PENSIONS EUROPE

ROAD TO DC

UNDERSTANDING THE SHIFT

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A Foreword by Jerry Moriarty, Chairperson of PensionsEurope

As the Chairperson of PensionsEurope, it is with great pleasure that I introduce the paper "Road to DC: Understanding the Shift". This publication studies the transition from Defined Benefit (DB) to Defined Contribution (DC) pension schemes in Europe.

In recent years, many Member States have experienced a shift from traditional DB pension schemes to DC or hybrid models. Millions of Europeans already depend on workplace and/or occupational DC pension schemes alongside state benefits, and this reliance is set to grow. Employers are shifting away from DB to more stable options, while governments are working to bridge the gap between state pensions and citizens' retirement needs amidst economic and demographic challenges. These transitions have significant implications for the design and delivery of retirement benefits.

This paper offers a comprehensive study of the ongoing shift to DC in Europe, examining its ramifications and outlining key principles to design resilient pension schemes tailored to the diverse needs of retirees across Member States. By providing these insights, it aims to guide policymakers and other stakeholders in navigating the evolving pension landscape and pave the way for sustainable and adequate retirement provisions for future generations.

Prepared by the Standing Committee Future of Pensions, this publication underscores our commitment to understanding present and future pension challenges and finding optimal solutions. We present this paper as a contribution to the evolution of DC schemes and a natural follow from our previous papers on the topic. Through our Member Associations and our Corporate and Supporter Members, we have access to resources and expertise, which will continue to be used to participate in the debate on DC schemes and help to ensure better outcomes for members and beneficiaries.

I would like to thank all the members of the Board and Secretariat of PensionsEurope, who contributed to this paper, as well as the Members of the Standing Committee Future of Pensions.

A Foreword by the Eversheds Sutherland DC Team

We are delighted to have worked with Pensions Europe on this hugely important and timely publication: "Road to DC: Understanding the Shift".

Across Member States, we are starting to see a wholesale shift from traditional Defined Benefit (DB) pension schemes to Defined Contribution (DC) or hybrid alternatives. This trend is being driven by political, socio-economic, and regulatory changes. These make it less palatable for many employers to continue running – and financially underwriting – traditional DB pension arrangements.

The shift to DC has seen a fundamental change in the structure, risk, and implications of pension provisions. In DB arrangements, members benefit from a pension promise of a set level of retirement income. In DC and other hybrid arrangements, there may be no guarantees and savers often bear the investment and longevity risks in relation to their retirement savings.

While the precise nature of DC often differs across Member States, and there is no "one-size-fits-all", there are several consistent themes emerging in the shift to DC. Policymakers, supervisors, and the governing bodies running DC funds are all grappling with how to ensure that savers: achieve good retirement outcomes and an adequate pension; obtain good value for money; benefit from decent risk-adjusted investment returns; engage with their retirement savings so they can plan from an earlier stage; and receive the right level of support and guidance they need to make complex decisions at retirement.

Most of the focus so far has been on the "save" or accumulation phase of DC. But a generation of DC savers will soon start to reach retirement. At this point, the challenges associated with the "payout" or decumulation phase of DC – how to turn a finite pot of money into a reliable source of retirement income – will become pressing.

In this publication, we explore these key themes and look at how they apply holistically and strategically to all Member States on the road to DC, while drawing out some of the differences in approach between jurisdictions.

There is a societal and social obligation for policymakers, industry stakeholders, and supervisors to work collaboratively, embrace innovation, and adopt a solutions-driven approach. This will help to mitigate the changing landscape and ensure savers have sufficient savings for a dignified retirement.

We look forward to playing our part in that collaboration and hope you enjoy this publication.

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EXECUTIVE SUMMARY

The paper "Road to DC: Understanding the Shift" provides an exhaustive analysis of the ongoing transformation from Defined Benefit (DB) to Defined Contribution (DC) pension schemes across European Member States.

The objective of this paper is to explore the shift from DB to DC schemes taking place in many European countries and to provide some general solutions for building resilience and adequate retirement provisions in a more DC-orientated world.

The precise nature of DB and DC often differs across Member States, and there is no single approach to pensions. This paper uses the OECD taxonomy of DB and DC schemes to streamline the discussion.

While the shift has been in place for many years in some European countries and remains steady, the paper indicates that some historically DB/hybrid-dominated countries have been experiencing a more recent transition towards DC schemes with different magnitude levels. Despite the growing importance of DC schemes, it outlines that DB provisions persist in Europe, with the majority of members still enrolled in those schemes at the moment.

Various general factors, including demographic shifts and accounting standards changes, have caused this shift. Different trajectories are taken by countries. Country-specific reforms are important drivers as illustrated by the Dutch transition from DB to DC and the adoption of auto-enrolment in the UK and Ireland.

The transition to DC schemes shifts a greater burden of risk onto employees, potentially jeopardising pension adequacy. Factors, such as inadequate contribution levels or suboptimal decision-making by participants can exacerbate these risks. However, the degree of risk exposure varies based on the scheme model. Collective Defined Contribution (CDC) schemes and hybrid models, for example, provide greater risk-sharing among participants compared to individual DC schemes. in addition, it is essential not to overlook the advantages of DC schemes, particularly for employers seeking cost predictability.

While DC frameworks are different among Member States, several common themes are emerging. The paper advocates for key principles spanning from robust scheme design to comprehensive decumulation options, and tailored legislation to national contexts. Striking a balance between regulation and operational efficiency is essential to safeguard members' interests and minimise administrative burdens.

Ultimately, the paper stresses the importance of ensuring savers achieve secure retirement outcomes, receive adequate support and guidance throughout their pension journey, while also optimising value for money and participation costs.

INTRODUCTION

Occupational pension schemes can take two primary forms: Defined Benefit (DB) and Defined Contribution (DC) (although it is perfectly possible to combine elements of both within "hybrid arrangements". These schemes differ in how pension benefits are determined, and who bears the associated risks. In traditional DB schemes, where benefits are often linked to a worker's final salary, employers bear the vast majority of the risks, while in traditional (or sometimes called pure) DC schemes, risks are shifted towards the individual employees. Between these extremes, various hybrid arrangements exist in practice, featuring different degrees of risk-sharing between employers and employees, which may be accompanied by certain guarantees or collective risk-sharing.

