Good Decumulation of Defined Contribution Pension Plans throughout Europe

1. Foreword

Policymakers, employers and those responsible for running pension plans have sought ways of delivering workplace pensions that provide value for money to the members, whilst these do not mean unlimited risks for the sponsoring employers and/or pension providers (e.g. IORPs). Therefore, there has been a continuation in the growth of Defined Contribution (DC) pension plans in Europe. The number of members and beneficiaries of DC plans is increasing with more and more members reaching the decumulation phase and, with that, the first DC plans of significant scale are reaching maturity. This has resulted in individuals becoming more responsible for their pension provision as employers have typically a more diminished role than in traditional Defined Benefit pension plans.

The final phase of the pension plan, the decumulation or pay-out phase, is the most crucial to the individual participant. This often determines how they can live when they have little or no other source of regular income. As it is the final stage of the process, it sometimes doesn't get sufficient attention at the design or policy making stage. This paper looks at some of the issues in achieving Good Decumulation of Defined Contribution Plans throughout Europe.

The paper continues the series of PensionsEurope publications on DC issues which include Principles for Securing Good Outcomes for Members of Defined Contribution Pension Plans throughout Europe, Pension Design Principles applied to modern Defined Contribution solutions and Key Principles of Good Governance for Workplace Defined Contribution Pension Plans throughout Europe. These papers are addressed to regulators and policymakers across the EU, researchers, and not least to social partners and those running pension plans.

It highlights the diversity of the decumulation phase throughout Europe, ranging from very structured decumulation paths with little choice for members to those with lots of choice for members including taking all their accumulated retirement savings as cash. The paper also provides examples of the options available in different countries.

The paper was prepared by the DC Committee of PensionsEurope and we would like to acknowledge the contributions made by all the members, either from our Member Associations or Corporate and Supporter members who give us access to resource, expertise and local knowledge. We hope this can be harnessed to further the development of DC pension provision and help to ensure good decumulation for members.

Janwillem Bouma
Chair of PensionsEurope

Jerry Moriarty
Vice-Chair of PensionsEurope and Chair of Standing Committee DC

2. Summary and key messages

- This paper focuses on decumulation in workplace DC pension plans in different countries. It explores the pros and cons of decumulation options, both in cases where there is no (or very limited) choice available to members at retirement and cases where members have choice. In the latter case, it looks at how members can be informed to make a choice that is right for them.
- Furthermore, this paper explores (i) what options there are available at retirement, and (ii) potentially what guidance, choice and tools could be desirable during the decumulation phase. Answers to these questions might vary from different respondents, and this paper particularly focuses on the needs of participants (i.e. members and beneficiaries of pension plans) and employers.
- As a general rule, pension options should be kept as simple as possible in order to minimise both (i) administrative costs (ii) and the risk that the options are not understood. The participants have different kinds of needs in different countries, and those country specificities also need to be taken into account in the decumulation phase.
- At least five years before their expected retirement, members need to start considering the possible decumulation options (where available). Where member have the option to continue to invest and drawdown on funds, there is a need to ensure participants better understand the balance between using funds to finance their initial years of retirement lifestyle versus the risk of exhausting funds too early, and that solutions are designed that meet their needs. Good quality information is essential to help participants plan their retirement.
- This paper outlines a potential hybrid retirement income solution, and the Annex contains case studies from France, Germany, Italy, Ireland, the Netherlands, and the UK.
- The paper concludes:
  - With increasing longevity and many countries cutting back on first pillar pension provision, DC pensions should more and more take into account the decumulation phase after retirement and provide appropriate solutions;
  - Collective DC pension plans with no (or very limited) choice contain benefits for many members during the decumulation phase but, of course, can be perceived as restrictive by those who want to make their own choices;
  - Plans that provide lots of choice can require lots of information and guidance in order to help participants to make the best choices;
  - There is no one-size-fits-all solution for the EU Member States regarding the framework for the decumulation phase;

- **Beyond a duly determined national overall "adequate income at retirement", participants should have some flexibility related to decumulation options – while taking into account that flexibility always comes at a cost;**
- **Participants should be well informed, especially in countries where there is choice to members at retirement, with access to appropriate modelling tools to enable them to understand their options and the consequences of choices and be asked for their choice;**
- **Appropriate communication and modelling tools should be provided well in advance;**
- **DC plan can be an effective instrument to support an adequate income in retirement.**

3. Introduction

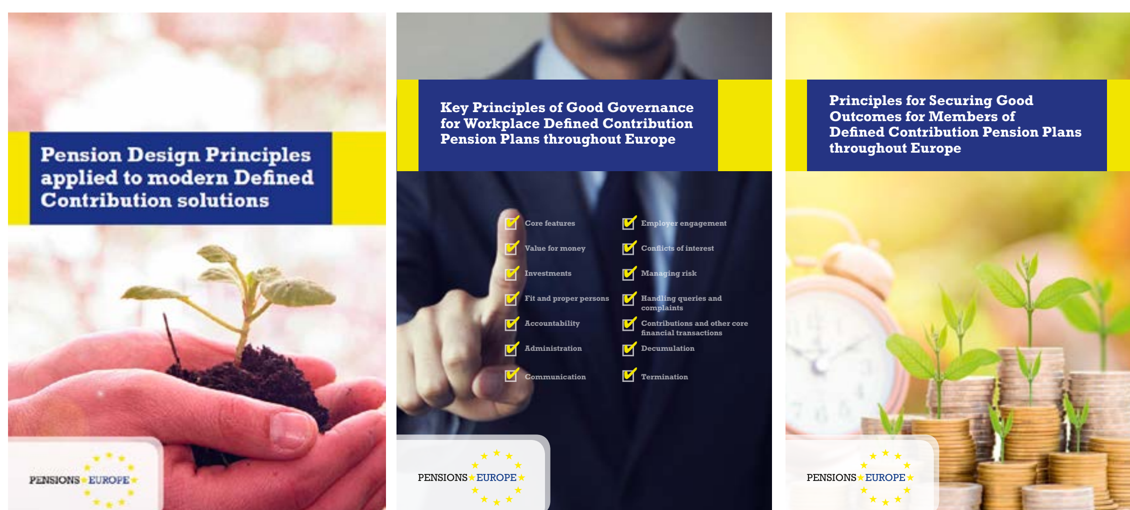
With many countries cutting back on the cost of first pillar pension provision, increasing longevity and in the wake of the generation of baby-boomers retiring, policymakers are looking for other ways to strengthen their pension systems. Second and third pillar funded systems are ever more important in ensuring an adequate income in retirement but have come under pressure because of persisting low interest rates.

