

How important are pensions for the CMU?

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1. Pre-funded pension systems are a key driver for constituting pools of capital

Pension systems, beyond providing future revenue for workers during retirement, also play a significant role in the funding of the economy, particularly when they are pre-funded.

There is indeed strong evidence that pre-funded pension systems (pillar II and III asset-backed pension schemes and pre-funded components of the pillar I system¹) are a strong determinant of the development of capital markets, which are essential for funding growth and innovation. This is due to a combination of supply side and demand side factors².

Pre-funded pension systems are indeed providers of significant sources of long-term capital that are mostly invested in the capital markets to achieve sufficient returns. Unlike pay-as-you-go (PAYG) systems used in particular for pillar I public statutory pensions, where contributions from the working age individuals pay for the benefits of current retirees, which means they do not have any disposable assets to invest (except for a limited reserve fund in some cases), pre-funded schemes work on an asset accumulation basis.

In addition, their long-term perspective reduces the sensitivity of savers to short-term volatility, which may facilitate the funding of more innovative and growing companies. In turn, larger and deeper capital markets supported by pension savings provide citizens with opportunities for higher long-term returns, encouraging more retail investment. Regular investments in the capital markets via the pension system also contribute to developing investor culture and experience among the

population that may further contribute to retail engagement in the capital markets and also smooth out investors' investments, thereby reducing their investment risks.

Literature shows that pre-funded pension systems such as pension funds can also have a positive qualitative impact in terms of corporate governance, given their size and long-term perspective, and may also foster the modernisation and efficiency of capital markets. A further element is that asset pools supported by pre-funded pension systems, such as mandatory or quasi-mandatory (with opt-out options) pillar II occupational pensions, can accumulate capital quite rapidly, as shown by IORP (institutions for occupational retirement provision) statistics³.

2. Market statistics show a connection between pension assets and capital market activity

Market statistics tend to confirm that a connection exists between the size of capital markets and the volume of pension assets.

For most countries there is indeed a correlation between the volume of pension assets in pre-funded pension systems as % of GDP (pillar II and III) and market capitalisation as % of GDP⁴.

Practically all countries with high levels of pension assets have large market caps⁵ and the countries with the largest market caps tend to be those with the highest volumes of pension assets⁶. There are however some exceptions such as Japan and France that have relatively high market caps with fairly

1. See Eurofi note from the February 2024 Regulatory Update for further detail on EU pension systems and EU competencies in this area – Pensions in the EU: challenges, EU competencies and on-going reforms.

2. Existing literature shows that supply factors, including the presence of strong asset-backed pension systems, as well as the legal system, market liquidity and shareholder protection, play a stronger role in the development of capital markets than the demand for capital market products, which may be obtained by measures aiming to develop retail investment. See: Pension funding and capital market development T. Niggermann and J. Rocholl August 2010.

3. The assets of EU IORP pillar II schemes grew by about 9% between 2020 and 2021 in the EU countries where IORP schemes were available and significant growth in the assets managed by IORPs has been observed in the last few years in the countries where they are offered.

4. These statistics may also illustrate a higher home bias of investments in countries with a higher level of pension assets, although a more detailed analysis would be needed, since pension funds tend to invest in a geographically diversified range of assets and that listed companies have diverse investors as well.

5. Except Iceland which is among the countries with the highest level of pension assets (200%) but only has limited market cap as % of GDP (63%).

6. Some studies also show that there is a negative relation between the size of the stock market and the proportion of GDP devoted to unfunded PAYG public pensions. See: Pension funding and capital market development T. Niggermann and J. Rocholl August 2010.

limited pension assets, which shows that other factors need considering such as the size and competitiveness of listed companies, the maturity of the stock market, the volume of issuances, the role of foreign investors, etc...

Countries with the highest levels of pension assets also tend to be those where households hold the highest proportion of financial assets as a % of GDP (i.e. financial assets invested in capital market instruments, excluding cash, deposits and unlisted equity)⁷.