Over the past few decades, several Member States have experienced a shift from traditional DB pension schemes to DC or hybrid schemes, a trend that has also been highlighted by EU policymakers. This shift has been driven by a combination of factors, including demographic changes, economic pressures, and evolving regulatory landscapes. Many European citizens already rely upon workplace and/or occupational DC pension schemes to supplement their pension benefits from the first pillar, and it is expected to grow in the future.

The paper ‘“Road to DC: Understanding the Shift” represents an in-depth study of this ongoing transition from DB to DC schemes occurring in many European countries. Through this project, PensionsEurope’s Standing Committee on the Future of Pensions surveyed PensionsEurope’s members to gain insights into the factors driving this shift, and the various challenges and opportunities it presents in Member States. The findings of this survey showcase the heterogeneity of the occupational pension landscape in Europe, highlighting the diverse approaches taken by different countries and ways of structuring DC pensions.

The paper continues the series of PensionsEurope’s publications on Defined Contribution schemes, which include Good Decumulation of Defined Contribution Pension Plans throughout Europe, 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 publications aim to benefit not only regulators and policymakers across the EU, but also researchers, employers, and those responsible for pension schemes. Through this paper, we also aim to update our previous research by analysing the current state of DC schemes in Europe, assessing their impacts, and reflecting on how to promote policies and best practices that ensure good pensions in light of these changes.

In addition, the paper aims to reflect on policies and best practices that can ensure good pensions. It also underscores the complexity of the transition towards DC schemes, emphasising the continued importance of DB schemes and many hybrid models that combine elements of both DB and DC. As the leading voice of occupational pensions in Europe, PensionsEurope advocates for the development of robust workplace pensions that provide adequate retirement incomes for workers. Achieving this goal requires policies that take into account this heterogeneity in Europe and are adapted to national contexts.

The primary objective of this paper is to explore the ongoing shift from DB to DC schemes by providing an overview of the DB and DC pension landscape in Europe (Chapter 1). It looks at the drivers behind this shift and makes the case that while general factors exist, national drivers, particularly reforms or changes in legislation, also need to be considered (Chapter 2). The paper highlights the associated risks and opportunities with DC schemes (Chapter 3). Finally, it provides some general principles for building resilience and adequate retirement provisions in a more DC-orientated world (Chapter 4).

01 Overview of the pension landscape in Europe

This chapter presents an overview of the occupational pension landscape in Europe. It analyses the split between DB and DC schemes.

Occupational pension schemes are those linked to an employment relationship between the scheme member and the entity that generally establishes the scheme (the plan sponsor). They may be established by employers or groups of employers (e.g., industry associations), sometimes in conjunction with labour associations (e.g., a trade union). Generally, the plan sponsor is responsible for making contributions to occupational pension schemes, but employees may also be required to contribute or allowed to pay voluntary contributions. Sponsors may have administrative or oversight responsibilities for these schemes, or there can be a separate governance structure. The pension benefits can either be DB or DC – (or a blend of the two) depending on how pension benefits are calculated and who bears the different risks.

According to the OECD taxonomy, a **Defined Benefit pension scheme** is *"any pension plan in which the financial or longevity risk is borne by the plan sponsor. Benefits to members are typically based on a formula linked to members' wages or salaries and length of employment"*. **Defined Contribution Pension schemes** are *"pension plans in which benefits to members are based solely on the amount contributed to the plan by the sponsor or member plus the investment return thereon. This does not include schemes in which the employer that sponsors the plan guarantees a rate of return."* As there is no guaranteed rate of return, any costs incurred from the fund within the DC scheme are the other critical element that will impact the level of benefits The OECD definition combines two elements: the legal nature of the accrual (a benefit or capital) and financial risk-bearing (either by the sponsor, the employee or an external party).

The distinction between DB and DC schemes is not always straightforward. For instance, Belgium introduced a legal minimum guarantee return on their Defined Contribution schemes. This guaranteed risk is carried by the employer, which technically means the schemes are DB as set out under the OECD definition. However, in the national context, they are still called DC.

Other countries have introduced hybrid DB schemes, which come in different forms, but effectively combine promising a benefit to members – a Defined-Benefit characteristic – with risk-sharing by those members – a Defined-Contribution characteristic. This was the case for instance in the Netherlands until the new Pension Act, which came into effect in July 2023. Until recently, benefits were accrued, but ultimately were conditional on the funding status of the pension provider.

Using the OECD definitions, the proportion of assets in DB and DC schemes varies greatly between European countries. Some countries operate mostly DB schemes. Finland and Norway have traditional DB schemes, which correspond to 100% of the assets allocated in the second pillar. DB and hybrid schemes are also dominant in countries, such as Belgium, Germany, the Netherlands, Luxembourg, Portugal, Spain, and Sweden.

By contrast, some European countries only operate DC schemes in the second pillar. This is the case in many countries of the Central and Eastern European (CEE) region, including Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania, and Romania. The share is also particularly high in countries, such as Austria, Greece, France, Iceland, and Italy.

DC schemes are gaining prominence at the expense of DB in some Member States. This shift has been in place for many years in countries including Ireland, Denmark, and Sweden, where there has been a steady increase in the asset allocation to DC schemes for the past 15 years. There, new and younger employees are usually covered by new DC schemes. Older employees remain covered by DB schemes.

More recently, some historically DB/hybrid-dominated countries have been experiencing a transition towards DC schemes:

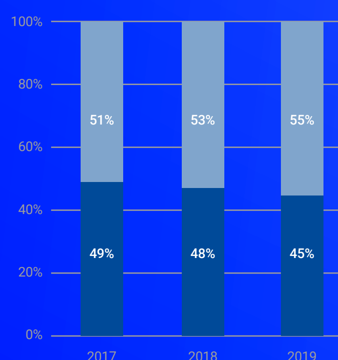
- On 1 January 2018, the "Law Strengthening Occupational Pensions" entered into force in Germany. This allowed the social partners to set up collective DC schemes exclusively via collective agreements – before this, German law did not allow occupational DC schemes. The first projects of collective DC schemes were already introduced in 2019. In 2022, the first DC schemes – one at the company and one at the industry level (chemical industry) – started operating. A third DC scheme, also at the industry level (banking sector), started operating in early 2024. While DB and hybrid schemes remain predominant, an increase in asset allocation in DC schemes can be expected over time. For the time being, most German pension schemes are treated as DC in international accounts (which is possible under certain requirements), but will remain, in legal terms, DB.