Despite these pressures, workplace pensions in particular are of growing importance. Policymakers, employers and those responsible for running pension plans have sought ways of delivering workplace pensions that provide value for money to the members, but do not mean unlimited risks for the sponsoring employers and/or pension providers (e.g. IORPs). Therefore, there has been a continuation in the growth of Defined Contribution (DC) pension plans[1] in Europe. The number of members and beneficiaries[2] of DC plans is increasing with more and more members reaching the decumulation phase and, with that, the first DC plans of significant scale are reaching maturity. This has resulted in individuals becoming more responsible for their pension provision, as employers have a more diminished role than in traditional Defined Benefit pension plans.

In the summer of 2018, PensionsEurope's Standing Committee DC conducted a survey on the decumulation phase amongst our members and this paper has benefited from the results of that survey. The answers to that survey e.g. highlighted the various pros and cons of DC pension plans both in cases where there is no (or very limited) choice available to members at retirement and cases where members have choice. They also covered different pay-out options available in various countries[3] and what would the ideal decumulation system look like, broken down in various areas.

The paper continues the series of PensionsEurope publications on DC issues which include Principles for Securing Good Outcomes for Members of Defined Contribution Pension Plans throughout Europe, Pension Design Principles applied to modern Defined Contribution solutions and Key Principles of Good Governance for Workplace Defined Contribution Pension Plans throughout Europe. **These papers are addressed to regulators and policymakers across the EU, researchers, and not least to employers and those running pension plans.**

1 What constitutes DC can vary from one Member State to another. For example, some countries, such as Belgium and Germany provide for a minimum return guarantee. In other countries, plan design may include a predominantly DC benefit with some form of defined benefit underpin.
2 Those in receipt of benefits – sometimes referred to as pensioners.
3 See also the stocktaking part of the OECD publication on Financial Incentives and Retirement Savings (2018).



The current paper promotes the idea of strong and efficient workplace pensions and shows what they can deliver. It also shows how diverse the decumulation phase of workplace pensions is across the EU – something to be kept in mind when legislating on matters concerning occupational pensions at the European level.

This paper focuses on workplace DC pension plans in different countries. It explores the pros and cons of DC pension plans both in cases where there is no (or very limited) choice available to members at retirement and cases where members have choice. In the latter case, it looks at how members can be informed to make a choice that is right for them. The plans considered include both mandatory 1bis workplace (DC) pension plans (common in Central and Eastern Europe) and second pillar pension arrangements with either a collective or a more individualized approach. They all differ from retail third pillar products under which an individual makes all the decisions, including which product offering to purchase in the first place.

Furthermore, this paper explores (i) what options there are available at retirement, and (ii) potentially what guidance, choice and tools could be desirable during the decumulation phase. Answers to these questions might vary from different respondents, and this paper particularly focuses on the views of participants (i.e. members and beneficiaries of pension plans) and employers. Finally, the paper outlines a potential hybrid retirement income solution, and the Annex of this paper contains case studies from France, Germany, Italy, Ireland, the Netherlands, and the UK.

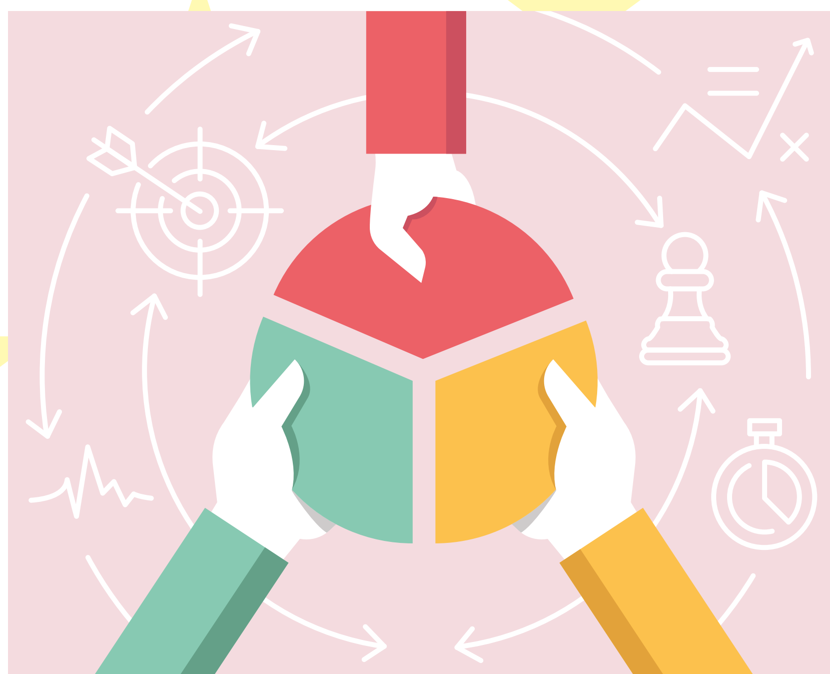
4. Key stakeholders

There are several parties who have an interest in the decumulation phase of DC pension plans, and these include:

Participants

Given the increasing reliance on DC pension plans throughout Europe, it is crucial that they deliver good outcomes for participants. Participants should be supported to plan and prepare for their retirement, particularly as there is more risk falling on individuals. The IORP II Directive sets out some minimum information requirements in this regard. It is also essential that participants know that someone is responsible for ensuring that the plan is operated in their best interests and that it is delivering good value for money. Furthermore, itis not all about accumulation. What happens at and after the point of retirement is equally important to participants.

With vast sums collectively being invested in DC pension plans it is also essential, both for employees and the European economy, that these funds are invested appropriately as required by the IORP II Directive and other national regulations and rules, and that participants are given the appropriate information at the right time during their saving lifecycle. It is also critical that participants plan for their retirement and, where there is a choice available, make informed decisions about how best to use their savings in later life.



Employers

Generally speaking, it is the employer, often as a result of collective bargaining, who chooses a DC pension plan (and its basic design/structure) for its employees and agrees to bear some or all of various related costs. Employers usually secure a better deal than an individual would have received on his or her own in the market. Moreover, employers/sponsoring companies have a strong interest in ensuring that the pension plan they choose and contribute to on behalf of their employees is well run, offers value for money, and delivers a good quality service.

In any event, employers have a self-interest in ensuring good workplace pensions and, as part of that, a good decumulation phase of DC pension plans. A well-governed plan:

- ★ helps them to get maximum value from their pensions spend and stand out from their competitors when seeking to attract and retain talent;
- ★ helps them to achieve their HR objectives related to succession planning by making it more likely that employees will be able to afford to exit the labour market at the end of their working lives;
- ★ mitigates the risks of any potential liability arising from the poor operation of the plan (including poor or inadequate choice of investment options), and;
- ★ enhances their reputation with employees and externally.

