Money and Pension Panel

Basic pension

The default option for labour-market pensions

Summary of the report from the Committee of the Money and Pension Panel on pensions

February 2013

The Money and Pension Panel has set up a committee to answer the following question:

> *How should a generic pension and life-assurance product be designed if it is to sustain the purchasing power of the members, ensure relevant insurance cover to members in different life situations, and be suitable for members who do not want to spend much time on pension choices, but who want a transparent product which "takes care of itself"?*

The terms of reference of the Committee asks how a default option for mandatory labour-market pensions can be designed so as to ensure a reasonable pension scheme including essential insurance elements.

The Committee comprises the following people:

Torben M. Andersen, Chairman, Professor, Aarhus University
Torben Möger Pedersen, Managing Director, PensionDanmark
Cristina Lage, Managing Director, Unipension
Peter Melchior, Executive Director, PKA
Lars Rohde, Managing Director, ATP, (Arbejdsmarkedets Tillægspension)

This publication is a revised summary of the report "Basic Pension" which can be found on the website of the Money and Pension Panel www.ppp.dk

Pensions – a vital welfare task

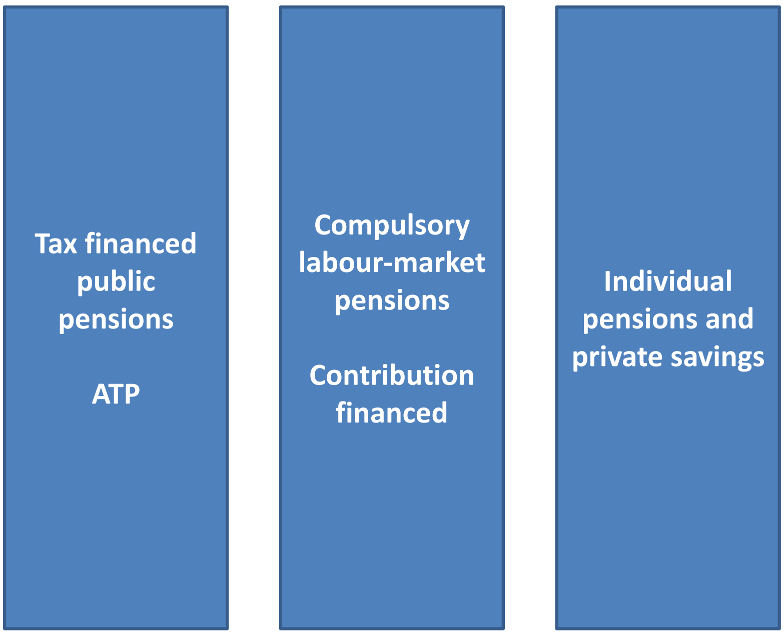
Ensuring reasonable pensions for elderly citizens is a vital welfare task. Therefore, welfare societies are often assessed on the basis of conditions for elderly citizens.

A reasonable pension system meets several requirements. It ensures that all elderly people, regardless of labour-market history or other conditions are, as a minimum, able to maintain a decent standard of living in their old age. It also ensures that retirement from the labour market is not associated with a significant drop in living standards. Therefore, pensions must be reasonable in relation to income during working life.

The Danish pension system

The Danish pension system rests on a division of responsibilities between the public sector and the private sector.

The three pillars of the Danish pension system



The welfare society ensures a pension - the public pension plus supplements - for all citizens. This right to a pension applies throughout life, and the size of the pension depends on income and financial circumstances. Public pensions are financed through taxes. Furthermore, the welfare society provides health services and elderly care for citizens.

Labour-market pensions are based on voluntary agreements between the social partners, but are compulsory for the individual person. Contributions paid during working life finance insurance cover and form the basis for a pension asset which, including interest, determines the pensions that the pension funds can offer to their members.

Moreover, the individual person can save more for his/her pension, either in tax-privileged pension schemes or through voluntary savings.

Therefore, in the division of responsibilities in the Danish pension system, the public pensions meet the goals of the welfare society to ensure a certain standard of living for all elderly citizens. The main task of labour-market pensions is to ensure that the pension is reasonable in relation to a member’s earnings prior to retirement. Private savings enable individuals to secure themselves even more as pensioners.