- The newly adopted Dutch Pension Act will abolish the system of DB accruals. Under the old system, indexation (or benefit reductions) was dependent on the funding status of the pension provider, and sponsor support was absent, meaning that the financial risk was shared collectively by members. Most pension funds are expected to convert the existing DB accruals into DC capital and annuities will become variable in principle. However, the majority of DC schemes will retain strong solidarity elements, including a solidarity buffer to mitigate the impact of financial shocks on pensions and risk-sharing between generations. The Dutch model therefore will be hybrid.

- Ireland is advancing on its journey to DC. The numbers of Irish DB schemes are incrementally declining each year, and most are closed to new members, with 36% frozen to further accruals. DC assets are growing annually and are now running at 65 – 70% of DB assets. DC schemes are consolidating into large master trusts, which are expected to further drive growth and innovation. Mandatory automatic enrolment into a pension scheme is being introduced in Ireland, and all the asset growth this will drive will be in DC.

In 2020, the EIOPA Consumer Trends Report noted that 55% of active members in 23 Member States were enrolled in DC schemes. Since then, this trend has continued to grow. The 2023 edition of the EIOPA Consumer Trends Report shows that number of new members in DC pension schemes in 2022 increased by 115% compared to 2021, with an increase in France (610%), and Sweden (90%). It corresponds to an increase of 11% in one year in active members in DC schemes as a percentage of total active members at the aggregate level.

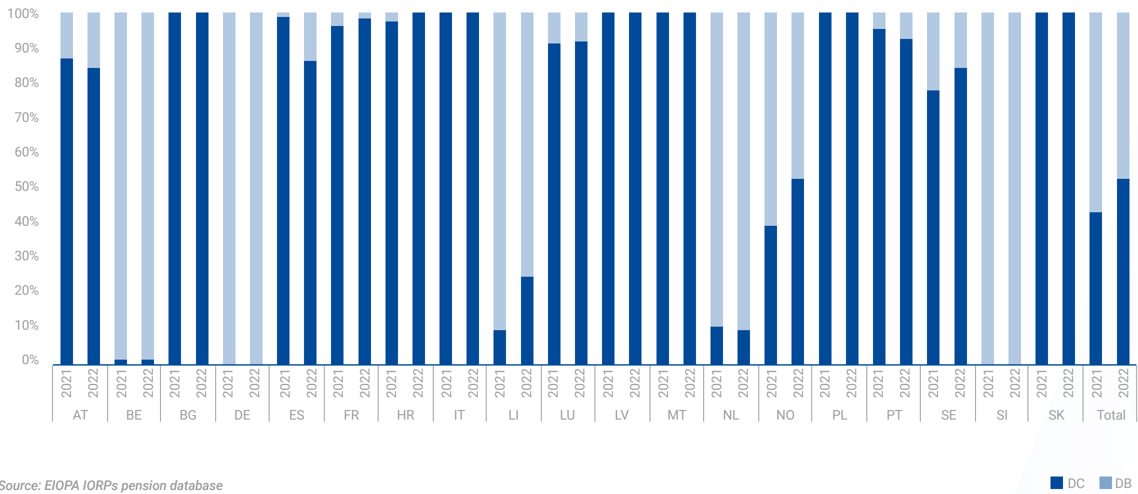
Active Members split by DB/HY and DC schemes (23 MS)



Source: EIOPA financial stability statistics DC DB

Consumer Trends Report 2020 - EIOPA

New Members by type of scheme and by Member State in % — 2022, 2021



Source: EIOPA IORPs pension database

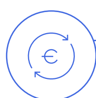
Consumer Trends Report 2022 - EIOPA

DB and hybrid schemes still remain larger both in terms of membership and assets under management. In 2022, DB pension schemes added more members in absolute terms (2.5 m for DB and 2.1 m for DC). It is important to note that the trend is not unilateral in Europe and that DB schemes will remain relevant as some Member States, such as Germany, will continue to provide mostly DB contracts.

02 Implications of the shift from DB to DC schemes

This chapter investigates the factors behind the shift from traditional DB to DC schemes. Some of these factors are faced by many countries, and others are specific to national contexts.

CHANGES IN ACCOUNTING STANDARDS



In 2001, the International Accounting Standards Board (IASB) was adopted to bring convergence between national accounting standards through the development of global standards. The IASB established new accounting and regulatory changes, which impacted both DB and DC schemes. It requires an entity to recognise a liability when an employee has provided service in exchange for his or her benefits to be paid in the future. This implies that the value of the DB scheme's liability had to be shown on a company's balance sheet. This calculation could lead to significant volatility on the balance sheet as interest rates and investment returns fluctuate, and no smoothing is allowed. Conversely, for DC schemes, costs are expensed when contributions are made – and the only defined element is the promised level of contributions – simplifying accounting. The adoption of these standards has encouraged a gradual shift towards DC schemes in the UK, Ireland, Austria, and Belgium, as it simplifies the accounting process, and removes volatility from sponsors' balance sheets.

SOLVENCY AND FUNDING RULES

Solvency and funding rules in Europe, shaped by a combination of the IORP directive and national regulations, have also had a significant impact on the treatment of pension liabilities for DB schemes. These rules require pension plan sponsors to ensure that their IORPs are adequately funded to meet their pension obligations.

As solvency and funding rules have become more stringent, even more pressure has been put on plan sponsors to ensure schemes are always well-funded. This has resulted in strong contribution demands on employers, even when employers are struggling financially. This funding strain on sponsors (and the associated volatility) makes DC schemes more attractive as the only corporate promise concerns the contributions to be paid. There is no corporate promise concerning the benefit, which emerges from the plan when members retire. This means employers have greater certainty about their pension costs, and are no longer exposed to the risks and volatility associated with DB schemes.