Overall, employers put a lot of belief in DC models: they allow them to deliver good workplace pensions without the significant financial risk that applies to defined benefit models. In the accumulation phase, the employer's role includes making timely contributions for and on behalf of employees. Those running the plan have responsibility to ensure contributions are invested appropriately according to the prudent person principle or that appropriate investment options are available where choice is offered to members. At the beginning and duration of the decumulation phase, the employer's interest is to ensure that those running the workplace pension provide the members with the relevant information so where they have different options, they can make an informed choice. In some countries the annuities will be outsourced to a third party, e.g. an insurer covering the longevity risks. Whilst, in other countries, the provision of benefits may be from the vehicle that had been used for the accumulation phase.

Those responsible in running or overseeing the plan

Those involved in the running of, or legally responsible for the oversight of, DC pension plans may, depending on the jurisdiction, include pension funds (IORPs[4]), fiduciaries (such as trustees/Board of Directors), employers, employee representatives, trades unions, actuaries, insurance companies, asset management companies and other commercial entities. They also have a clear and common interest in the success of these plans, and in the long-term success of and confidence in pensions saving in general. In particular, they have an interest in ensuring that plan members receive good quality service, adequate outcomes and value for money. Without this, those who run or oversee such plans face criticism and potential liability for poor performance. This could, for example, include issues around the choice of the default option. They also jeopardize the retirement prospects of their members, risk their reputation, increase the need for regulatory intervention and risk undermining trust and confidence in pensions more widely. Other (third party) service providers also carry commercial risk if they fail to deliver on the services they are supposed to provide to the plan.

4 Institutions for Occupational Retirement Provision

Policymakers and those responsible for regulating DC pension plans

As a policy objective, many countries/governments are looking at supplementary pension plans as a means to shift the dependence from state pensions, and they have a power to provide structures and fiscal rules that encourage that. Policymakers also consider the overall context of the different parts and pillars and how they interact. Under an EET framework, the state (and future taxpayers) have the strong interest that the pay-out phase generates foregone tax income. Regulators, tax and supervisory authorities also have an interest in ensuring that DC pension plans are efficiently run, well governed and are trusted by individuals and employers. Furthermore, they have an interest in ensuring that DC pension plans deliver good outcomes and contribute to long-term economic stability. This is increasingly becoming a priority for regulators who are focusing on plans achieving value for money and good outcomes. They need to find a balance to ensure plans are properly regulated and well governed, whilst also ensuring that regulation is proportionate, and its cost does not have an excessively negative impact on member outcomes.

In Europe, the IORP II Directive sets common standards ensuring the soundness of occupational pensions and better protects pension scheme members and beneficiaries, by means of among others: (i) new governance requirements, (ii) new rules on IORPs' own risk assessment, (iii) new requirements to use a depositary, and (iv) enhanced powers for supervisors. PensionsEurope shares the goal of this EU Directive to facilitate the development of occupational retirement savings and to provide sustainable and adequate occupational pensions to European citizens.

We would like to stress that what a "good outcome" is varies across the EU. Different social systems are a manifestation of the different objectives policymakers are seeking to achieve with workplace pension systems, as the next section shows.

5. The backdrop: systems that have grown over decades

1st, 1st bis, 2nd and collective 3rd pillar (DC) pension plans across Europe are embedded in historical developments in various countries and, depending on the type of provision, in their respective social and labour laws.

Institutions for occupational retirement provision (IORPs) are pension institutions with a social purpose that provide financial services, as is highlighted in the IORP II Directive. The Directive covers certain funded arrangements only. In some countries funded arrangements covered by other EU legislation and/or unfunded (particularly book reserve) arrangements also play an important role in citizens' overall retirement provision.

Whilst retail personal pensions are bought as products, workplace pensions are benefits provided by employers to their employees – in some countries voluntarily, in others based on legislation, social or collective agreements. The relationship between employees, employers, social partners and a pension plan is important during both accumulation and decumulation phases. In order that the latter is successful, the former needs also to be successful. Therefore, accumulation and decumulation phases should be coordinated as part of an overall, integrated system design.

Whatever framework is put in place to help savers make the best decisions at retirement, they will only get an adequate income if they have saved enough during their working career, and there is plenty of scope to help people understand more clearly how much they need to save. In the UK, the PLSA has been developing proposals, inspired by Australia's 'Retirement Standards, which present savers with three levels of retirement lifestyle, expressed in terms of the kind of car, holidays and household goods that people on each level could afford. These help savers to understand how much income they would need for the kind of retirement they want and then how much they need to save to generate that income. The PLSA has published on 17th October 2019[5] its own retirement living standards for use in the UK and will be working to get pension plans, providers and guidance bodies to adopt them.

5 See https://www.retirementlivingstandards.org.uk/

As with DB arrangements, DC pension plans are built on the foundation of first pillar pensions (state pension systems), which differ significantly from country to country. The differences are in terms of their objective (providing a basic income or providing an income relative to previous earnings), related to that, the 'replacement rate' they offer relative to average (or multiple thereof) earnings and the age at which benefits are payable. Moreover, in some countries, DC pension plans are particularly closely integrated with first pillar provision (so-called 1st pillar *bis* plans). Therefore, 1bis, 2nd and collective 3rd pillar pension design, in conjunction with widely varying first pillar provision, aim to achieve an adequate retirement provision overall. The definition of adequacy is highly dependent on the social policies of a country (additionally encompassing housing, health care, and social welfare). The first pillar plays an important part and will influence choices/risk etc. through second pillar and collective third pillar arrangements. Collective pensions[6] generally provide benefits that go beyond those available from individual 'retail' pensions. For example, they do or can offer:

- Economies of scale in governance, administration and asset management – leading to lower costs;
- Risk pooling and often intergenerational risk-sharing;
- ''Not-for-profit'' organisation of the plan;
- Usually there are no, or lower, marketing and sales costs which (in general) can be very substantial, especially in the third pillar;
- a lower risk of mis-selling/mis-buying as the decision to purchase products or services are made by employers or plans rather than by individuals who may have little financial knowledge;
- Contributions from sponsoring employers, including employers often paying some or all administration and other costs;
- Long-term horizon of investments – with strategic decisions made by the 'professional' governance body;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as automatic-enrolment;
- Better governance and alignment of interest resulting from the participation of the main stakeholders in the governance structure.

The set-up of national pension systems, the development of the 2nd pillar over time and cultural predisposition of different countries mean that choice plays a different role in different systems: while some systems are more social policy oriented - leaving limited choice to the individual - others offer more flexibility and are more liberal. Choice can, for example, be exercised over the age at which money is withdrawn, the type of payout (lump sum, draw-down, annuity etc.) or the provider who manages the payout. Depending on the objectives and the (envisaged) levels of both the first pillar, and workplace pensions, a more social approach (like in a protective state system that provides a greater protective cushion) or a more liberal approach (like in a less protective system that places greater reliance on citizens doing more to help themselves) can be taken.