At the same time, everyone is ensured access to a public healthcare system, which is financed through taxes and in which everyone has the same rights. Elderly care is also part of welfare-society programmes.

Pension systems under transformation

However, the conditions for pensions are under transformation. The elderly population is increasing, and the average Dane is living longer. At the same time, the expected return on the pension savings is currently low; a situation that may continue for a number of years.

Statutory ages are rising for early retirement and public pensions, and the early retirement period is being reduced in order to ensure the economic basis of the welfare society, and in future these statutory ages will follow the developments in life expectancy. These changes are currently being implemented.

Labour-market pensions are also still maturing. Many pension funds are relatively young, new groups have been included and contribution rates have been increased. This means that it will take decades before pensioners can retire from the labour market after having paid to a labour-market pension with the current contribution rates throughout an entire working life.

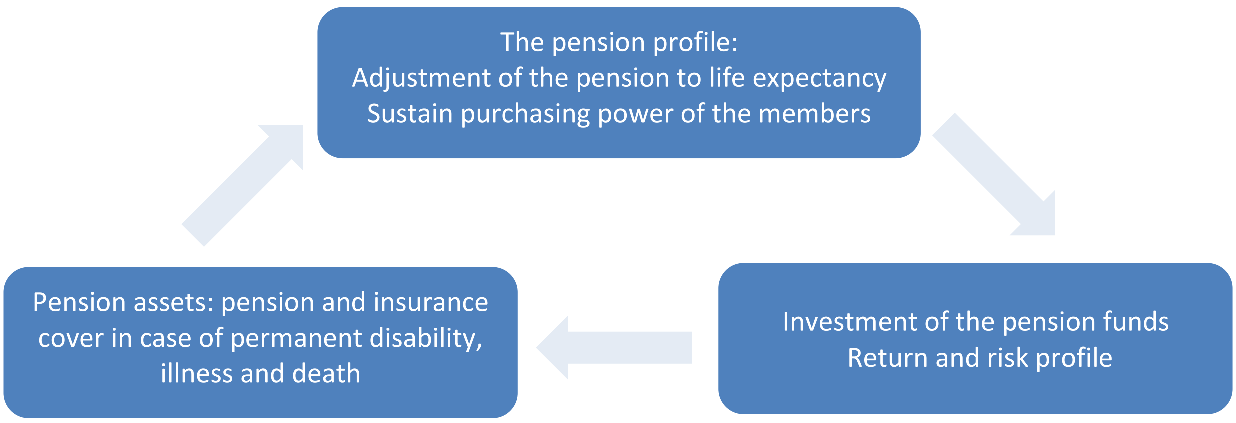
The welfare society has a strong interest in ensuring that everyone is secured appropriately in their old age. Contrary to other social events such as illness and loss of ability to work, old age can be predicted. Therefore, pensions can also be prepared and planned, for example through savings. This is the main argument for labour-market pensions, and the reason they are compulsory for the individual person. They ensure that large groups of people save up for their pension. Savings help secure individuals, and help relieve public finances. Both of these benefits help achieve the goals of the welfare society, and ensure its financial foundation.

Simple requirements - difficult to meet

The objective of pension schemes is simple; basically to secure a reasonable living standard for when retired. Achieving this involves many choices and decisions, and therefore it is not an easy task. There is also great uncertainty linked to pension savings and needs. How long will you live, and will you remain in good health? What will the return on your pension assets be, and how big is the uncertainty? What will be the purchasing power of your future pension?

Thus, investment of pension savings as well as payment of pension benefits raises further questions: How should the funds be invested? What risks should be taken in order to receive a higher return? How should the pension be paid? A fixed amount every year? Should it be indexed? How much should be allocated for insurance cover such as death or loss of ability to work? Which contingencies should such insurance cover? How should the level of service, and the administration expenses be determined? The questions are many and involve many decisions and require specific knowledge.

Many dimensions in decision-making by a pension fund



The pension paradox

In a welfare society, we all assume that we can look forward to acceptable conditions in old age. Perhaps this is the main reason that very few people are interested in decisions regarding their pension. This could almost be described as a pension paradox. We all have high requirements and great expectations to a reasonable and acceptable pension, and yet, unless we are actually about to retire, we rarely pay any interest in pension matters, let alone in the many technicalities and details.