Mortality

Population aging has been increasing over the past decade and is expected to accelerate significantly over the next 20 years. Life expectancy has also increased, which means pensions are paid for longer, increasing the cost of providing them. Demographic changes are resulting in notable shifts in population structures in Europe.

Structural changes in populations

Several Member States, including Greece, Lithuania, and Poland, face challenges as their working-age populations are projected to shrink by at least one-third by 2060. These demographic changes place significant strain on existing and future pension systems, particularly Pay-As-You-Go structures. Age dependency ratios (the ratio of dependents compared to the working-age population) are also expected to rise in some countries. Some projections indicate that in over half of the EU Member States, there will be fewer than two working-aged individuals for each person over age 65 by 2060. In response to these changes, some governments have developed policies that encourage or require employers to instead DC schemes.

Changes in the labour market and companies' preferences

The changing landscape of the labour market, including the rise in workforce mobility, self-employment, and flexible work arrangements, is also contributing to the shift towards DC pension schemes. There is a growing preference for pension options that match evolving work patterns, and provide easy portability when employees leave a job or take breaks from work. Companies are also choosing DC schemes as they offer greater control over pension costs and less exposure to the risks and volatility associated with DB schemes (see above).

Economic pressures

Pension expenditure as a percentage of GDP has risen in some European countries, with Greece and Italy allocating over 15% of their GDP to pensions. Eurostat data indicates that, on average, pension expenditure in the EU stood at 12.9% in 2021. This significant share of GDPs allocated to pensions can be explained by demographic changes, employment trends, and variations in the labour share of GDP. In the second pillar, declining interest rates, from the late 1980s to recently, have also made it difficult for DB schemes to generate sufficient returns to meet their obligations. These factors have further intensified the shift towards DC.

Regulatory changes

National legislation, regulation, and tax incentives can drive or encourage the transition from DB to DC. For instance, the UK's Pension Regulator has promoted lower-risk investment and funding strategies, which increase the sponsor's cost of DB schemes, thereby boosting the popularity of DC schemes. Changes in tax rules, and greater flexibility around how benefits can be taken, have also made DC schemes more financially attractive to members. In particular, the UK has a developing DC master trust sector, which allows employers to offer their employees a trust-based DC occupational scheme without the need to set this up, and administer it themselves. The UK's automatic enrolment requirements mean that employers are required to make a pension scheme available, and contribute to it for their employees.

03 Consequences of the shift from DB and DC

This chapter explores the outcomes that arise when moving from DB to DC schemes. It analyses the consequences of this shift in retirement strategies and the broader impact it brings to pension systems.

SHIFTING RISKS

In traditional DB schemes, most of the risk rests with employers, who effectively promise that the scheme will provide a predetermined payout at retirement. DB and hybrid schemes may offer more protection against biometric risks in comparison to DC schemes. Indeed, traditional DC schemes shift more risk onto employees; each employee generally has an individual pension account, the size of which depends on contributions, charges, and investment performance. When members can make choices as it is the case for some DC schemes, their decisions can directly influence their retirement benefits.

The extent of the risk to which members and beneficiaries are exposed varies significantly based on the DC scheme design. In general (although there are notable exceptions), employees' participation in the decision-making process is limited, and most decisions are taken by employers, the fiduciaries or governing boards running the pension funds or social partners.

Collective Defined Contribution (CDC) schemes and hybrid models provide greater risk sharing among participants compared to individual DC schemes. This distinction is evident in the recent pension reform in the Netherlands. The reform aims to accumulate a form of individual pension capital while incorporating the advantages of collective risk-sharing. Another example is Denmark, which operates a compulsory-funded CDC scheme with a unique contribution structure. Here, 80% of contributions come from the "guaranteed contribution", serving as the basis for the guaranteed nominal pension. The remaining 20% corresponds to the "bonus contribution", directly channelled into reserves or buffers for future pension indexation and accrued entitlements based on conditions. In Germany, the possibility of establishing occupational collective pure DC schemes was legally introduced in 2018 with the "social partner model", which can only be established via collective agreements. Investment decisions are taken by the schemes´ committees, in which the social partners are involved. Their participation in the implementation and management of the scheme is mandatory. Investment risk is collectively shared by the scheme´s participants.

It is important to note that the implications and risks associated with DC schemes are described below in general terms. In practice, they will be heavily dependent on national rules and specific scheme design.

COVERAGE AND ADEQUACY

DC schemes are a useful tool to help employees save for their retirement and to improve the coverage of funded pensions. For employers, DC schemes offer a higher predictability in terms of cost planning compared to DB schemes. Their obligations are limited to paying a defined level of contributions rather than guaranteeing specific retirement benefits, which can encourage them to enrol their employees[1]. Participation can be additionally facilitated by measures such as automatic enrolment and/or be regulated via collective agreements or agreements at the company level, which often also provide the basis for the joint financing of

1 In some DC schemes, employers' involvement is not limited to paying contributions. Depending on the scheme/ national context, they might be required to provide a security buffer or guarantee or participate in the scheme's management.

contributions by employer and employee. Auto-enrolment is becoming more widespread in Europe, and has been a successful driver to improve the number of people saving via a pension scheme. Notably, the UK introduced auto-enrolment in 2012. Over the period to 2019, it led to a tenfold increase in total membership of DC occupational schemes, from 2.1 million in 2011 to 21 million. Lithuania implemented an auto-enrolment reform in 2019. In one year only (2020), it led to a participation rate of 75.7%. Ireland is set to implement auto-enrolment in 2024. It is estimated that the reform will encourage 750,000 workers to start a pension.

However, a significant challenge with DC schemes is that they can fall short of providing adequate retirement incomes. There are several reasons: contribution levels are often too low; an individual may hold multiple small pension accounts which fragment his or her purchasing power at retirement; or the DC savings are only a small proportion of his or her retirement planning. This means they are unable to secure an adequate level of income in retirement lifelong income – whether through annuitisation or otherwise.