Both the social and the liberal approach have their merits, but also their drawbacks: a system offering a lot of choice to beneficiaries means that individuals can tailor their DC decumulation exactly to their needs – taking into account other income in retirement, housing needs, health and the need or desire to improve the financial situation of their dependents. However, such a system also puts a lot of responsibility on the individual. It follows that, in such a system, individuals should have relatively high levels of financial

6 Collective pensions are arrangements where pensions are pooled into one fund. In this way, the risk of investing and paying out a pension over a lifetime is shared by all members of the scheme, and not shouldered by an individual on their own.

literacy. Moreover, behavioral factors such as (i) inertia and a tendency to postpone (''I'll look at my pension plan next week''), (ii) choice overload (too many options so that people cannot make up their minds) and (iii) shortsightedness (buying an expensive car today and being left with low income in old age) need to be taken into account. In addition, if beneficiaries can switch providers at retirement, the market for these products needs to be competitive and without major information asymmetries. A system offering many different options is also likely to be more expensive – both the provision of choice and the information / advice necessary to sensibly exercise that choice are costly.

At the other end of the spectrum is a collective approach, which provides a standard plan for the whole group with low costs and limited risks to the individual: all parameters such as, for example, the earliest age at which payments can start and the type of payment are set. This means little flexibility for the individual to tailor the payments to their needs, but on the other hand it lifts the burden of choosing from them. Financial literacy becomes less of an issue, and behavioral factors no longer need to be taken into account. Importantly, if tax breaks have been granted during the accumulation phase, the state has a strong interest in ensuring that the accumulated resources are converted into an income stream during retirement. This way, tax income and, depending on the system set-up, health and long-term care insurance contributions are postponed into the future and the need to pay social assistance for retirees becomes less likely.

On the other hand, the format of the benefits may not suit every individual and it may be that individuals could receive benefits more appropriate to their personal circumstances or better value on the open market.

In reality, pure versions of the social and the liberal approach can only rarely be observed, often the liberal approach includes some social elements and the social approach includes some flexibility to mitigate the drawbacks of the pure versions: in the liberal approach, a default option can be a safety net for those with low financial literacy; the social approach can be exercised through tax incentives, where it is e.g. possible to choose a different pay-out option, but where this comes at a cost. However, the distinction as to whether a system is more social or more liberal is analytically helpful when looking at different decumulation practices across Europe. The following two sections discuss these two approaches in more detail.

Current decumulation options

At least five years before their expected retirement, members need to start considering the possible decumulation options (where available). Current decumulation options can be seen from two angles: (i) what is allowed under a particular national supervisory or legal structure (or what is included in the contract), and/or (ii) how the options are treated under national tax and social security contribution legislation. It is also important to note that the decumulation options below can be combined.

- In general, **annuities** are useful in providing regular secure income to individuals. There are several different kinds of annuities including lifetime annuity, guaranteed annuity, enhanced annuity, deferred annuity[7], and Long-Term Care (LTC) annuity (in Italy)[8]. Under a pure DC system, they are often provided by a third party (insurer) rather than the pension fund or employer. The main advantage of an annuity is that it gives individuals an opportunity to insure against the risk of longevity and benefit from ''mortality credit'' (a gain related to the fact that the funds contributed by individuals who die younger are shared with those who live longer). Another advantage for the beneficiary is that if the money is paid out through an annuity, their yearly income does not spike in one year, avoiding very high tax rates. However, life annuities guaranteeing a fixed income are currently very expensive due to extremely low interest rates. In addition, fixed annuities do not offer any protection against inflation or allow individuals who wish to do so to continue investing in return seeking assets to achieve a potentially higher benefit level. Finally, a life annuity is irreversible. In its simplest form, it precludes the ability to hand down capital to one's heirs or collect capital if cash is needed due to unexpected expenses.

7 Unlike an immediate annuity, which starts annual or monthly payments almost immediately, investors can delay payments from a deferred annuity indefinitely. During that time, any earnings in the account are tax-deferred.

8 The Long Term Care is an insurance that covers the expenses deriving from the impossibility to autonomously carry out the normal functions of daily life (simple actions like moving, washing, get dressed and eating), with consequent inability of self-sufficiency. LTC provision may be offered both as a specific type of annuity and as enhancement of the amount of the annuity paid to the beneficiary, when the conditions to be qualified as no longer self-sufficient apply (a sort of enhanced annuity).

- In some jurisdictions, **lump sum** disbursements benefit from favourable tax treatment, which makes them attractive to members. The lump sums can be total or partial (with limits potentially applying as a result of domestic legislation); in other words, they can be taken out in a single event or in a series of (possibly *ad hoc*) events. If a pension pot at retirement is small, a lump sum can be more cost-effective option than a very low annuity and domestic legislation can permit trivial lump sum payments even when other lump sum options might be restricted.
- **Drawdown plan** is a plan that allows participants to continue to invest post-retirement and withdraw savings from their fund. These can be programmed withdrawals that contain a series of fixed (or escalating) payments paid at regular intervals, generally calculated by dividing the accumulated assets by a fixed number or by life expectancy in each period. Alternatively, they can be variable payments, where the individual draws down funds on an *ad hoc* basis in line with their requirements, often with either minimum and/or maximum amounts that must or can be drawn down each year. They may be associated with an annuity that comes into payment at a prescribed time as a form of longevity insurance (see hybrid retirement income solution example on page 19). It should be apparent that the line between irregular, variable drawdown and *ad hoc* lump sum withdrawals can be blurred. They provide flexibility and the ability to continue to invest post-retirement and benefit from investment returns. However, they also require the participant to manage the fund and ensure they always have sufficient funds available for their needs. This can become more difficult as cognitive ability decreases.

6. Collective DC pension plans with no or very limited choice at retirement

At the *social approach* end of the spectrum, the individual is likely to have limited, or no, choice over decumulation. Different actors are involved in setting up the framework for decumulation: at the very top level, policymakers set tax, labour, prudential and social law as a framework. They can for example. stipulate by law when and how a DC pension can be withdrawn. Then, at a lower level, the social partners usually set up pension schemes within that framework, which may be 'bespoke' to a particular entity or via an existing 'sector-wide' arrangement or participation in an existing commercial arrangement. The social partners can limit choice; for example in relation to sector-wide pension arrangements. In bespoke arrangements, social partners or employers (unilaterally) may set the rules. Despite the restrictions in choice, when changing employers, it is often possible to transfer to the new employer's plan prior to reaching the designated or expected retirement age.

Absence or restrictions in flexibility are more of an issue if the group covered by the rules is very diverse. That makes it more likely, though not certain, that the framework that is set will not be suitable for at least some of the beneficiaries. By contrast, for a homogeneous group (for example, individuals on similar incomes) the framework set by, for example, an employer is more likely to be appropriate for most of the employees and their circumstances.

