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ACTUARIES AND CONSULTANTS

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The Evolving Pension and Investment Landscape in Europe

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The Vision

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graph TD; A[The Vision] --> B[The Reality]; B --> C[The Assumptions]; C --> D[The Future]; D --> E[The Verdict];
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The Reality

The Assumptions

The Future

The Verdict

The Vision

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The Vision

White Paper on Pensions* published on 16 February by the European Commission sets out European vision for pensions:

- ✓ **Adequacy**
- ✓ **Sustainability**
- ✓ **Safety**

This represents a challenging balance since the three goals can pull policy in very different directions.

*“Unless women and men, as they live longer, also **stay longer in employment** and **save more for their retirement**, the adequacy of pensions cannot be guaranteed as the required increase in **expenditure would be unsustainable.**”*



*WHITE PAPER, An Agenda for Adequate, Safe and Sustainable Pensions, 16 February 2012 European Commission

The Vision

ADEQUACY

“...allow people to *maintain*, to a reasonable degree, *living standards* after retirement, in the spirit of solidarity and fairness between and within generations... Broadly speaking, *this has been achieved* across the EU, although important gaps remain.”

2010 Data ¹	27 EU States	Cyprus
Aggregate Replacement Ratio ²	53%	36%
At Risk Poverty Rate for Older People ³	16%	41%
At Risk Poverty Rate for Population ⁴	16%	16%

¹EUROSTAT Data 2010

²Aggregate Replacement Ratio: The indicator is defined as the ratio of the median individual gross pensions of 65-74 age category relative to median individual gross earnings of 50-59 age category, excluding other social benefits

³At risk poverty rate for older people: Share of population aged 65 or over with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income after social transfers

⁴At risk poverty rate for population: The share of persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers)

⁵2012 Ageing Report

SUSTAINABILITY

“Ensure the *financial sustainability of public and private pension schemes*... Pensions represent a very large and rising share of public expenditure.”

Public Expenditure on Pensions % of GDP ⁵	27 EU States	Cyprus
2010	11.3%	7.6%
2060	12.9%	16.4%

The Vision

The Reality

The Assumptions

The Future

The Verdict

The Reality

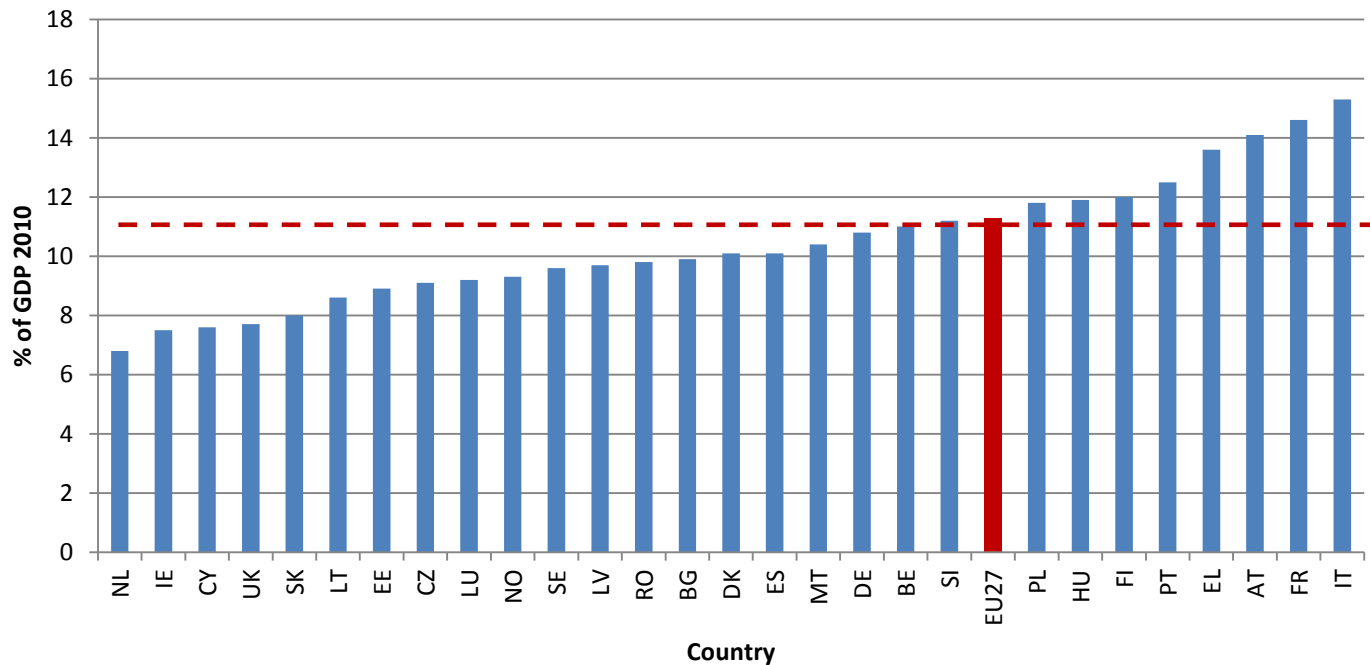
We must recognize the current reality, initiatives and challenges, and evaluate how these will impact the pursuit of the pension vision of sustainability, adequacy and safety.