Box 1: Little interest in decisions regarding pensions

- 49% have no interest in the information they receive from their pensions provider
- 47% say that the information they receive from their pensions provider means nothing to them
- 39% say that information about pensions is unimportant
- 35% say that the information from their pensions provider is irrelevant.

Other studies show that Danes spend very little time on decisions regarding their pension, they do not have an overview of their pension savings, and they do not make use of the options many pension schemes offer their members.

Very few members make use of the options offered by some pension funds, for example in connection with investment decisions.

The above is based on a questionnaire survey carried out by the Money and Pension Panel.

It is important to improve the knowledge and information base, so that members who want to engage in pension matters can do so. Transparency in the work of pension funds is also crucial for management to be assessed on their ability to satisfy the interests of the members.

However, it is not realistic, and not necessarily desirable that all citizens become engaged and well informed about specific decisions regarding their pension. This creates special responsibilities for the management of pension funds to offer a reasonable, automatic solution for the members who do not want to play an active role in decisions regarding their pension.

Basic pension

Labour-market pensions have special responsibilities. They are compulsory for the individual member. Therefore, it is important that the pension product provide a reasonable coverage for the members who do not want to engage in choices and decisions. A basic pension should be the default option which most members can rely on to provide them with a reasonable pension scheme. The basic pension should be easy to understand for the individual member, and only require a minimum of active decisions. Members who are not interested in engaging in decisions regarding their pension must be confident that they are reasonably covered by their pension scheme.

It is not possible to construct a labour-market-pension system which relieves members from making any decisions at all. As a minimum, the individual member must decide when he/she will retire from the labour market. However, it is possible to offer a basic pension that does not demand great involvement and many choices for the individual member.

The basic principles for a basic pension for labour-market pensions:

- **Comprehensibility:** It must be easy for the individual member to understand the pension and insurance cover he/she has, and the information provided must be easily accessible.

- **Investment policy:** Is determined by the pension fund, aiming to ensure high returns balanced against the risk profile linked to the age of the member as well as the predictability of the future pensioner's purchasing power.

- **Benefits:** The pension benefits should be lifetime benefits (annuities) to ensure pensions cover throughout life.

- **Purchasing power:** The profile for the lifetime benefit should ensure the desired development in the purchasing power of the overall pension. If the policy chosen implicates an uneven distribution of consumption opportunities during retirement, typically with more opportunities in the early retirement years, this must be stated clearly.

- **Insurance cover:** Cover in relation to disability, illness and death should be included in the basic pension, but not to an extent exceeding 20% of contributions.

- **Transparency:** The terms for allocating and paying pensions and insurance cover must be in line with the terms for allocating and paying similar public benefits (for example early retirement and public pensions).

- **Costs:** As the labour-market pensions are compulsory and collective, they should have considerably lower costs than corresponding individual and voluntary schemes.

- **Reporting:** Reporting regarding investment results, insurance cover costs as well as other costs should be understandable for clients.

Part of good management for any pension fund is to examine how the pension product being offered to members reconciles with the principles above. The principles are indicative minimum requirements. Depending on the composition of its members, the individual pension fund may have reasons to deviate from these principles, but these should be fully explained and justified.

Labour-market pensions in a societal perspective

Labour-market pensions must primarily satisfy the interests of the individual member, but they should also take into account the social implications of the labour-market pensions. Public and labour-market pensions are mutually interconnected. Members of pension funds are also interested in maintaining the schemes provided by the welfare society.

Therefore the labour-market pension funds have a social responsibility to underpin political goals linked to pensions, such as lifetime cover, active labour market participation, and later retirement in line with increasing life expectancy. For larger changes in the terms for pensions, the parties to the agreement and the pension funds should therefore also incorporate the consequences for society and the possibilities to maintain the public schemes, although taking into account that, on behalf of their members, funds always seek to optimise their schemes in relation to the relevant regulations on public benefits etc.

An important societal balance-point is to ensure reasonable pensions and well developed welfare programmes for all the elderly at the same time as encouraging later retirement from the labour market. The social consequences of later retirement are significantly more important than the consequences for private finances, and therefore later retirement in line with increased life expectancy is extremely important in securing the economic basis for the welfare society. This has also been a central element in recent years' reforms.