A study by the Pensions and Lifetime Savings Association (PLSA) (2023) revealed that:

- only **79%** of individuals saving in a DC scheme across the UK were on track to meet its Minimum Retirement Living Standard (£19,900 for a couple[2]) and assume entitlement to a full State pension (£10,600 in 2023/2024)
- only **30%** were on track to reach their Moderate Living Standard (£34,000 for a couple).

This is compounded by the fact that most individuals do not know how much they need to save (or to contribute) to secure an adequate income in retirement. There is a need for contributions to DC schemes (and within any auto-enrolment regime) to be set at an appropriate level to help savers achieve an adequate retirement income. Some countries have implemented tools to assist savers practically in estimating the amount of money needed for their desired lifestyle in retirement. For instance, the PLSA has introduced the Retirement Living Standards, which help individuals envision their retirement lifestyle and the associated expenses needed to maintain a specific standard of living. Similarly, the ASFA Retirement Standard Explainer offers insights into the lump sum required by the average Australian to afford a comfortable or modest retirement. It is important to note that these conditions vary significantly on the country. A study conducted by the OECD on the role of private pensions in the retirement readiness of the working-age population across various countries, such as Chile, France, and the Netherlands, highlights that factors including the mandatory or voluntary nature of individuals' enrolment in the private pension system, retirement age preferences, and economic conditions, lead to varying degrees of reliance on private pensions. Consequently, countries require tailored strategies to their national context to assist their citizens in understanding how much they need in retirement and how to achieve their goals.

LONGEVITY RISK

Longevity risk refers to the uncertainty that an individual, or a group of individuals, might live longer than initially estimated. When a retirement income is not guaranteed to be paid for life, the risk is that individuals exhaust their retirement savings prematurely or

2 This assumes a couple is mortgage and rent free in retirement

are forced to live with reduced income during their retirement years. In a traditional DC scheme, individuals may face the uncertainty of accurately estimating the savings needed for a secure retirement, and the possibility of outliving their savings. This depends on the types of decumulation that are allowed under national social, labour, and tax law.

The cost of self-insuring longevity risk can be significant. In general, however, these biometric risks are less significant in collective DC schemes due to the nature of the pooling of resources and risk-sharing mechanisms inherent in these schemes.

The risk of running out of savings can also lead some individuals to be too cautious with the result that they do not spend their savings effectively and proportionately across their retirement.

In addition, there is a common tendency for people to underestimate their life expectancy. A study conducted in the United States by Jackson Financial Inc. and Boston College (2023), which aimed to identify and assess retirement-related risks, surveyed 1,000 investors aged 55-84, along with over 400 financial professionals and financial psychologists. The study revealed that only 12% of participants accurately predicted their life expectancy in line with the mortality tables of the US Social Security Administration. A significant portion of participants, over 32%, underestimated their life expectancy.

INVESTMENT STRATEGY

The shift to DC can impact the demand from pension schemes for specific asset classes due to different risk and investment characteristics between DB and DC schemes, and how investment strategies are implemented.

In a DB scheme, the body running the fund is usually responsible for deciding how the fund is invested, following the "prudent person" rule. Some regulatory limitations have more influence on DB schemes, impacting how portfolios are allocated. In some jurisdictions, DB schemes are restricted by minimum investment ratios or by regulatory requirements, setting a lower limit on anticipated returns, and/or are exposed to interest rate risks through their liabilities. How deficits in DB schemes must be reported in the employer's accounts or to regulators can also lead employers and schemes to seek to match the profile of the scheme's assets and liabilities as closely as possible. This can lead schemes to de-risks, which will greatly increase the chance of delivering the promised benefit, but reduce the chance of outperforming it.

In contrast, traditional DC schemes may offer a more extensive array of investment options: often, they provide default funds for members, who do not choose (or want to choose) their investments, and also, they may allow members to choose from a range of investment options, which include potentially higher-risk investments with greater growth potential or funds with an ethical or specific ESG component (e.g., impact investing funds). This can result in increased investment returns, thereby bolstering assets and eventual retirement benefits for the scheme's members. However, these kinds of DC investments may also experience greater volatility the performance of these investments heavily depends on the strategies available to members, guidance in navigating risk-return preferences, but also the ongoing monitoring and adjustment of the available options.

An important consideration when participants can choose between different investment options is

that they may lack sufficient financial knowledge, leading to uninformed or poor decisions that may impact their investment choices.

INTEREST RATE RISK

Interest rate risks pose significant challenges for both DB and DC pensions. In DB schemes, fluctuations in interest rates affect the valuation of pension liabilities. When interest rates are low, the value of future benefit payments increases, straining pension fund finances, and potentially requiring extra contributions from employers to maintain solvency. In DC pensions, interest rates changes affect investment returns and annuity payouts. Low interest rates can imply lower returns on fixed-income investments (but increase the value of bonds) in DC portfolios and reduced annuity payments for retirees, impacting their retirement income. On the contrary, high interest rates can push down the value of bonds, which can negatively impact the value of DC pensions invested in this asset class, for example during a "lifestyling" phase (which typically moves assets from growth-related classes to bond-related classes as individuals get closer retirement)

FLEXIBILITY

Individual DC schemes typically offer individuals control and flexibility in managing their retirement funds. This flexibility enables participants to tailor their investment choices according to their risk tolerance, financial goals, and market conditions. Additionally, it can help to foster a sense of ownership and engagement, as individuals actively manage their retirement funds, potentially optimising returns. As discussed above, this depends on individuals having the required knowledge, and being interested enough to engage with their DC retirement savings. Scheme design with flexibility therefore needs to mitigate the risk that individuals make choices that are not in their interest.

FINANCIAL LITERACY AND BEHAVIOURAL BIASES

When members make active decisions regarding their DC scheme, their understanding is important in determining retirement outcomes. Achieving an optimal investment strategy can require substantial financial skills, time, and motivation from participants. However, in Europe, financial literacy remains relatively low. The Eurobarometer (2023) reports that only 18% of EU citizens have good financial knowledge.

A multitude of challenges contribute to this financial literacy gap. They encompass an overwhelming abundance of financial choices and information available to individuals, inconsistencies in how much time individuals have for financial matters, reliance on mental shortcuts in decision-making, reluctance, or unwillingness to pay for financial advice, susceptibility to framing effects, excessive confidence overreliance on past trends, the terminology associated with pensions and financial products, which is often technical and difficult to understand, and aversion to losses.