1. Pension diversity within the European Union
2. Ageing populations
3. Budgetary pressures – short term and long term
4. Pension Reforms

The Reality – Pension Diversity within EU

Diversity within the pension systems of Europe is vast. Pillar II & III are different phases of development in most countries. Benefit parameters and design of public pensions vary widely.

Public Pension Expenditure as % GDP in 2010*



*2012 Ageing Report

The Reality - Ageing



The financial consequences of the ageing of Europe is extensively addressed in the 2012 Ageing Report by the European Commission with detailed projections from 2010 to 2060.

Fertility rates:

Expected to rise slightly. The total fertility rate (TFR) is projected to rise from 1.59 in 2010 to 1.64 by 2030 and further to 1.71 by 2060.

Life expectancy:

Gains are projected In the EU, life expectancy at birth for males is projected to increase by about 8 years from 76.7 in 2010 to 84.6 in 2060. Life expectancy at birth is projected to increase by 6.5 years for females, from 82.5 in 2010 to 89.1 in 2060, implying a slight convergence of life expectancy between males and females.

Net migration to the EU

Decelerating inward immigration for the EU as a whole. Annual net inflows are projected to increase from about 1,043,000 people in 2010 (equivalent to 0.2% of the natural EU population) to 1,332,500 by 2020 and thereafter declining to 945,000 people by 2060.