The 2006 Welfare Agreement and the 2011 Retirement Agreement imply an increase in statutory ages for early retirement and public pensions. The early-retirement period is reduced, and in the long term, statutory ages will be indexed in relation to life expectancy. This will reduce the "window for early retirement via public schemes" and make it less attractive and accessible. In the longer term, these reforms will affect retirement patterns and labour-market participation by the elderly is expected to increase. When the statutory retirement ages are increased in this way, it may, however, give a need for more flexible types of retirement and possibilities to combine pension and work, including possibilities for part payment of pensions. To a large extent, these possibilities involve labour-market pensions.

The Committee has the following general recommendations for the design of the labour-market pensions:

- **Incentives:** When establishing products and services in the labour-market pensions, it should be ensured that coverage does not result in an inappropriate incentives structure in relation to retaining people in the labour market. It is especially important to avoid negative incentives by setting coverage for loss of ability to work, for example, at such a level that the public disability pension and supplementary disability pension from the pension scheme remove the incentive to take part in rehabilitation/job tests and schemes with less demanding jobs on special conditions.

- **Interaction between benefits:** Both savings and insurance products and services should be designed in relation to the public benefits, such as public pensions and disability pensions as well as ATP (*Arbejdsmarkedets Tillægspension)*. This will give members of labour-market pension funds a balance between the tax-funded welfare schemes and labour-market pensions based on savings, and it will ensure that pension schemes underpin high job mobility and later retirement etc. Assessments of ability to work should therefore take a broad approach across skills and sectors, while preventive measures and initiatives to strengthen ability to work should have high priority in relation to more passive benefits.

- **Mobility:** Labour-market pensions should support job mobility in the labour market. This involves:

  - Excluding admission requirements for health information and waiting periods so that, even when they are older, wage earners can change job (and thus also pension fund) without risking losing insurance cover.

  - Products and levels of cover should be constructed on the basis of job mobility within the respective sectors/work functions as well as average pay levels (and the spread in these). This should ensure appropriate levels of insurance cover (in combination with the public basic benefits) in relation to the possible earnings of members in work. It is especially important to avoid negative incentives by setting coverage for loss of ability to work, for example, at such a level that the public disability pension and supplementary disability pension from the pension scheme together remove the incentive to take part in rehabilitation/job tests and schemes with light jobs on special conditions.

  - Regulations relating to transfer of pension assets between funds should support job mobility by ensuring that, for all types of products, the market value of the liability is transferred in connection with a job change.

  - The pension funds should actively advise their members on the possibilities to take their savings with them when a change of job involves changing pension fund. Transfer of pension savings when changing job should be without charges or other costs.

- **Guarantees:** Recent years' developments in the financial markets have illustrated the challenges in having guarantees which are difficult to hedge on the financial markets. Given the forthcoming solvency regulations, it will be crucial that new average interest-rate products with some type of nominal guarantee can be hedged suitably using common financial instruments. The alternative is market-interest-rate-based life-cycle products in which the risk is reduced towards retirement age, with smoothed payments in retirement based on relevant interest-rate curves and market conditions.

- **Adaptation:** Products from the labour-market pension funds (both insurance and savings products) should constantly be adapted to changes in public regulations.

- **Costs:** As labour-market pensions, and the majority of company schemes in the commercial pensions market, are compulsory for the individual member, the pension funds should design their products and services so that, after taking into account the differences in services, the administration costs of the labour-market pension schemes are kept at a low level (and at all events significantly under what is observed in companies with acquisition costs).

- **Options:** If a member wants to acquire more information about his or her pension scheme and actively make choices, the pension companies should offer a limited number of well thought out choices, for example in relation to risk cover and savings, so that members can adjust their pension scheme to their own needs, family situation etc. Pricing of these options should reflect the costs of making the choices and the extra risk assumed by the pension companies.