Insights from behavioural science emphasise that when confronted with complexity and presented numerous options, individuals tend to make suboptimal choices within DC schemes (particularly when they come to access their savings at retirement). For instance, a large number of options often leads to decision paralysis or choices that do not align

with long-term financial goals. Mental shortcuts and biases, such as overconfidence or loss aversion, can further influence an individual's decision-making and may lead them to make decisions that may not be in their best financial interests. This is why default options are important. Many people prefer not to, or find it difficult, to make choices.

COSTS, CHARGES AND VALUE

Operating pension schemes involves various expenses related to governance, administration, reporting, and investment activities, which are typically covered by contributions from both members and employers. Some pension schemes, particularly those offering a wide array of options, tend to incur higher costs, ultimately impacting the final retirement income. The OECD notes that annual costs amounting to 1% of assets could potentially reduce pension income by over 20% after 40 years of saving, requiring more than a 20% increase in contributions to achieve the same retirement income level.

However, according to EIOPA´s Costs and Past Performance Report of December 2023, in only three out of 18 EEA-countries, the average ratio of total expenses over total assets of DC schemes is above 1%. A single focus on costs without taking into account benefits presents an incomplete picture. A DC IORP that invests also in private equity and other alternative investments probably has higher operational costs than one that is not investing in these asset classes – but is also more likely to benefit from higher capital yields and thus justifies these additional costs. Furthermore, IORPs that insure their members against biometric risks usually display higher costs.

Overall, while it remains an unanswered question whether the costs/fees of DC schemes are higher than the costs/fees of DB schemes, some research suggests lower administration costs in DB schemes. The reason is economies of scale in DB schemes, especially regarding investment costs. In addition, recent commentary from the Netherlands – which is undergoing a major shift from DB to DC in its pension provision – is also that DC governance and administration is deceptively complex and that the overall costs in a DC environment could end up being higher than they were with DB. This may be due to a combination of factors including fewer economies of scale as DC schemes operate individual member accounts and investment choices, and different communication needs as members become more responsible for managing and investing their accounts.

GOVERNANCE

Regarding governance, workplace DC pension schemes are designed for the long term, and require oversight by individuals or entities bound by law or regulation to act in the interests of scheme members and beneficiaries. Inadequate management of default funds, and/or offering a range of investment options that are too narrow, too wide, not kept under review, or otherwise unsuitable, can expose participants to various risks, including inappropriate investment and withdrawal options, poor investment performance, excessive volatility and costs, misleading communications and potential regulatory breaches. A well-governed scheme with efficient administration is fundamental in ensuring favourable retirement outcomes for members.

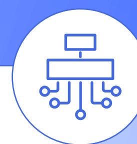
04 Managing the shift and providing good and complete pension arrangements

This chapter aims to propose solutions to the implications and risks associated with DC schemes by outlining key principles for achieving good retirement outcomes.

In recent years, EU policymakers have consistently highlighted the trend of transitioning from DB to DC. The IORP II Directive, which sets common standards on occupational pensions, is currently under review, The technical advice of EIOPA on the IORP II review includes a chapter on the "Shift from Defined Benefit to Defined Contributions", in which EIOPA provides recommendations for regulating DC schemes and to address their specific risks.

PensionsEurope advocates for the development of strong workplace pensions, many of which are transitioning to DC schemes. However, it is essential to consider national differences when creating legislation for DC occupational pensions. Member States have varying interpretations and definitions of DC pension schemes and regulatory requirements depend on the specific type of DC pension in place. Different social systems reflect policymakers' diverse goals regarding workplace pension systems. Policymakers must balance the need for proper regulation and governance of schemes with the risk of imposing overly burdensome regulations on pension administrators and employers, potentially harming members and beneficiaries by increasing participation costs. Regulators need to recognise that compliance costs in DC schemes are typically borne by members, either directly or indirectly. Therefore, any proposed regulations specific to DC schemes should be thoroughly assessed to ensure they are also justified, necessary, and proportionate.

Building on our previous work on DC schemes, this chapter establishes general principles for achieving adequate retirement provisions within DC schemes and other hybrid alternatives.



DC SCHEME DESIGN

Workplace DC pension schemes should prioritise good outcomes for members, based on a robust yet flexible design.

Consideration should be given to providing a default lifetime income during the pay-out phase unless other pension structures which are already in place in the national jurisdiction guarantee adequate payments.

Determining the desired outcome is challenging and depends on various factors like the state pension level, members' demographics, and individual savings. Despite these challenges, the scheme should establish clear objectives for its participants. Inclusivity is key and eligibility criteria that may exclude certain groups should be minimised and avoided as far as legally possible.

While auto-enrolment can enhance participation, contribution levels often remain insufficient. Enrolment mechanisms embedded in collective agreements hold promise for boosting contribution levels by addressing the specific needs of workers in a scheme, but also by providing joint financing of employer and employee contributions. Defining acceptable levels of retirement income within each country can serve as an initial guide for members and employers alike to improve adequacy. Additional methods include employer-matching contributions, leveraging technology to streamline contribution processes, and facilitating access to affordable financial planning services. In some Member States, such as Germany, the state offers subsidies employers, who enrol their low-income employees in the occupational pension scheme, which as proven to be effective.

Individuals will only receive an adequate income in retirement if they have saved enough throughout their careers, but also depending on how costs and investment performance are managed. Helping savers to focus on understanding their savings needs is therefore crucial because the timing of when contributions start to be paid has large impacts on the ultimate pension outcome. Starting to save for retirement early increases the likelihood of achieving a higher pension, especially with increasing life expectancies. Simplifying the decision process for members by limiting options for contribution rates, investment strategies, and payout choices can enhance participation.

Default funds can serve in scenarios where multiple investment options are available, offering a safety net for participants who are hesitant to actively manage their investments. However, there is a fundamental tension between default and apathy on one side and choice and engagement on the other. This tension is at the core of designing a successful DC scheme in practice. Auto-enrolment has proven effective in initiating DC savings by placing individuals into a scheme, leveraging their apathy to keep them enrolled. Yet, as the payout phase approaches, greater engagement, and member decision-making, and a range of choices become necessary to tailor the DC benefits to each individual's needs. Navigating this transition requires careful consideration.

