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Richard Detje

Systemic Danger?

The Effects of the Financial Crisis on Private Pensions

Editorial

Richard Detje authored the study on „Systemic Danger? The Effects of the Financial Crisis on Private Pensions“ on behalf of *transform! europe*. So far it has been published in German and French. With its publication in English we are launching a new format of our print medium, the *special editions*, in which we will at irregular intervals provide relevant materials and documents for the left discourse – an undertaking supplementing the *transform!magazine*, which is being published in eight languages every half a year. The *special editions* will primarily be published in English, but occasionally also in other languages. They can be ordered via the transform web-page, from our members and observing members or from **office@transform-network.net**.

Richard Detje is a member of the scientific association for the analysis of capitalism and social policy, WISSENTransfer.

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Systemic Danger?

The Effects of the Financial Crisis on Private Pensions

At the beginning of the current financial crisis – i.e. a crisis of a finance led accumulation regime – in 2007 and early 2008 declining banks and stock markets have been the focus of attention. In the U.S. already in this early stage, in Europe beginning with the end of summer 2008 the sharp downturn of the business cycle indicated a second source of what can be characterised as a double crisis.

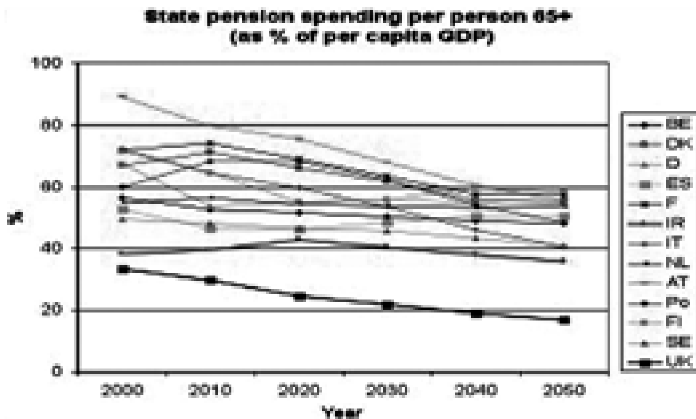
The consequences are: growing mass unemployment and tightened pressure on wages, henceforth deteriorating living conditions. The double economic crisis transforms more and more into a social crisis.

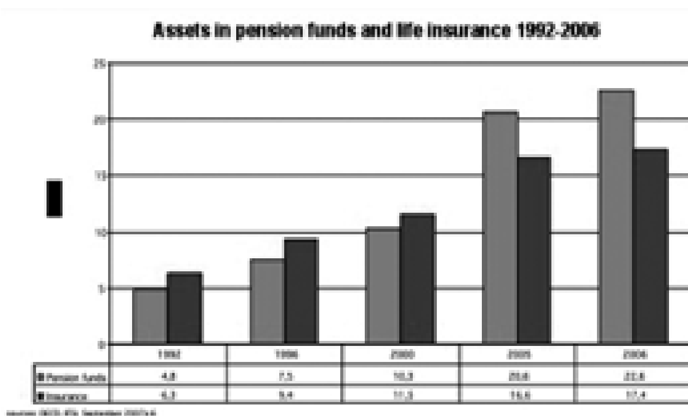
In this social crisis one crucial point is almost ignored: the future of private pensions. For reasons easy to understand: insurance companies, banks and private pension funds who deal with these assets are not at all interested in reports about the instability of private pension funds. Therefore empirical analysis is rare.

In the following we will present some main findings about the consequences of the financial crisis on funded pensions and argue for a (re-)strengthening of publicly organized and controlled pensions systems.

1. Privatization of pensions – a misleading way into crisis

According to the opinion forming debate in the political mainstream in the last two decades public pension systems suffer – and will even more suffer up to the 2020ies – under the burden of an aging population. International organizations like the OECD therefore promote a three pillar model with public pensions (either as pay-as-you-go-systems or tax-financed) covering the basic needs (first pillar), with company pensions (second pillar) and private pensions (third pillar) on top, to secure a sufficient living standard. According to the promoted three pillar model, the spendings in state pension have been cut all over Europe, especially in Austria, Italy, United Kingdom, Finland (until 2020) and Germany (until 2010).