Political framework

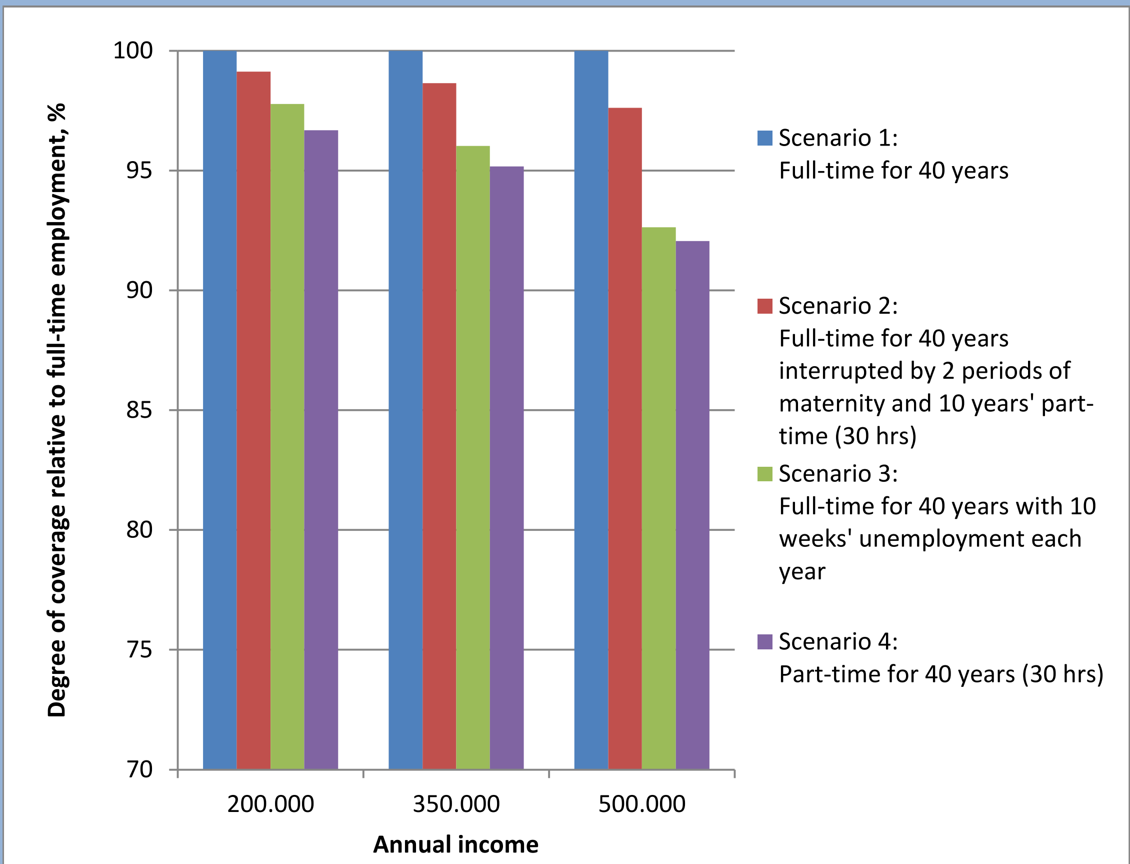
Politicians are responsible for ensuring that all elderly people have reasonable consumption opportunities. This is done through an interplay between the public pensions and the compulsory labour-market pensions. Because of income and asset dependency, public pensions are targeted at the economically weakest pensioners. Despite the structure of labour-market pensions, a residual group remains; the pension-related residual group without pension-scheme cover.

For large income groups, targeting public pensions means that variations in the employment rate (and thus pension contributions), income and return etc. have relatively little effect on the overall pension, see Box 2 below. The lower private pension is counteracted by a higher public pension and vice versa. This is part of the redistribution through the public pensions, and thereby creates an insurance function for the individual person. However, this also means that the incentives to work more (later retirement), or to save more, are very modest, as the majority of the gain is counterbalanced by a smaller public pension. More targeted public pensions will exacerbate this problem.

Box 2: The interplay between public pensions and labour-market pensions

Variation in labour-market participation due to maternity leave, unemployment or part-time employment means lower contributions to labour-market pensions compared to full-time employment throughout a working life. Lower contributions result in a lower labour-market pension. The effect of lower labour-market pension is counteracted for the individual person since the public pensions, supplements to pensions and special pension benefits *(ældrechecken)* are dependent on income and assets. The figure below shows the degree of coverage for different income groups, depending on labour-market participation over a 40-year period, relative to full-time employment. Degree of coverage includes public pensions and labour-market pension. As stated above, interruptions in pension savings only have a minor effect on the total degree of coverage; the effect is smaller the lower the annual income. The public pension therefore provides the individual member with an insurance in relation to interruptions in employment. This also applies in relation to variations in the labour-market pension due to changes in returns or contribution rates. However, this also causes an incentive problem. The interplay between the two pension systems means a reduced pension gain by working more (for example later retirement) or by saving more.