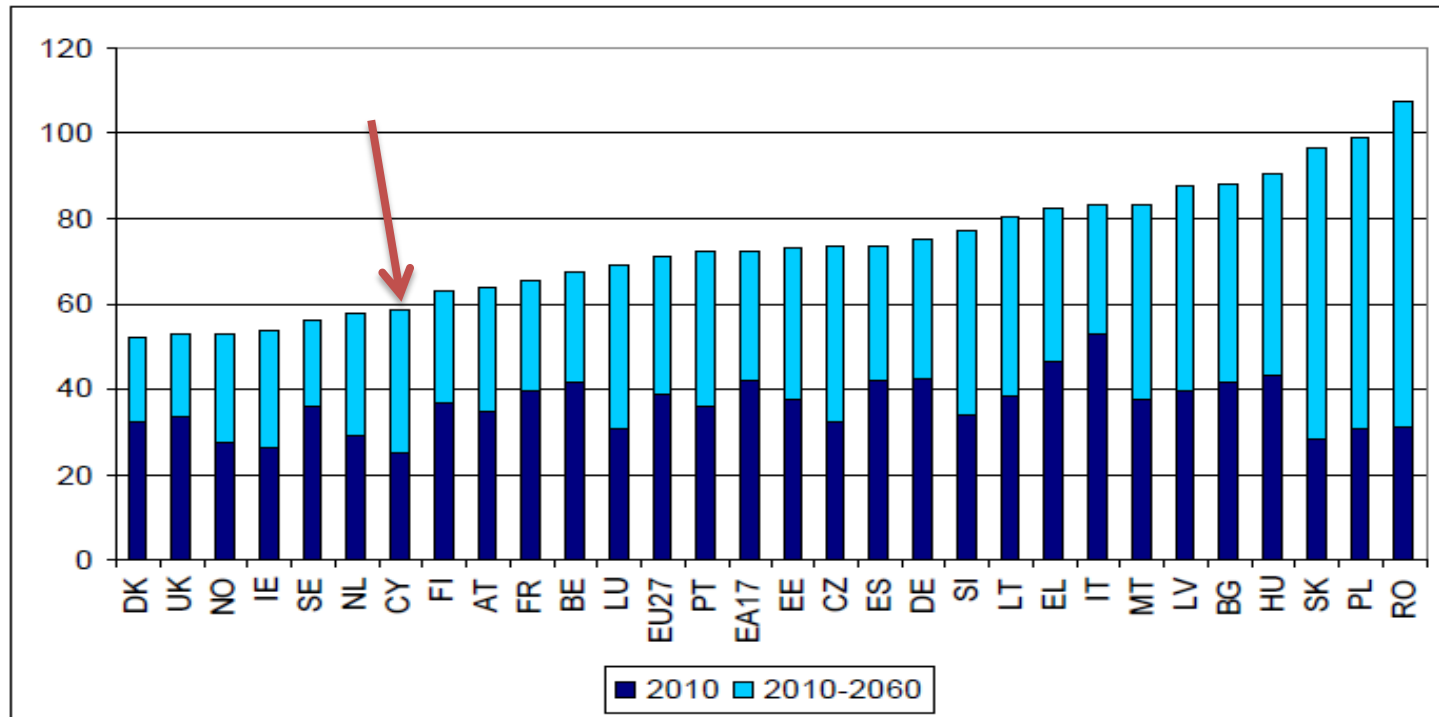
EU population

Projected to increase up to 2040 and decline thereafter. The EU population is projected to increase (from 502 million in 2010) up to 2040 by almost 5%, when it will peak (at 526 million). Thereafter, a steady decline occurs and the population shrinks by nearly 2% by 2060.

The Reality - Ageing

Old-age dependency ratio*

Effective economic old-age dependency ratio is calculated as the ratio between the inactive elderly (65+) and total employment (15-64) and is projected to rise significantly from around 39% in 2010 to 71% in 2060 in the EU27.