Country (% GDP)	Market cap	Pension assets	Household financial assets
US	190% (*)	138%	310%
Canada	135%	153%	
Australia	100%	131%	
UK	91%	85%	180%
Japan	126%	30%	
EU average	54% (*)	29%	90%
Sweden	155%	100%	165%
Denmark	150%	192%	187%
NL	136%	151%	174%
France	134%	11%	100%
Germany	45%	7%	100%
Italy	32%	11%	105%

In % of GDP. Figures are from 2022 except (*) from 2020

Sources: CEIC database for market cap, OECD Pension markets in focus 2023 for pension assets and AFME CMU key performance indicators November 2023 for household financial assets

In term of assets, bonds and equities represent more than 70% of the investments of pre-funded pension systems at the OECD level, with equities representing 30 to 40% of assets in most of the countries where pension assets as % of GDP are highest⁸. EU IORPs also invest on average 75% of their assets in bonds and equities (about 45% in corporate and government bonds and 30% in equities), when considering both the amounts invested directly and via investment funds, the rest being invested in money markets, real estate and alternative assets⁹. The split between equities and

bonds depends on regulatory investment requirements in some cases and also the attitude towards risk of savers and the managers of the pension assets¹⁰.

The Swedish pension system is often cited as an example in Europe where an adequate balance between PAYG and pre-funded mechanisms has contributed to the development of a vibrant equity ecosystem and to a strengthening of equity culture. PAYG is the main component of the pillar I pension system, but it is completed by a mandatory pre-funded premium pension system with a default option managed by the AP7 fund¹¹ that exclusively invests in equity until savers reach the age of 55 and then the proportion of equity is gradually reduced to reach 33% at the age of 75. This premium system is financed by a mandatory contribution rate of 2.5% of pensionable earnings, completing the 16% of annual pensionable income that finance the PAYG system¹².

3. Further leveraging the role of pension savings in the CMU

3.1 Actions proposed in the context of the September 2020 CMU action plan

This interplay between pension savings and capital markets is recognised in the Capital Markets Union (CMU) initiative. Supporting people in their retirement is indeed one of the actions of the September 2020 CMU action plan set out by the European Commission as part of the objective to increase the level of retail investor participation in capital markets.

Actions aiming at identifying best practices that may be developed at EU level have been launched by the Commission in three main areas: auto-enrolment (mechanisms that enrol individuals automatically in a supplementary pension scheme), pension dashboards (dashboards that facilitate the monitoring by policy-makers of pension adequacy) and pension tracking systems (online

7. The high saving rate in the EU (calculated as gross saving divided by gross disposable income) compared to the US (around 14% in the EU in 2023 up from 12% before 2019 compared to about 4.5% in the US) shows the significant potential that exists for the increase of investment in financial assets in the EU. The lower rate of saving in the US may be accentuated by the fact that a significant proportion of savings in the US are invested in mandatory retirement plans such as 401 (k) which represent up to 10 to 14% of disposable income, when considering employee and employer 401(k) contributions, part of which may not be taken into account in the evaluation of gross savings. Source Fidelity Q2 2023 retirement analysis, Eurostat indicators 5 October 2023.

8. Source: OECD Pension markets in focus 2023 for pension assets.

9. Source EIOPA How do IORPs invest 2023 (figures from Q4 2022).

10. Asset-backed pension systems also tend to diversify their investments geographically, particularly for equity investments, in order to maximize returns and reduce investment risks. The data on IORPs shows that while US markets represent about 45% of the equity investments of EU IORPs, they mostly invest in EU debt instruments. Source EIOPA How do IORPs invest 2023 (figures from Q4 2022).

11. Alternatively savers can choose to invest directly in a range of funds.

12. Most employees in Sweden are also covered by semi-mandatory occupational pension schemes based on collective agreements between the unions and employer confederations which invest in a diversified portfolio comprising equities, bonds and real estate. Different options are also available for pillar III including the investment savings account (ISK) that facilitates investments in financial instruments with simplified tax returns in particular. Source Regeringskansliet The Swedish pension system.

systems that allow citizens to benefit from a consolidated overview of their pension entitlements). A study on auto-enrolment best practices was published by the Commission in November 2021 and EIOPA provided technical advice at the end of 2021 on how pension dashboards and pension tracking systems may be implemented.