On the contrary the total assets of pensions funds doubled and assets in life insurance increased by nearly 50% from 2000 until 2005. In the EU the privatization of public pension systems was – and still is – a key project in the Lisbon process (2000, renewed in 2005). "The last ten years have been a period of rapid expansion in private pension systems. Governments have reformed public pension systems in order to make them financially sustainable and hence more secure, and have promoted private pensions to offset future declines in retirement income from public pensions. In half of the OECD countries, private pensions are now mandatory or cover a vast majority of the workforce." (OECD 2009a: 1)

Main arguments for the privatization of welfare state organized retirement systems have been

- that state pensions become unsustainable and too expensive with population ageing;
- that privatization lowers the financial burden for both the working population and the management of real capital;
- that funded pensions increase savings and therefore supply capital for more investments in the real economy;
- that private pension systems offer a high rate of return: according to OECD-data 8,5% in Sweden and 6,1% in the UK and the U.S. in the last 15 years, while it was zero in the public funds.

These arguments have proved to be misleading.

First: Population ageing does not necessarily undermine the economic and financial basis of state pensions. The demografic change of the ratio between people living from pensions and the total workforce can be compensated by higher employment rates especially among woman, a long lasting reduction of unemployment until full employment is achieved, and by rising productivity.

Second: The financial burden in pay-as-you-go pension schemes is eased for only one side: the companies. Their contribution to state pensions is reduced (at least in relation to the GDP). On the other hand the employees have to pay twice: for their state pensions and for their private pensions. "A move towards funding imposes an added burden on today‘s workers" (Barr/Diamond 2009). To lower the burden for wage earners and capital affords higher productivity.

Third: There is no evidence that savings are transformed into real investments. Finance market led capitalism is on the contrary characterized by a profound weakening of the real economy. According to Ginn (2009) in the United Kingdom "a maximum of 15% of private pension saving is used for new investment. The rest goes to the city for speculative dealing".

Fourth: Defined contribution schemes "performed no better than cash savings accounts over the past 20 years. DC funds amout to less than total contributions over the past 10 years" (Ginn 2009). And: a higher rate of return on financial assets simply means that the financial sector claims a higher percentage of the domestic product; this is why the rise of financial market led capitalism is closely linked to the increase of private pensions.

Generally speaking: It‘s fundamentally misunderstood that private pensions are financed by long term collected assets which ease the financial burden in the present. It‘s a basic economic law that all expenses have to be worked for and financed in the present period.

"We are not saving in terms of saving real things… this saving does not mean we are transporting this money into the future. We are giving this money to someone who owes it to us, and we just hope that this person uses it well. It is not transported into the future. This is a big misunderstanding and this misunderstanding was created by this idea of funded pensions. And many people that have based their retirement provision on such accounts are now seeing that nothing is left, and that is really bad. And then again the government has to step in to prevent the people from starving and dying." (Flassbeck 2009) That means: "Whatever financing problems a pension system may face, privatization does… nothing to alleviate them… it may exacerbate them" (Barr/Diamond 2009).

The expension of funded pensions was a corner stone for the transformation into a finance market led capitalism. "Pension funds were in many countries of the world the drivers of this casino capitalism. Because the pension funds were competing for high returns. And they all, for a time, believed that they could earn 10 or 15 or even 20 or 25 per cent, which is absolutely impossible. The real world economy is growing by say 3 per cent so by the end, everyone can get 3 percent increase, but not 25 percent. It is impossible that a big sector that is not productive at all takes such a huge slice out of the cake." (Flassbeck 2009) A growing amount of funded pensions is a source of economic and social instability.

