover a prudent, risk-sensitive assessment of technical provisions. If the valuation is inappropriate, the Regulator has powers to intervene and bring about a timely resolution. In addition, the employer covenant legally enforces the sponsoring employer to increase funding if there are unexpected shortfalls and in the event of insolvency where the scheme has insufficient assets to cover liabilities, the Pension Protection Fund provides compensation for members.

Capital requirements should reflect the nature of the risks for pension schemes relative to Member States' regulatory and legislative frameworks. While there could be an equivalent level of protection across Member States, a one size fits all approach to calculating capital requirements would not meet the Member State prerogative of ensuring appropriate levels of security without arbitrarily raising capital levels in certain instances. The flexibility in the current system enables Member States to implement the IORP Directive in a way that fits the nature of pension funds in their country, in order to achieve an optimum balance between member protection and adequate provision.

The best starting place in analysing if changes are needed to the rules governing the solvency of pension funds is the IORP Directive but Solvency II may offer some useful principles that could be explored in the areas around governance and disclosure.

## **Q11. Should the protection provided by EU legislation in the case of the insolvency of the pension sponsoring employers be enhanced and if so how?**

The UK supports the principle that scheme members should be protected against employer insolvency, and is committed to protecting their benefits and encouraging high standards in running pension schemes.

Looking at one element in isolation (such as pension guarantee schemes) can give a misleading picture of the overall level of security of member benefits. All elements must be looked at to have full appreciation of pension security.

In the UK, the scheme sponsor has a legal obligation to honour the promises made to members of their Defined Benefit schemes and the Pensions Regulator has significant powers to ensure these obligations are met.

However, where the sponsor is insolvent and the scheme is insufficiently funded to pay the benefits due, there is recourse to the Pension Protection Fund, which pays compensation to members. The PPF paid out £8.75 million in compensation in July 2010. With around £4.5 billion in assets, the fund has successfully weathered the financial crisis without encountering liquidity problems.

For Defined Contributions schemes, which cannot be in deficit, an employer's insolvency should not affect the pension pots. However, the Government will make good any outstanding employer contributions (and recover the sum if possible as a creditor). The FSCS (see Q9) can provide compensation in relation to personal pensions and annuities in the event of a pension provider becoming insolvent.

This is the appropriate method for providing member security in the UK. The UK has accomplished this within the framework of the IORP and Insolvency Directives, and we are happy to share our success in providing solutions to pension protection.

Member States are best placed to determine the appropriate requirements for IORPs located in their territories. Solvency rules at an EU level should ensure that Member States have freedom to act within a minimum framework as is consistent with the principle of subsidiarity.

## **Q12 Is there a case for modernising the current minimum information disclosure requirements for pension products (e.g. in terms of comparability, standardisation and clarity?).**

It is important that consumers receive clear, succinct and well-presented information when they join a pension scheme and thereafter, including at retirement. The UK believes that the current EU framework based on minimum harmonisation is correct for this, allowing Member States to take account of information requirements in national social and labour law and to facilitate the best consumer outcome for a range of products and contexts.

The UK welcomes discussion on how disclosure requirements could be modernised based on careful use of evidence and consumer testing. But there is a limit to the extent to which disclosure for pensions and other retail investment products should, or could, be made comparable. Pensions are specifically designed to provide a retirement income and should not be seen as substitutable for other financial products, and comparability of information should not be pursued at the expense of clarity. There needs to be careful analysis and impact assessment before any of the key information developed for other products is read across into the pensions arena.

The UK recognises that high quality information depends on the active scrutiny and enforcement of disclosure requirements. High quality can also be encouraged by other initiatives, such as the “Pension Quality Mark”, awarded by the UK National Association of Pension Funds to employers whose DC pension meets three tests, including a good communications strategy that provides clear information to new and current members.

Improving citizens’ financial literacy and ability to take personal responsibility for their future financial provision is a long term proposition. With this in mind, the UK has recently set up the Consumer Financial Education Body to help consumers understand financial services and better manage their finances, through the provision of free, impartial information, education and guidance to all consumers. The UK is happy to share its experiences in this area.

## **Q13. Should the EU develop a common approach for default options about participation and investment choice?**

Default funds have an important role to play as member inertia means a large proportion of Defined Contribution scheme members end up in the default fund. Default funds should therefore be created with a focus on delivering good member outcomes, and there should be robust processes for their design, review and promotion.

The UK does recognise that there is a need for more information on default options for investments and has considered this when implementing the new “auto-enrolment” reforms which will ensure that, beginning in 2012, employees should be automatically enrolled into a pension scheme. This will result in up to 8 million more people saving for their retirement many of whom will be placed in the default option for their investment choices.

The UK is happy to share its experiences about how to manage this and what sort of investments should be selected for those who do not make their own decision. The UK system uses lifestyling, which places the assets of scheme members in less volatile investments, e.g. Government bonds, as they near retirement. This limits the loss that may occur should there be a financial downturn.

However, there is no one-size-fits all approach to default funds and investment choices as the level of risk appetite of members/policyholders differs and there needs to be flexibility to allow for free choice to enable members to balance the risk and reward within pension schemes. Good member outcomes should be the overarching aim. Member States should be individually responsible for setting a framework to balance risk and rewards, taking into account the nature of their national pension scheme. Overarching legislation from the EU might not be compatible with all types of pension systems across Member States and might have a detrimental affect on investments.

**Q14. Should the policy coordination framework at EU level be strengthened? If so, which elements need strengthening in order to improve the design and implementation of pension policy through an integrated approach? Would the creation of a platform for monitoring all aspects of pension policy in an integrated manner be part of the way forward?**

As the consultation states, there is no “one size fits all” solution. Pension systems are a competence of individual Member States and the Commission should respect the principle of subsidiarity. Given the diversity of national pension systems, the UK believes it would be difficult to create new frameworks without having detrimental effects on pensioners in some Member State. The UK will not support any proposals that have a negative impact on pensioners in the UK or in other Member States.

The implementation of the European Insurance and Occupational Pensions Authority (EIOPA) will strengthen the framework at EU level as it will have the power to act quickly and solve disputes which will be important to prevent pensions being affected by future financial downturns. However, the UK expects that any binding regulations coming out of EIOPA or any part of the Commission to be subject to rigorous impact assessments. Any costs of additional reporting must be included in the assessment as occupational pensions are there to provide benefits to their members and not data to third parties.

The best way of creating a coordinated framework to support Member States is through the Open Method of Coordination for sharing information and good practice. The UK has extensive experience of pension reforms and we are keen to share this with the Commission and other Member States. We believe that other Member States, including the UK, can learn a lot from each other and this is the way in which frameworks should be strengthened rather than through further policies, regulations or legislation. However, there is scope for closer work within the directorates in the Commission on pensions issues and we welcome the fact that the consultation is a combined effort of the different parts of the Commission with an interest.