Other measures of the CMU action plan could also help to tackle the pension savings gap. These actions include the Retail Investment Strategy (RIS) proposal, which sets out measures in different areas to increase retail participation in the capital markets and is currently under review at Parliament and Council levels. The Commission proposal includes measures aiming to improve the value for money of investment products and enhance financial literacy and product disclosures, as well as reviews of MiFID and IDD to limit the use of inducements to cases where they are considered to enhance the quality of service, and extend these measures to insurance-based investment products with an alignment of MiFID and IDD in this area. The measures related to inducements and value-for-money are among the most debated ones in Parliament and Council, so the outcome of the approaches of the co-legislators is still uncertain at the time this note is written. A further issue to consider is that some personal pension products may not be covered by the RIS (e.g. products that do not come under MiFID and IDD rules) and that some types of private pension providers may fall outside the scope of EU regulation¹³. A review of the ELTIF framework has moreover been adopted, which should contribute to enhancing the attractiveness of ELTIF long term investment funds for retail investors in particular.

3.2 Future stages of the CMU

The future stages of the CMU and on-going initiatives, such as the work undertaken at the Eurogroup level to propose measures for deepening the CMU should provide fresh opportunities to further assess the role of pre-funded pension products in the development of capital markets and the actions needed to increase this role either at the EU level or at Member State level.

Addressing pension savings gaps requires a combination of supply side actions to improve the

offering of private pension products across the EU and provide appropriate incentives and demand side actions such as those set out in the Retail Investment Strategy¹⁴, to foster more long-term investment in pension-based capital market products.

While pensions are a Member State competence, which means that the EU has no powers to legislate on the design of pension systems or take measures which may affect the fundamental principles or financial equilibrium of national social protection systems, the EU can legislate on matters that affect the functioning of the internal market relatively to pensions. This includes aspects such as worker mobility across the EU, the freedom for private pension providers (pillar II and III) to supply products and services across the EU and consumer protection. Issues such as gender equality and workers' rights to secure equal pension benefits can also be addressed at the EU level.

The pan-European personal pension product (PEPP) framework, which was implemented in 2022 following the proposals of the 2017 CMU action plan was an attempt to provide a voluntary pillar III pension scheme at EU level. The objective was to address worker mobility issues across the EU and complete the current offer of private pensions, particularly in Member States where these schemes are in limited availability.

So far the take-up of PEPPs has been very limited with only one provider in the EU offering these products. Some reasons put forward by product providers for this lack of success include the fee cap and the challenges of implementing capital protection and risk-mitigation techniques for the Basic PEPP default option¹⁵, and also the problems posed by the disparity of national tax incentives and national authorization obligations that PEPPs are subject to¹⁶. The alleged insufficient added value of the PEPP compared to existing domestic pillar III products, beyond portability, is a further issue. The low interest rate environment was also considered by the private sector to be a disadvantage for the PEPP when it was launched. A review of the fee cap of the Basic PEPP default option is due in 2024. A review of the PEPP Regulation due in 2027 should be an additional opportunity, albeit relatively distant, to identify the conditions for a successful relaunch of the PEPP¹⁷.

13. See Article written by P. Hielkema in Eurofi Views Magazine February 2024 Building on past initiatives to address growing pension gaps.

14. The scope of the RIS may need to be adjusted to ensure that all pension products are captured by the legislation.

15. PEPP products should include a default investment option (the Basic PEPP) with costs capped at 1% of the accumulated capital per annum offering a capital protection that can take the form either of a capital guarantee or of other risk mitigation techniques.

16. See note of the Eurofi Regulatory Update of February 2024 for further detail on the PEPP 'Pensions in the EU: challenges and possible EU actions' and also on the IORP II regime for supplementary pensions.

17. Some commentators have suggested that one aspect to consider for example is the scope of the PEPP regulation, which could be broadened to include occupational pensions, for which there is potentially a greater demand than for pillar III supplementary pensions. See Article written by P. Hielkema in Eurofi Views Magazine February 2024 Building on past initiatives to address growing pension gaps.