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Private pensions for Europe

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There is a large variety of pension systems across EU members. This column argues for more private retirement saving as it is necessary to maintain old-age incomes and as it may also contribute to the stability of markets for government debt. But, it adds, governments should retain important responsibilities to prevent moral hazard due to intragenerational redistribution, to facilitate risk-sharing, and to minimise the agency issues due to financial illiteracy.

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The current EU debt crisis makes more private funding of pensions desirable.

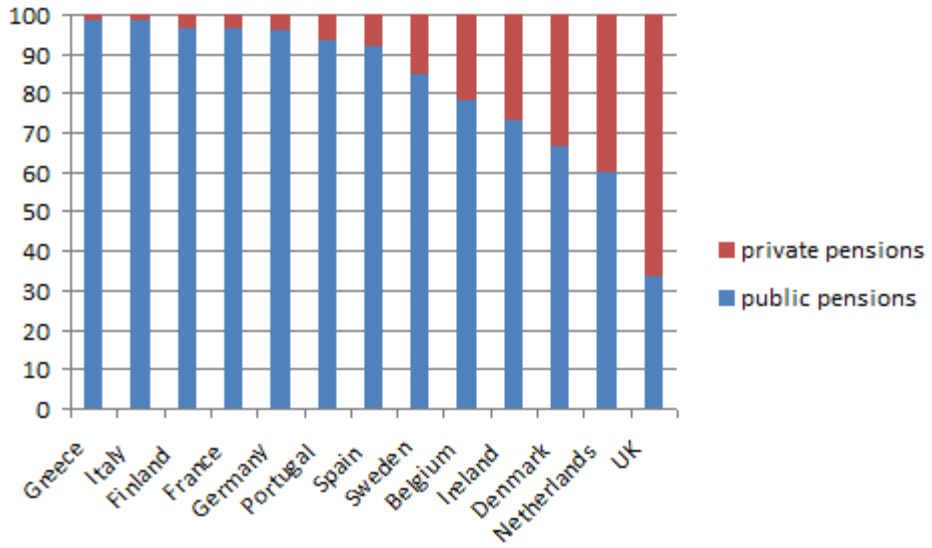
- First, more private retirement saving is necessary to maintain old-age incomes when public pensions are being cut under pressure of the debt crisis.
- Second, private saving in pension funds may also contribute to the stability of markets for government debt.

Diverting risks from banks to pension funds reduces systematic risks in the financial system. Pension funds are better able to deal with macroeconomic risks than banks because pension funds adopt investment strategies with a long time horizon. Moreover, participants cannot withdraw their funds on short notice.

One reason why the current Eurozone crisis has become so serious is that banks are major investors in sovereign debt. Sovereign defaults would cause a banking crisis (see *eg* Wyplosz 2011). Non-European governments typically obtain more funding from unleveraged lenders, which makes the financial system more stable.

There is a large variety of pension systems across EU members, some countries relying almost entirely on pay-as- you-go public pensions (first pillar) whereas others feature substantial funded private pensions (second pillar), see figure 1. These differences have contributed to the diverging performance of EU member states in reaction to the financial shocks in recent years.