INVESTMENT DECISIONS

Investments should be suitable to participants' needs. Any default should also be appropriate. When individuals choose how their funds are invested, the scheme should offer a variety of options, which consider members' preferences and profiles. In the context of collective investment, the profile of the fund must be suitable for the membership as a whole.

Implementing these strategies implies that schemes must enable effective diversification with funds primarily invested in regulated markets with a prudent level of exposure to unregulated markets. Offering funds that invest in less liquid investments can boost returns over the longer term, but care should be taken over liquidity management. Individuals should also receive timely and adequate information, including details about costs and charges.

The ongoing performance and appropriateness of available investment funds should be regularly reviewed by those managing the scheme with adjustments made as necessary. This review should consider the risks affecting DC pensions in the short-term, but also for long-term sustainability.

Risk assessment must also be duly considered to establish appropriate investment strategies. The Own Risk Assessment (ORA) outlined in the IORP II Directive rightly emphasises the risks facing IORPs and their impacts on members and beneficiaries, while providing adequate space for national implementation. DC schemes can take many different forms in Member States, so flexibility in the implementation of risk assessment and other exercises is therefore important. Policies must be tailored to national contexts to be effective.

When relevant, a default fund should be available. Empirical evidence demonstrates that most people will not choose even if they can. In the UK, the Pensions Regulator reveals that between 2022-2023, 97% of memberships in DC schemes followed the default investment strategy. This means that the design of the default must be suitable for large numbers of participants, who may not exercise a choice. It is especially relevant in a system where auto-enrolment is put into place. The fund must strike a balance between reasonable returns, security, and reduced volatility. The default fund's structure should also align with the objectives of the DC pension system, and ideally be suitable not just during the accumulation phase, but also for the payout phase. For example, life cycle investment strategies can allow members to take on more risk when young, and mitigate extreme negative outcomes as they approach retirement.

VALUE FOR MONEY

Promoting cost-effective retirement arrangements is important both in the accumulation and pay-out phases. Costs and charges, especially, must offer value for money to ensure affordable access to quality DC pensions, but it is important to avoid a "'race to the bottom" where a focus on low costs can come at the expense of wider value, quality, performance, and service delivery.

Transparency is particularly important when members and beneficiaries make their own investment choices. Collective DC schemes tend to be more cost-efficient relative to individual products since these IORPs are in most cases set up by social partners, enjoy economies of scale, and act of their accord in the best interests of their members and beneficiaries. There should be a focus on costs because they directly impact members outcomes.

IORPs must diligently monitor their costs to ensure optimal value. Experience in the Dutch market illustrates that transparency of costs effectively combats high pension administration and asset management costs. It helps social partners who are engaged in benchmarking exercises to assess effectively whether their scheme is cost-effective. Low and transparent costs also facilitate standardisation of compulsory participation in pension schemes.

Rules regarding costs and charges, including their granularity, should be left to Member States. National policymakers should also consider additional measures to enhance value for money. For instance, many countries have imposed caps on payable fees, particularly those linked to assets under management, which is a common method for pension providers to charge members.

Setting the cap at the appropriate level is crucial yet challenging. If set too high, savers may not receive adequate value. Conversely, if set too low, pension providers may resort to suboptimal investment strategies and lower service quality. It is important to avoid proposing suboptimal investment strategies; for example, diversification across less liquid assets, albeit with higher costs, can offer benefits.

Consideration should also be given to identifying the elements of service and delivery that contribute to good value – it is not just a question of cost. In the UK, there is an active debate on improving the value of DC pension schemes and shifting away from the dominant focus on costs and to focus on other factors including investment performance and quality of services. The goal is to ensure that pension schemes offer meaningful value to their members beyond just cost considerations.

Tax regulations should be clear, consistent, and uniform in each pillar to prevent confusion. The structure of financial incentives should align with the different retirement saving needs and capacities of different population subgroups.

COMMUNICATION

Good communication must ensure that participants in a retirement scheme have a clear understanding of what to expect at retirement and their responsibilities in achieving those expectations.

Clear and balanced communication is required to empower participants in their planning efforts. Communication must set out the risks and the benefits of, where possible, changing contributions. If joining a scheme is voluntary, the risks of not joining should be specified, along with the benefits of joining. Those managing the schemes should communicate with the participants on an ongoing basis so that they can track their progress toward their goals.

National governments should be able to determine their own pace and direction of change in communication. Differences in terms of structure and layout do not necessarily hinder an adequate understanding of pension communication. The most important is that the means of communication work effectively in a national context.

Simplicity is key, especially because information overload can harm a participant's comprehension. Communicating about complex information, such as investment rules and returns may not be relevant. This is especially the case when members cannot make investment decisions, for instance in Collective Defined Contribution schemes. Overburdening participants should be avoided.

The ongoing transition towards digitalisation offers a good opportunity to enhance pension communication. Digital tools can empower participants to better understand their options and the potential impacts of their decisions, particularly when confronted with making investment choices. However, communication channels and formats should not be codified in regulation because new ones might emerge, and focusing on one form of communication can exclude members, who are more comfortable with or can only access other forms of communication. Considering the speed of change in the field of communication technology, any envisaged regulation should be flexible and principle-based to make it possible to change the modes of communication as digitalisation progresses.

Financial literacy is important when members make decisions concerning enrolment in a pension scheme or investment choices. National strategies, including national tracking systems, should not only offer general information about retirement options, but also aim to raise awareness of the critical importance of consistent savings for retirement. Importantly, the continuous nature of financial education, featuring focused messages that evolve with changing life stages, ensures that participants are well-informed and capable of making sound decisions throughout their retirement planning journey. This is, however, likely to be a long-term strategy that will take considerable time to show results.

Governance

Managing DC schemes requires good administration systems for accurate benefits, prompt transactions, and positive retirement outcomes.