The main advantages of collective DC pension plans with no or limited choice at retirement are:

- Behavioural issues such as choice overload, inertia, biases etc. are mitigated;
- More options often mean higher costs, which ultimately leads to lower outcomes for retirement benefits;
- Employers or social partners are often better placed to make decisions than an individual: they bring (or buy) expertise and the necessary power to negotiate better conditions than most individuals on their own. However, under any kind of DC model it is important for many sponsoring companies that they are not liable for any shortcomings arising from the support they have offered to their employees.

The main disadvantage is the lack of flexibility for the individual, which might mean that they have to put up with an option that they know is not ideal for them.

While this paper generally focuses on the perspective of participants (i.e. members and beneficiaries of pension plans) and employers, it is worth at this point also taking into account the high-level social policy and fiscal perspective: it is not desirable that individuals fall back on social assistance in old age, which could happen if an individual, for example, takes out his/her total retirement benefits as a lump sum and spends it straight away. Under the social model, the state may, therefore, set the parameters to limit choice.

To address this issue, taxation during the decumulation phase can be used to steer participants towards specific options and choices. It is debatable as to how successful this is as, in most countries, individuals do not fully understand the tax benefits. From the perspective of the individual, this means that the decumulation options are not always tax neutral when compared to each other. Most EU countries tax workplace pensions according to the EET[9] system or ETT[10] principle[11].

The general principle behind the EET approach is that participants are taxed on their retirement savings when they actually access them. The EET framework for supplementary pensions often comes with conditions attached: if the State allows a particular tax structure for retirement provision, it wants not only to incentivize citizens to save for their retirement but also to make sure that the accumulated capital is used to generate a life-long income rather than being spent straight away. In addition, the State offering EET for supplementary pensions has a justified interest in receiving tax income based on supplementary pensions to 'recoup' some of the up-front cost of tax relief granted on contributions and investment returns.

Of course, differentials in individuals' pre and post-retirement incomes and the tax rates applicable can mean that tax recouped does not fully offset the cost of tax relief granted. However, taking account of the wider social benefit of lifting citizens out of retirement poverty and thus being less reliant on State support helps redress this imbalance.

9 Exempt contributions, Exempt investment income and capital gains of the pension institution, Taxed benefits.
10 Exempt contributions, Taxed investment income and capital gains of the pension institution, Taxed benefits.
11 See also the European Commission Communication on the elimination of tax obstacles to the cross-border provision of occupational pensions.

7. DC pension plans where there is choice available to members at retirement

As we have seen in the previous section, pension options should be kept as simple as possible in order to minimise both (i) administrative costs (ii) and the risk that the options are not understood. The participants have different kinds of needs in different countries, and those country specificities need to be taken into account also in the decumulation phase.

As stressed earlier, at least five years before their expected retirement, members need to start considering the possible decumulation options (where available). There is a need to ensure participants better understand the balance between using funds to finance their initial years of retirement lifestyle versus risk of exhausting funds too early, and that solutions are designed that meet their needs. Good quality information is essential to help participants plan their retirement. It is worth noting that often pension funds are based on a collective system and that there should be simple options. In general, the age at which decumulation is allowed from private pension plans should not be tied to the age at which state pension becomes payable. Rather, that age should depend on a participant's needs while also taking into account employers´ interests. For example, a participant's transition from employment to retirement may be 'phased' – with a move to part-time employment/retirement. Furthermore, where appropriate to the individual's situation, the ability to defer the pay-out stage should be allowed. As State pension ages increase, private DC pensions may become a vehicle to help employers support employees who may need to leave the workforce earlier than that increased State pension age for valid reasons for example, where a lot of manual labour is involved. In the end, however, it is a national competence how decumulation phase is organized in the most suitable way for the whole pension system taking into account the national specificities.

Where participants have a choice of how to use or access their pension savings, the plan should, within the constraints of the applicable legal and regulatory framework, offer appropriate decumulation options (such as annuity, lump sum, drawdown plan, or a combination) that provide value for money and help achieve good member outcomes[12]. Appropriate and timely information should be made available to participants to enable them to make informed choices. Ideally, this should take into account the development and increasing usage of new technology including, for example, digital tools.

Where appropriate, bearing in mind the plan design and subject to the applicable legal and regulatory framework, members and beneficiaries[13] can be given the ability to select, efficiently and cost effectively, their own decumulation option from the open market or transfer their pension fund to an alternative plan. Transfer, or purchase on the open market, may be necessary in cases where there is no requirement within domestic legislation for a particular IORP to offer all decumulation options available under statute.

Possibilities to organize a decumulation framework

National social policy, regulatory framework, and taxation need to be considered, when thinking about possible improvements to current decumulation options. PensionsEurope recognises that setting an 'adequacy' level for retirement income is largely a decision for national Governments. However, there are also examples of other bodies that publish retirement income targets. PensionsEurope's view is that flexibility in terms of how benefits are taken should be considered when retirement income exceeds any such level. However, we acknowledge that this too is a decision for national Governments.

In some cases, current decumulation options could include additional flexibility. For example, they might require members to make a decision at a single point in time (immediately prior to 'retirement' – even though they have limited knowledge of their actual retirement income needs over the longer term. Any solution should address member needs in retirement. PensionsEurope considers that this should, in principle[14]:

- ★ Start with a foundation level of income, variable per individual, in retirement with sufficient security that the individual will not out-live this amount. This may derive from different sources – not necessarily second or third pillar pensions;
- ★ Enable individuals to have the confidence to spend the savings they have accumulated and not excessively worry about outliving those savings;
- ★ Permit participants to continue to invest their accumulated retirement savings with a long-term investment horizon, particularly in light of increasing longevity;
- ★ Include a degree of flexibility to amend the retirement journey as actual needs change (for example reflected in drawdown plans);
- ★ Embed protection for individuals who are no longer able to make complex financial decisions due to a decrease in cognitive ability;
- ★ Support combinations of solutions to meet a specific participant's needs – so fewer "either/or" scenarios.

12 Outcomes should be 'optimal', but recognising that, in this context, optimal does not mean "highest value at all costs", because the level of return needs to be balanced against risk.
13 As with footnote 2, beneficiaries in this context means those in receipt of benefits (through a means other than secured annuity)
14 In certain circumstances, for example where an individual is in serious ill-health, the 'normal' route may well be inappropriate,

A potential hybrid retirement income solution

Where legislation allows, default investment strategies that combine individual solutions can be designed to help address some of these member needs. Figure 1 (below) illustrates one example of a hybrid retirement income solution. The solution combines the flexibility of a drawdown plan in the early part of a participant's retirement with the secure income of a deferred annuity in later life (see also German case study on page 23).