Figure 1. Large variety in pension systems among EU members

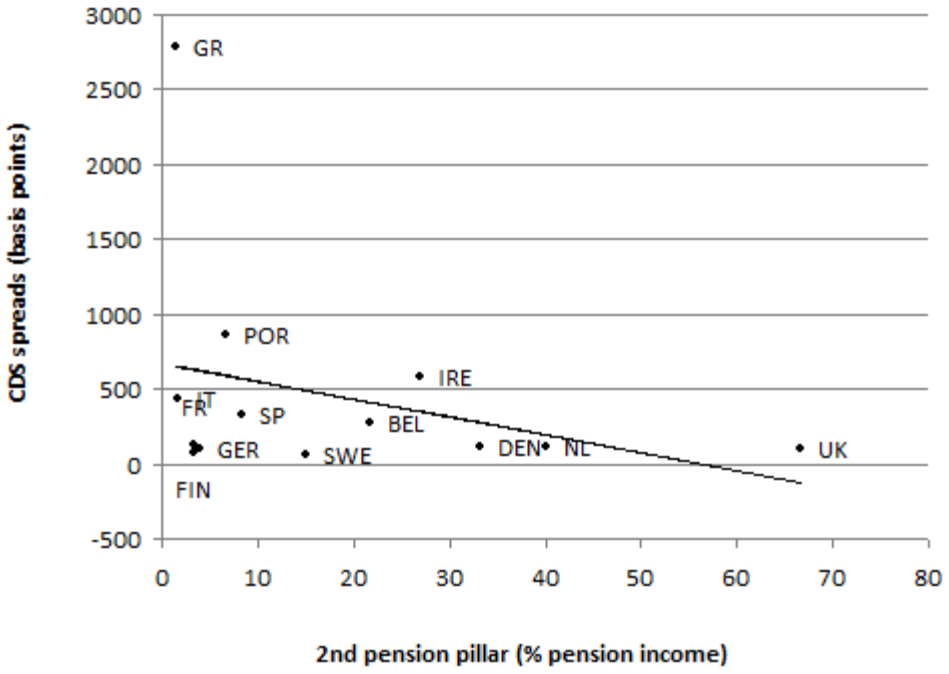


Source: Boeri et al (2006) and CEA (2007)

The quality of domestic risk-sharing institutions is an important reason behind the European debt crisis. Countries with a solid pillar of funded occupational pensions on average are better able to cope with shocks than countries that rely primarily on public pensions, such as the southern European countries, and to a lesser extent Ireland and Belgium.

Figure 2 depicts the default-risk premium on public debt – as measured by the credit-default-swap spread - in relation to the share of private funded pensions in total pensions.

Figure 2. Default risk on public debt vs private share of pensions (October 2011)



Source: Boeri et al *(2006) and CEA (2007)*

A larger role for private pensions helps to diversify risks for citizens. Public pensions nowadays prove to be

less safe than often expected in the past. The current debt crises in southern European countries and Ireland illustrate the vulnerability of the public finances and hence public retirement benefits to shocks affecting the domestic economy. One may in fact view pay-as-you-go pension schemes as a claim of citizens on future provisions by their national government. This leaves citizens heavily exposed to the credit risk of their own governments. With funded private pensions, credit risks can be diversified. Just as the European banking system becomes more robust if banks diversify their holdings of public debt over various countries, so do European pension systems become safer if pension promises are backed by financial instruments of various countries rather than by a single country only.

By stimulating private funding of pensions and limiting the scope of pay-as-you-go arrangements, member states of the EU help create a deeper, more integrated European capital market. Hence, pension savers can finance investments in other EU countries and can enhance their retirement security by better diversifying country-specific and firm-specific risks. The creation of more scope for international risk-sharing within Europe enhances financial stability and the growth potential of the European economy.

In organising private pensions one should avoid the mistakes of traditional, ill-designed defined-contribution systems as well as unsustainable defined-benefits systems, which exposed participants to the specific risks of the firm they work for. Mutual, stand-alone pension funds could offer optimal pension schemes to their participants. They back their obligations with financial assets and do not rely on sponsoring companies to guarantee pensions. Hence, participants are not exposed to credit risk of their own firm.

A good pension is a risky pension. Risk-taking is optimal for the economy as a whole because risk-taking contributes to innovation and economic growth. Risk-taking is optimal also for individuals because it yields higher expected returns. Pension funds should therefore embrace risk by exploiting the tradeoff between return and risk and share risks among participants. Efficient risk-sharing implies that shocks should be spread out over as many investors as possible, including the elderly generations who own most financial capital. Hence, EU regulation of financial markets should not prevent pension funds from exploiting the risk premia on financial markets, but rather should mandate funds to communicate to individual participants the risks that result from their investment policies and risk-sharing mechanisms. Indeed, the investment perspective rather than the insurance perspective should be the dominant perspective in government supervision of pension funds. The supervision of pension funds and related EU regulations should therefore not be modelled on that of insurance companies providing guarantees.

Policy conclusions

In the presence of more private pension provision, governments retain important responsibilities. To prevent moral hazard due to intragenerational redistribution, governments should mandate individuals to participate in funded pension saving plans. Mandatory or semi-mandatory participation in specific pension plans can give private plans sufficient scale. Moreover, governments can facilitate risk-sharing in private pension funds by providing tradable financial assets such as GDP bonds and longevity bonds. By buying these public securities to match their liabilities, private pension providers do not have to hold substantial solvency buffers. Moreover, participants can hold individual accounts with transparent property rights that can be valued on the basis of objective market prices.

Financial illiteracy combined with the nature of the pension products as an experience good give rise to serious agency issues. Collective standalone pension funds can play an important role as trusted partners facilitating intergenerational risk-sharing. The scale and type of collectives may vary, depending on the institutional setting and preferences of each specific European country. The welfare effect of more individual choice raising competition on costs is ambiguous and depends on the specific institutions.

Hence, the EU should resist imposing free competition and unlimited individual choice in the market for pensions in order to not block the emergence of collective standalone pension funds.

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