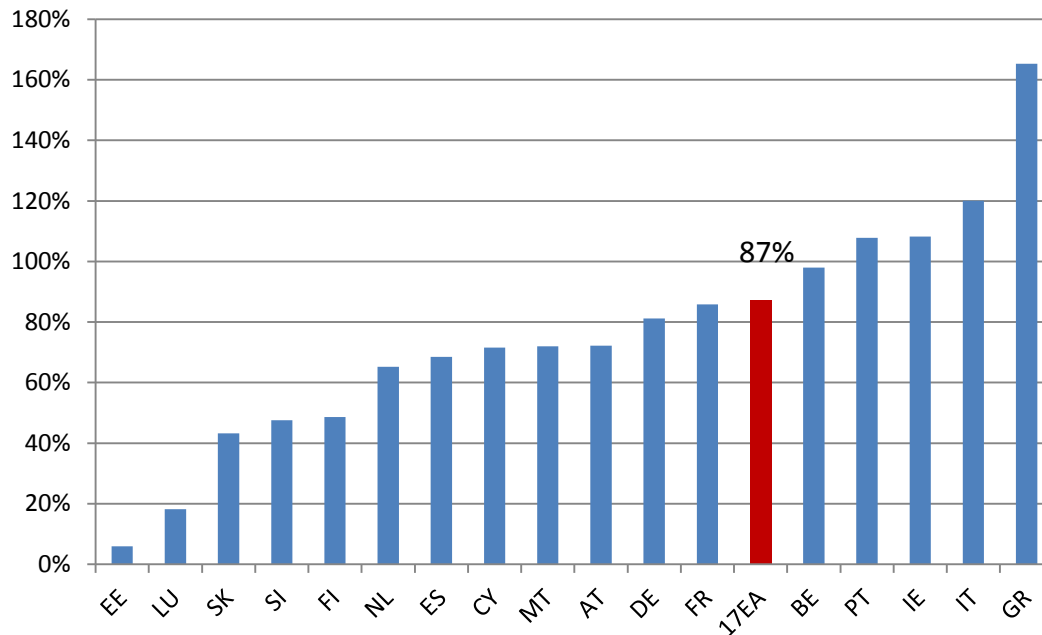


*2012 Ageing Report

The Reality – Budgetary Pressures

“The long-term public expenditure projections reveal a daunting challenge for policy makers in the EU”

Total Public Debt as % GDP for 2011*



- Total public debt in 17 Euro Area for 2011 was 87% of GDP and the primary deficit was 4.1%
- Member States shall avoid excessive government deficits. Compliance with this rule is to be examined on the basis of reference values for the general government deficit (3%) and gross debt (60%) in relation to GDP
- The financial crisis has eroded public finances, triggering additional austerity measures, including deep and far-reaching reforms to public sector pensions in affected countries
- Reverting to Pay (a lot!) As You Go from Take As You Go, creating generational cross-subsidy

*European Central Bank

The Reality – Pension Reforms

“This White Paper presents a comprehensive set of initiatives to be taken at EU level in support of national pension reforms. These address the two main areas for reform recognised in the AGS, i.e. balancing time spent in work and retirement and developing complementary private retirement savings.”

❑ Retirement ages are increasing fast

Increases in retirement ages have been implemented in many EU countries, typically phased in e.g. Greece 65, Germany 67, Denmark 67, UK 68, etc.

These increases have demonstrated improvements in sustainability and adequacy

❑ Public Pension accruals are declining

2012 Ageing Report claims 12% reduction in accrual in EU27 by 2060

Austerity measures have directly targeted levels of public pensions

❑ Review of the IORP Directive

Strengthening second and third pillar provisions

Level the playing field with Solvency II (launch QIS for pensions – outcry from industry)

Portability of pensions

The Vision

The Reality

The Assumptions

The Future

The Verdict

Survival of the Euro Currency

Any country currently using the Euro to announce intention to drop it before midnight ET 31 Dec 2014 at 21 October 2012 closed at 65% (Source: Intrade.com)

Closing prices chart

EURO.DROPPED.2014

Apr 10, 2010 - Oct 21, 2012



Financial Integration of the EU

The financial crisis has given new impetus for the financial integration of the European Union and some significant steps have been taken and are being contemplated. How far will they go?

Europe advances towards single banking supervisor



Eurozone summit: Will EU get veto over national budgets?

Before leaving for the summit, German Chancellor Angela Merkel called for the EU to be given veto power over national budgets. But European leaders remain divided on the idea.



Economic recovery and investment returns

*“The recovery has suffered new setbacks, and **uncertainty weighs heavily on the outlook**. A key reason is that policies in the major advanced economies have not rebuilt confidence in medium-term prospects. Tail risks, such as those relating to the viability of the euro area or major U.S. fiscal policy mistakes, continue to preoccupy investors.”*

*“**Financial stress in the euro area periphery has ratcheted up**. The recession in most of the periphery is increasingly spilling into other economies in the region. The measures agreed to at the June 29, 2012, European Union (EU) summit and the European Central Bank’s (ECB’s) establishment of the Outright Monetary Transactions (OMT) program were steps in the right direction and have improved financial conditions, which nevertheless remain fragile. ”¹*

WORLD ECONOMIC OUTLOOK
October 2012

Coping with High Debt and Sluggish Growth



International Monetary Fund

¹World Economic Outlook October 2012, Coping with High Debt and Sluggish Growth IMF