From the age a participant enters the workforce up until 10 years from retirement (age 55 in the example), the solution operates like a traditional DC accumulation strategy. One of the key risks participants face when seeking to purchase an annuity is sequencing risk. In order to prepare participants for the deferred annuity purchase, the solution starts to build an allocation to an annuity replication strategy 10 years prior to the expected date of retirement. This strategy consists of a pool of assets with a risk profile that is broadly consistent with the expected cash flows and price of a deferred annuity that will be purchased at the age of 65 and will start paying out at the age of 80. The fund will systematically increase the allocation to the annuity replication strategy on a quarterly basis, reaching the desired target allocation (e.g. 25% of the total portfolio) when the participant reaches retirement date. Building the exposure up gradually can protect participants against changes in the cost of annuity income at a given point in time.

When the participant reaches retirement age (age 65 in the example), the solution uses the accumulated balance in the annuity replication strategy to purchase a deferred annuity that will start paying out at the age of 80. In this example, there is a life assurance element included if the individual participant dies before age 80.

For most people, financial decision-making capacity peaks in the mid-50s and remains strong through the 60s. After the age of 70, however, the rate of cognitive decline increases rapidly. This solution is designed so that participants make the decision whether or not to purchase the deferred annuity at retirement age. Participants who do not wish to purchase the deferred annuity will have to affirm that they wish to opt out.

If they do not opt out, from the age of 80 onwards, participants will receive steady income from the deferred annuity, providing security that they will not outlive their savings and relieving them of the need to make significant financial decisions at a time when they are likely to have diminished capacity to do so.

Using a deferred annuity also means only a portion of the participant's assets are used to provide insurance against longevity risk, while maintaining the flexibility to draw down the remaining 75% of assets at their own pace. Research and practical experience show that people are far more willing to annuitize part rather than all of their savings. In addition, participants know how long their drawdown assets must last (age 65 to 80 in the example) and can budget with more certainty than they could with traditional drawdown plans. By insuring against the risk of ''living too long,'' the participant is able to draw down the remaining assets faster, resulting in higher income in retirement.

It is worth noting that it would not be in the interest of participants if providing greater flexibility results in them withdrawing their retirement savings and putting them in their bank accounts without generating any real returns. Investing for appropriate returns during decumulation – other than where funds are annuitized is important.

DC savers will face challenging decisions about how best to use their pension pots, and it is essential that they have external help and support. At the very least this should ensure savers have access to guidance that enables them to understand the options available to them and make the right choices. In the UK, for example, the PLSA has proposed that members should automatically be directed towards the government-run Money and Pensions Service prior to withdrawing funds from their pension pot. Members could opt out of taking this guidance if they wish to do so.

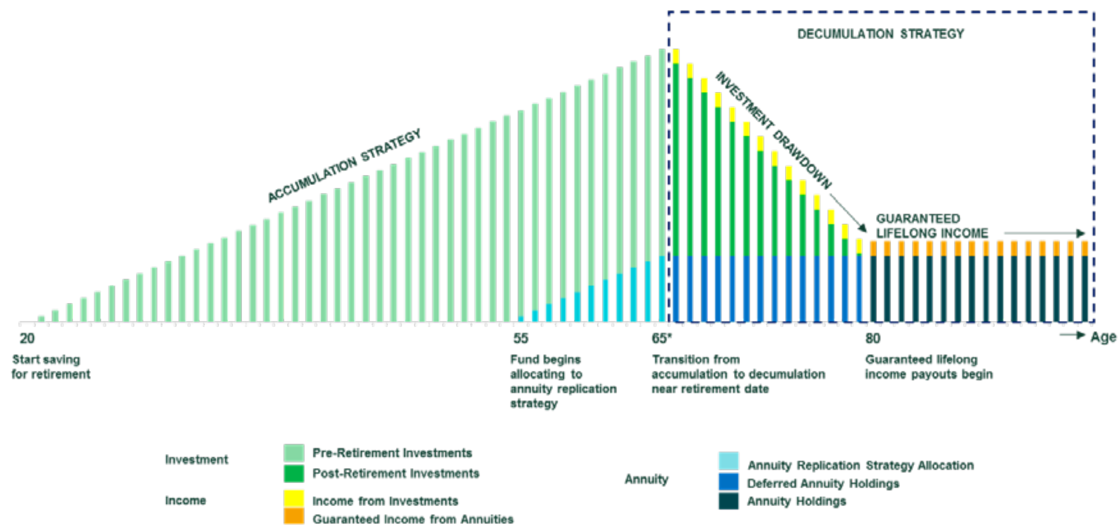
A framework for advising participants on an appropriate investment and longevity risk strategy needs to be further developed. However, when drafting such a framework, it will be important not to put such information/consulting duties on employers, as they are not pension consultants and this will translate into additional costs. It is important that individuals have the tools to understand their options and select those that are best for them. New technologies such as robo-advice should be considered.

As more participants consider accessing their benefits from DC pension plans – and the range of options increases – it is important that they have the tools to understand those options and select which is best for them. These should include:

- Appropriate default investment solutions for those who do not wish (or do not feel able) to make choices – focused on participants' needs;
- Simple tools and information to guide them through decisions – including a role for robo-advice;
- Simulation tools, so as to illustrate expected level of income and how long it could be generated (in case of drawdown products).

The Figure 1 illustrates a potential hybrid retirement income solution.

Figure 1: A potential hybrid retirement income solution



Source: SSGA
*Assumed age at retirement
The information contained above is for illustrative purposes only.

8. Conclusions

- With increasing longevity and many countries cutting back on first pillar pension provision, DC pensions should more and more take into account the decumulation phase after retirement and provide appropriate solutions;
- Collective DC pension plans with no (or very limited) choice contain benefits for many members during the decumulation phase but of course can be perceived as restrictive by those who want to make their own choices;
- Plans that provide lots of choice can require lots of information and guidance in order to help participants to make the best choices;
- There is no one-size-fits-all solution for the EU Member States regarding the framework for the decumulation phase;
- Beyond a duly determined national overall "adequate income at retirement", participants should have some flexibility related to decumulation options – while taking into account that flexibility always comes at a cost;
- Participants should be well informed, especially in countries where there is choice to members at retirement, with access to appropriate modelling tools to enable them to understand their options and the consequences of choices and be asked for their choice;
- Appropriate communication and modelling tools should be provided well in advance;
- DC plan can be an effective instrument to support an adequate income in retirement.

Annex

(Case studies from France, Germany, Ireland, Italy, the Netherlands, and the UK)

France

The Pacte Law, (2019-486 on 22 May 2019) should come into force in early 2020. Its main goals are to finance the French economy more effectively, do a better job of ensuring that employees share in the benefits of growth, and encourage French people to save and invest, particularly with a view to supplementing their pensions.

The new legislation will have major implications for retirement savings and is expected to:

1. Promote retirement savings within small businesses by scrapping the forfait social (a contribution paid by employers and levied on compensation or gains that are not subject to social security charges and contributions) for incentive plans at companies with fewer than 250 employees and for profit sharing plans at companies with fewer than 50 employees.

2. Promote employee share ownership by relaxing the procedures used by simplified joint-stock companies to offer shares to their own employees, by allowing employers to contribute unilaterally to employee share ownership funds and by halving the forfait social for employer contributions to such funds.