The degree of coverage of the pension depending on employment during lifetime



Increasing the average age of retirement is a political goal. However, the consequences of changing the age of retirement may be difficult to comprehend for the individual member. The interplay between rules for early retirement, public pension, postponed pension and tax regulation is difficult to comprehend, even for experts. Therefore, there is no clear signal for the individual person which underpins the political objectives.

The overall framework for the Danish pension system is relatively clear, and the Welfare Agreement and Retirement Reform secure a significant robustness in coping with changes in demographics and in particular with increases in average life expectancy. The long-term economic viability of the system is reasonably assured, even though the budget profile of public finances leaves systematic budget deficits for a period of approximately 30 years after 2020. The reforms in recent years have therefore come a long way in establishing security and credibility for welfare-society programmes and thus the entire pensions system. Therefore there is no need for larger and more extensive reforms of the Danish pension system. However there are some aspects which require initiatives and adjustment:

- **The residual group issue:** Through their savings in labour-market pensions, people with a stable attachment to the labour market will be assured a good supplement to the public pensions. However, there remains a residual group of people without pension savings or with very modest pension savings. These are primarily wage earners outside of collective agreements, people without or with very weak attachment to the labour market, as well as many self employed. It should be noted that the residual group has become smaller in recent years.

- **Compulsory pensions:** Securing a specific level of pension for all is better achieved through a compulsory pension scheme than through more targeted public pensions. A solution to this problem by targeting the public pensions will increase overall marginal taxation and thereby reduce incentives to save and to work. This may also affect support for the labour-market pensions. A compulsory pension scheme ensures that everyone saves up for a pension. The scheme can therefore ensure that everyone who is not covered by a labour-market pension saves up for a certain level of pension.

- **Targeting public benefits:** Recent years' enhancement of pension savings, including in particular the labour-market pensions, means that the incomes of the pensioners of the future will deviate significantly from previous incomes and a rather large group of people will receive a reasonable pension. The public welfare programmes and schemes include a number of special age-related schemes and subsidies. These arise from a time when reaching retirement age was often associated with a significant deterioration in financial circumstances. This situation will be increasingly rare in the future and unlike illness and loss of ability to work, age should not automatically trigger a special subsidy or benefit. Maintaining these schemes will not be targeted in terms of economic distribution policy, and changes should be considered.

- **Financial consequences of later retirement:** There is a political wish to encourage later retirement. The existing schemes, including in particular the interplay between the public pensions, labour-market pensions and the tax system, are complicated and they often leave a modest financial incentive to retire at a later age. There is a need for simpler rules and more transparency, and in the longer term there are issues in an incentives structure which does not comply with the political objective to increase the age of retirement.

- **Tax regulation:**
    - The age limits in tax regulation should be adjusted to the changes in ages for early retirement and public pensions and therefore increase in line with these.
    - Differentiated, effective taxation of all types of savings (different types of voluntary savings (including in housing), labour-market pensions etc.) make the system more complicated and can create unfortunate effects on incentives.

- **Continuity and stability:** The possibilities in the pension system to secure members reasonable pensions depend on continuity and stability in the regulations relevant for pension funds. This also includes the interplay between tax regulation and social benefits. Predictability is a vital factor for the individual, and therefore continuity in policy in this area is important, and notice of any changes should be in good time and there should be a phasing-in period.

- **Ready for change:** Regulation should ensure that the labour-market pension schemes are designed so that they can easily be adjusted to new rules and frameworks in labour-market legislation or in other relevant areas. For example, it should be ensured that the lowest age for receiving a pension is adjusted immediately in line with changes in the qualifying ages for early retirement or a public pension, and that this applies for new as well as existing contracts. This will ensure clarity regarding the overall rules, while the need for transitional schemes, which often undermine the political motives behind legislative changes, will either disappear or be significantly reduced.