Accurate recordkeeping, effective systems, and good governance are important to ensure that participants receive the right benefits. Administration tasks include recording participants' choices (for example, around joining, leaving, investment funds, and contribution levels), calculating and deducting the correct contributions from salaries, ensuring proper investment alignment with participants' instructions, promptly allocating contributions to the correct investment funds, calculating, and allocating the investment returns (positive or negative) due to member accounts, and calculating and deducting charges correctly.

Effective scheme management requires robust oversight to ensure adequate service levels, especially if administration is outsourced, with good checks and balances in place. Regular monitoring and assessment of administrator performance are essential for proper plan administration.

Diversity in management bodies can also contribute to improved decision-making processes by better reflecting the profile of members amongst decision-makers, and ensuring a variety of cognitive approaches to decision-making. IORPs cannot always represent the entire society in their management bodies, but should aim to represent appropriately the population of the pension fund, and take into account other elements as needed to ensure diversity. Finding board members can be challenging, especially for small IORPs. However, some steps can be taken to increase the pool of candidates, including using inclusive recruitment language. All that said, the fitness of potential Board members is fundamental, and should always be the primary factor taken into account.

Decumulation

DC pension schemes should default to providing lifetime income during the pay-out phase, unless other pension arrangements cover adequate lifetime payments.

Flexibility could be provided by allowing partial, deferred, or delayed lifetime income combined with programmed withdrawals. Full lump sums should generally be discouraged, except for low account balances or special circumstances, such as extreme financial hardship. During the COVID-19 pandemic, some countries allowed early access to retirement funds, such as France for self-employed workers or Iceland. The main concern is that it could leave individuals with no retirement savings. They may have to resort to social assistance to support them in their old age.

In the pursuit of good outcomes for members and beneficiaries, many workplace DC pension schemes grant participants the autonomy to choose how to access or use their pension accounts upon retirement. Within the national legal and regulatory framework, schemes should offer suitable decumulation options that deliver value for money, and provide support for members over the rate and extent of withdrawals in the pay-out phase.

Members should have access to appropriate information. Early enough before their anticipated retirement, they should start considering potential decumulation options when available. They should be aware of how to use their funds to support their initial years of retirement lifestyle, while also knowing the risk of exhausting funds prematurely. If feasible, pension plan administrators should consider enabling access to advice or guidance on drawdown options for their members and beneficiaries. However, administrators or employers may be hesitant to provide advice due to the potential legal liability involved. For these reasons, national governments and regulatory bodies could consider specific measures to encourage providers to give information without being liable. For instance, by establishing relevant frameworks to define what constitutes advice, and how to deliver information in the form of guidance instead which does not have the same legal responsability.

In essence, the organisation of the decumulation phase in the pension system is a matter of national competence. National social policy, regulatory framework, and taxation should be considered when considering potential changes to existing decumulation options. Defining an "adequacy" level for retirement income is primarily a decision for national governments. Flexibility in how benefits are taken is also a decision for Member States.

So far, most thinking on DC has focused on the accumulation phase (the process of building up the account). However, as an increasing number of people start to retire in circumstances where DC benefits make up a larger proportion (and possibly all) of their retirement wealth, more time and attention will need to be given to delivering good member outcomes in the decumulation or pay-out phase, to ensure that the time, effort and money spent during the accumulation period is not wasted. Decumulation is the critical time when accumulated DC savings are converted into benefits to support members through their retirement, and hopefully to provide an adequate income. Finding a balance between the ability to continue to invest post-retirement and the need for predictable income for the rest of a lifetime is difficult. Options can range from a lifetime annuity to 100% post-retirement investment with a flexible drawdown. Some forms of longevity protection can deal with the concern of money running out, but there is also an issue about the extent to which pensioners will be able to make decisions as they age.

CONCLUSION

The analysis presented in this research project sheds light on the ongoing transition from DB to DC pension schemes across European countries. In Chapter 1, we provide an overview of this shift, which highlights the complex landscape of occupational pension schemes in Europe, wherein distinctions and definitions between DB, DC, and hybrid models vary significantly across different nations. Moreover, the chapter outlines the heterogeneous nature of the transition, with some countries experiencing recent shifts, such as the Netherlands or Germany, while others witness more steady transformations, as exemplified by Sweden's case.

Chapter 2 delves into the reasons driving the evolution towards DC schemes. While general factors such as demographic changes and shifts in accounting standards are discussed, the research underscores the crucial role of country-specific factors, including government reforms and tax policies, in shaping the pension landscape. Notably, cases like the Dutch reform and the introduction of auto-enrolment in the UK and Ireland illustrate the diverse paths taken by individual countries.

Chapter 3 explores the consequences of this transition, highlighting both risks and opportunities. It points out that DC schemes often transfer more risks to employees. These risks include - but are not limited - to insufficient savings, primarily due to low contribution levels, and the potential for poor decision-making stemming from limited financial knowledge among members leading to suboptimal decisions. The level of risk varies depending on the scheme's structure. A clear distinction is drawn between pure DC schemes and Collective DC schemes, which involve more risk-sharing. The chapter also discusses the potential benefits of DC schemes, including broader coverage and increased flexibility.

Finally, Chapter 4 offers some solutions to address the implications and risks associated with DC schemes and other hybrid models by proposing key principles for achieving good retirement outcomes ranging from the scheme design to decumulation options. It stresses the importance of tailoring legislation to national specificities. The chapter advocates for a balanced approach to regulation and governance to prevent imposing excessive burdens on pension administrators and employers, which could raise participation costs, and negatively impact members and beneficiaries.

In conclusion, this research project offers a comprehensive exploration of the transition from DB to DC pension schemes in Europe, underscoring the factors driving this shift, its consequences, and some key principles for designing resilient pension schemes tailored to the diverse needs of retirees across Member States. It provides insights to navigate the evolving pension landscape and to ensure long-lasting and adequate retirement provisions for future generations.

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 25 Member Associations in 18 EU Member States and 3 other European countries.

PensionsEurope member organisations cover different types of workplace pensions for around 90 million people.

Through its Member Associations, PensionsEurope represents close to € 5 trillion of assets managed for future pension payments. Many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has 18 Corporate and Supporter Members, which are various service providers and stakeholders that work with IORPs.

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