3. Make retirement savings more appealing by allowing people to take their savings with them when they change employer and by harmonising investment vehicles (Article 83, PERP, Madelin, Perco), including in terms of tax treatment for payments.

4. Relax exit requirements at retirement: the requirement to take out an annuity will be restricted to products subject to mandatory payments, early withdrawals will be possible, notably to buy a primary residence, and all annuity policies will include the option of paying survivor benefits to a spouse. The legislator voted these changes because former pension products with mandatory annuity pay-out never took off because fewer and fewer individuals want to take the irreversible decision to convert all of their assets into an annuity tens of years ahead of their retirement.

EET pension taxation in Germany

Current decumulation options for EET taxation according to §3.63 EStG and Riester

In Germany, a fundamental reform for EET pension taxation (including 1st pillar pensions) came into force in 2005 (Alterseinkünftegesetz) including several grandfathering provisions. Since then, monthly disbursements in the second (§3.63 EStG and Riester) and third pillar (Riester) can be made from either a lifetime annuity or a combination of programmed withdrawal and an annuity starting at the age of 85. The decumulation choice is part of the initial contract.

Going forward: The law strengthening occupational pensions in Germany

In Germany, the law strengthening occupational pensions (Betriebsrentenstärkungsgesetz - BRSG) came into force on 01 January 2018. Under specific conditions, occupational pensions can now be set up on a collective defined contribution basis (Social Partner Model). The new law was discussed for three years. The rules for DC decumulation can therefore be taken as what is currently seen a good decumulation approach for a collective DC plan. In terms of the decumulation phase, the inclusion of life-long pension payments is one condition for IORPs and insurance companies offering plans under the Social Partner Model (Art. 244b VAG). The level of the life-long payment can vary depending on the capitalisation ratio (Art. 38 PFAV). It is calculated as the relation between the actuarial reserve (Kapitaldeckungsgrad) and the net present value (Barwert) (Art. 36 PFAV). If it exceeds 125%, benefits have to be increased, if it falls below 100%, benefits have to be cut. For more information, see the aba / IVS Report "Die reine Beitragszusage gemäß dem Betriebsrentenstärkungsgesetz" (in German; for this issue, see particularly p. 13ff). The social partners are still discussing issues around this model and so far, no such plan has been set up in Germany.

Italy

A possible way to ensure a good decumulation phase for DC pension plans may be represented by the joint selection of the annuity provider by a group of pension funds. This solution may be useful where the market of annuities is not well developed yet. In this case, in fact, a single pension fund could struggle to agree value for money and fair clauses when negotiating the annuities for beneficiaries with an insurance company. The joint selection gives members more contractual power with the providers of the annuity, both in terms of costs of the annuities and in terms of availability of suitable options. In the end a higher income at retirement for retirees may be achieved.

The joint selection of the annuity provider represents a very suitable solution for Italian occupational collective pension funds. Italian legislation states that, at retirement, beneficiaries can ask for a lump sum payment (up to 50% of their pot) or an annuity[15]. There is not a constraint in the number of annuities a pension fund can offer to beneficiaries, however schemes decided to provide them with more options to choose from. The underlying idea is that a diversified supply may increase the efficiency of the market. Pension funds may pay directly the annuity[16] or may mandate an insurance company to pay pension provisions. The latter is the norm of the market and so pension funds have to select the annuity provider.

The market of Italian pension funds is still relatively young (the largest part of occupational collective pension funds is 20 or less) and the members themselves are relatively young (average age of active members is 46.3; 75% of members is 54 or less). This situation is reflected by a market of annuity still thin.

15 If the final pot is lower than a certain threshold -50% of Assegno sociale, a means-tested subsidy equal to 5,953.87 in 2019- beneficiary can withdraw the pot fully with a lump sum.
16 In this case they need to set aside technical provision. *De facto* it prevents pension funds to become annuity provider themselves.

In these conditions the joint procedure gives occupational collective pension schemes more contractual power than in the case in which they were to select the insurance company by themselves.

In 2019, 25 occupational collective pension plans jointly selected the annuity provider through their association (Assofondipensione) and with the technical and legal advise of Mefop. The selection procedure ended up with the choice of the insurance company which will be in charge of the payment of the annuities on behalf of the group of the 25 pension schemes from January 2020. The joint selection has been carried out for the third time. Under the new framework the pension funds of the joint venture will be able to provide members with 5 different types of annuities: 3 types of life annuity, 1 survivalship annuity, 1 refound annuity. The 5 annuities may be voluntarily complemented by a Long Term Care provision. In this case the amount of the basic annuity is doubled.

Beneficiaries may choose between one of the 5 options. In order to ''advice'' the choice and to try to orient the beneficiary towards the more suitable option, in the websites of the pension funds beneficiaries can simulate different scenarios.

Ireland

In Ireland, members can retire from occupational pension plans from age 50 if they have left the service of the employer. Under DC plans, an individual can take a tax-free lump sum of either 25% of their accumulated fund or 1.5 times their salary (subject to some tax rules).

They will have the option to use the remaining funds to purchase a life annuity. This will generally be through an open market option. The plan administrator will obtain the best quotes in the market and give the members a choice on which annuity provider and also on other options such as including dependants' benefits or indexation.

Alternatively, members can transfer their benefits to an Approved Retirement Fund (ARF) which allows them to continue to invest and draw down as they need to. In order to transfer to an ARF, a member must be able to demonstrate that they have guaranteed income of €12,700 per annum. Any member that receives a full State pension (first pillar) will now automatically qualify. If they don't qualify they must invest €63,500 in an Approved (Minimum) Retirement Fund which cannot be touched until age 75.

The proceeds of an ARF can be passed on to the individual's estate on death. Once over age 60, there is an annual tax applied on a 4% withdrawal of the funds (whether there is a withdrawal or not). For those over 70 the tax is on a 5% assumed withdrawal, or with funds over €2m, the tax is 6% for those over 60.

Law on improved DC schemes in the Netherlands

The Dutch Law on improved DC schemes (*"Wet verbeterde premieregeling"*, or Wvp) came into force in September 2016. The Wvp requires that every participant in a DC scheme has the choice to opt either for a fixed annuity or a variable annuity at retirement age. This choice must be offered to the employee when the investment profiles for the fixed and variable annuity start to differ (well before the retirement age).

The aim of the Wvp is to improve DC schemes in The Netherlands – in particular during the decumulation phase – by adding the following elements:

★ *Continue to invest after retirement date*

Offering the possibility to invest in return seeking assets also after retirement (not possible with fixed annuities), will result in a higher expected retirement benefit with improved purchasing power.