The Vision

The Reality

The Assumptions

The Future

The Verdict

The Future – Pension Burden Shifting to Pillar II & III

“Complementary retirement savings have to play a greater role in securing the future adequacy of pensions”



- 2012 Ageing Report suggests a decline in public sector pension replacement ratios from 48% in 2010 to 39% in 2060 for the EU27.
- Only 40% of Europeans are currently covered by a supplementary workplace pension scheme, this is a major culture shift and painful for those caught in transition
- There are limits to how far personal savings can subsidize the shift
- Key messages from IMF on Pillar II & III:
 - Households do not save enough for retirement and do not mitigate risks through annuities if not mandated
 - Households are ill-equipped to make investment decisions

There is a grave risk of inadequacy depending on retirement & savings behaviour to recoup losses from public sector schemes

The Future – Dominance of Defined Contribution

“The vast majority of European analysts are anticipating a continued growth in occupational DC schemes in their respective countries and are able to confirm that there is an ongoing shift from DB to DC. In fact, DC is expected to dominate the pension market in most countries in the future.”¹

The main drivers of the trend from DB to DC are:

- Volatility and reduction of pension costs
- Current underfunded status of the DB schemes
- Investment and longevity risk
- Accounting standards



The current economic crisis is accelerating the trend and **defined contribution arrangements are set to dominate Pillar II and III**, and even some Pillar I provision, effectively moving towards FUNDED pension systems.

¹*Defining the Direction of Defined Contribution in Europe: Results of an Expert Survey by Allianz 2009*

The Future – Convergence of Pensions Across EU

Convergence of pension provision within the EU will touch areas of supervision, social security, collective protection vehicles and portability.

SUPERVISION:

One pensions regulator for the European Union (following the Banking Union) with one solvency regime (risk-based system in line with Solvency II principles)

SOCIAL SECURITY:

Following stronger budgeting cooperation, convergence in social and labour laws and the level of contributions and benefits of social security towards reducing poverty culminates in the creation of a Universal European State Pension. Auxiliary pensions may be payable by Member States, depending on development of Pillars II & III.

PROTECTION FUND

A EU-wide Pension Benefit Guarantee Scheme is created to support DB funds, book-reserve arrangements and “excessive losses in DC” plans. (As discussed in the Green Paper on Pensions).

FULL PORTABILITY

EU creates legislation to allow for the creation of a simple, transparent, pan-European DC plan which member states can freely adopt – a framework for a pan-European 401(k) plan.

The Vision

The Reality

The Assumptions

The Future

The Verdict

The Verdict – European Union and Member States

The European Union and Member States are aware of the challenges ahead. Numerous studies, analysis, debates and consultations have been carried out. The financial consequences have been contemplated. It is time to act on the wealth of knowledge and expertise to:

1. Define the social values driving pension and other social benefit reforms , is there a right to social security and at what level?
2. Restore trust and stability to pensions across the EU and recognise implicit obligations
3. Join up discussions about pension reform and budgetary coordination
4. Establish robust, aligned regulatory and supervisory frameworks for Pillars II and III in every Member State that are efficient and tax incentivised (possibly mandatory)
5. Monitor the progress of Pillar II & III performance and coverage and quantify the pensions gap

The Verdict – Private Pension Industry & Individuals

The private pensions industry and individuals are increasingly aware of their role in future pension provision and the financial challenges ahead. The shift to Pillar II and III is happening fast with limited measures to ease the transition. There is an urgent need to:

1. Improve defined contribution pensions

- Leverage all providers (insurance companies)
- Invest better (choice, lifestyle options, guarantees)
- Improve the payout phase (flexibility, annuities, indexation with inflation, income drawdown)
- Better information provision to individuals (already envisaged in White Paper)
- Improve governance

2. Understand and manage pension guarantees

- Be careful what you promise
- Utilize de-risking opportunities

3. Understand and promote the importance of retirement planning

=> **Save more for retirement!**

Thank you!

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