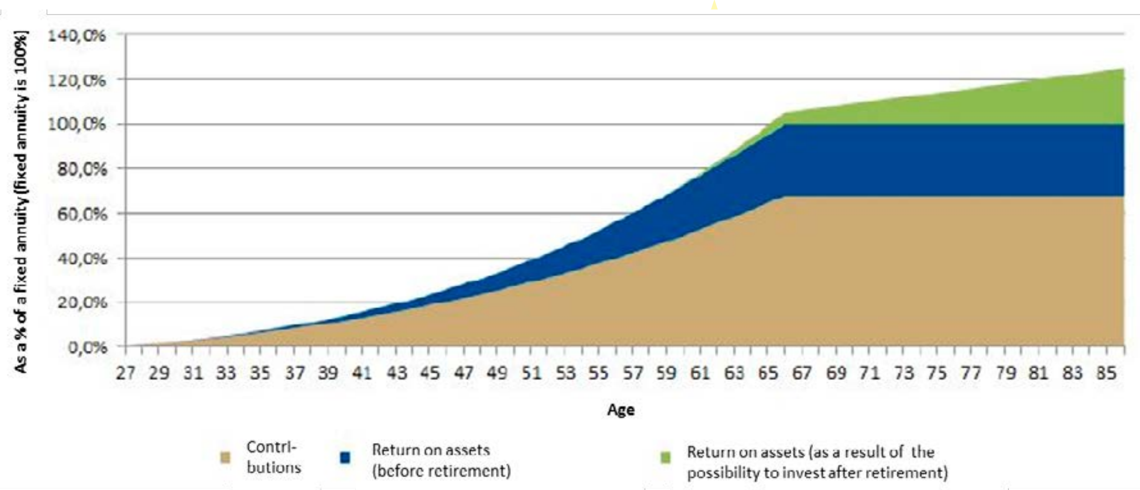
★ *Spreading of market shocks*

The impact of market shocks on benefit payments that result from investing after retirement can be mitigated through a spreading mechanism (over a maximum of 10 years) that stabilizes the level of the benefit payments from year to year.

★ *Spreading of interest rate and market risks (conversion risk) at retirement age*

Before the Wvp, a big conversion risk occurred at retirement age, as participants were legally obliged to convert the capital into an annuity at retirement age. Under the Wvp, this can be mitigated by allowing a gradual buy-in into a collectivity in the years (to a maximum of 10 years) before retirement.

The graph[17] below provides an example of the added value of the Wvp.



The brown colored block represents the contributions that employer and employees make towards the scheme. The blue block represents the investment return that is made on the contributions that are invested until retirement. From the capital that is available at retirement date the participants buy an annuity (set at 100% in this example). The expected added value of the Wvp is presented in the green block. The pension pay-out to the participants is expected to rise after retirement. Whilst such a rise can be expected, it is not guaranteed and the income to the participant may both rise and fall after retirement.

17 Source: the brochure "De variabele pensioenuitkering - Praktische handvatten voor het maken van de juiste keuzes" by Sprenkels & Verschuren.

The Wvp does not prescribe exactly how variable annuities should be designed. It is left to contract parties (employers, representatives of employees, pension provider) to come up with possible products. However, because the risks are borne by the employee, the law does contain a number of preconditions that pension providers need to comply with:

- The amount of the annuity at the start must be calculated based on the risk-free interest rate and the remaining life expectancy;
- The annuity must be lifelong;
- It will be possible to spread (both positive and negative) results over a period of a maximum of 10 years;
- Investments are subject to the prudent person principle and the provider is legally obliged to act in the best interest of the pensioner ('Duty of Care');
- There are additional information requirements for variable annuities incorporated in the Wvp to ensure that employees are well aware of both the upside potential and the downside risk.

The UK

In the UK, it is fiscal (tax) legislation that governs when and how retirement benefits can be accessed. Failure to abide by the rules set by the Finance ministry (Her Majesty's Revenue and Customs) can incur penal tax charges, which generally dissuade individuals from such action.

Superficially, the rules for accessing DC benefits are simple with 25% of accumulated funds being able to be taken as a tax-free cash sum and the balance being used by members in one or more of the following ways:

(i) to purchase one or more annuities;

(ii) to provide lifelong income from the pension fund (rather than annuitizing)[18];

(iii) to provide income through drawdown;

(iv) being withdrawn in one or more *ad hoc* taxable lump sum payments.

Providers of pension accumulation vehicles are not obliged to offer these options – so options are usually a 'contractual' matter or something set out in the pension fund rules. However, individuals also have a statutory right to transfer accumulated benefits – generally up to the expected age of retirement – so they can avail themselves of options unavailable in their accumulation vehicle. Commercial factors may mean that some options are not, in practice, available to some members – particularly those with small accumulated pots.

Some complications apply as there are various protections of historic rights to more beneficial treatment – for example in being able to access funds before age 55 or taking a larger proportion of funds as a tax free lump sum.

Other than the tax free lump sum, other forms of withdrawal are added to any other taxable income and taxed at the individual's marginal rate applicable in the tax year in which the withdrawal is made.

The UK's 'pensions freedom' reforms in 2015 gave savers freedom to use their pension pots as they wish, rather than being required (in most cases) to use the pot to buy an annuity. This provided scope for the market to develop new kinds of retirement income product, including products combining features of drawdown, annuity and cash lump sums, together with features catering for the different stages of retirement. Many

18 Provision of such a 'scheme pension' would mean the pension fund in the UK is considered not to be a pure DC arrangement, but subject to the requirements for defined benefit plans.

providers have been cautious about launching new products as they wait to see how trends develop, but new products are now emerging, and an example is highlighted earlier in this paper.

About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace and other funded pensions. Some members operate purely individual pension schemes.

PensionsEurope has **24 member associations** in 18 EU Member States and 3 other European countries*.

PensionsEurope member organisations cover different types of workplace pensions for over **110 million people.** Through its Member Associations PensionsEurope represents more than **€ 4 trillion of assets** managed for future pension payments. In addition, many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has **29 Corporate and Supporter Members** which are various service providers and stakeholders that work with IORPs.

PensionsEurope has established a **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

PensionsEurope has established a **Multinational Advisory Group (MAG)** which delivers advice on pension issues to PensionsEurope. It provides a collective voice and information sharing for the expertise and opinions of multinationals.

Our members offer

- Economies of scale in governance, administration and asset management;
- Risk pooling and often intergenerational risk-sharing;
- Often "not-for-profit" and some/all of the costs are borne by the employer;
- Members of workplace pension schemes often benefit from a contribution paid by the employer;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
- Good governance and alignment of interest due to participation of the main stakeholders.

What PensionsEurope stands for

- A regulatory environment encouraging workplace pension membership;
- Ensure that more and more Europeans can benefit from an adequate income in retirement;
- Policies which will enable sufficient contributions and good returns.

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* EU Member States: Austria, Belgium, Bulgaria, Croatia, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Iceland, Norway, Switzerland.