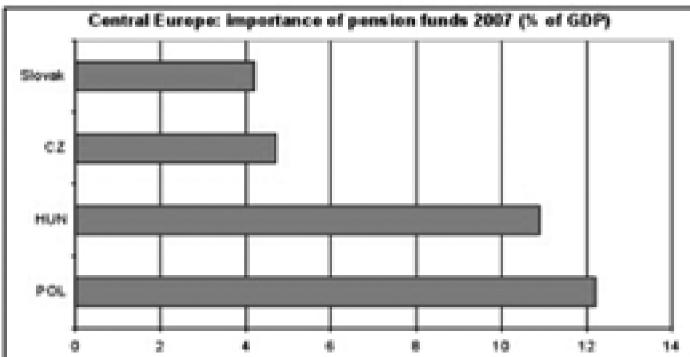
2. Growing importance of funded pensions

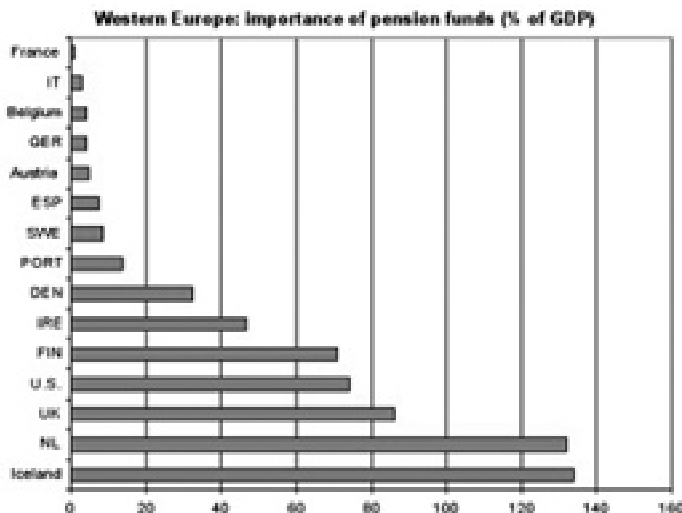
With the political wind blowing from behind – including subsidization of private pensions by the state – the assets of funded pensions expanded with an average growth rate of 9,3% between 2001-2007 in the OECD, interrupted by a short shrink in 2001 after the burst of the new economy bubble. In 2007 private pensions amounted nearly 28 trn USD which is 111% of the OECD's GDP. These "were accumulated in pensions funds (64% of the total), retirement savings accounts managed by banks or investment companies (18% of the total), pension insurance contracts (16% of the total), and other private pension arrangements in the OECD area." (OECD 2009a: 2)

More than 60% of the capital of pension funds is held in the US. But in relation to the national economy we find the biggest private pension system in Switzerland with a ratio to GDP of more than 150%, followed by (Chile and) the Netherlands, Iceland, Denmark and (after US, Australia and Canada) by Great Britain and Ireland with a ratio of 90-100%. Poland and the Slovak Republic have recently reformed their pension systems introducing mandatory private

plans, whereas Belgium and Germany develop voluntary private pensions. All this shows that private pensions gained growing importance in Europe.

17,9 trn USD, i.e. 64% of of private pensions assets, are managed by pension funds. Their growth was much faster: with an annual rate of 9% and a total growth of 67% from 2001 until the financial turmoil in 2007/2008. The asset-to-GDP-ratio for pension funds increased from 67,3 to 75,5%. According to OECD-definition, a ratio of 20% is the minimum to be characterized as a mature pension fund market. The leading countries in Europe – ahead of the OECD-average in 2007 – are Iceland (134%), the Netherlands (132,2%), Switzerland (119,4%) and the United Kingdom (86,1%). Also Finland (71%), Ireland (46,6%) and Denmark (32,4%) developed a mature pension fund market.





3. The new pension crisis

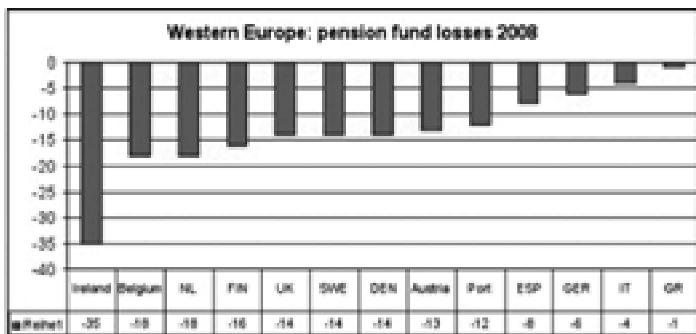
The situation changed fundamentally in 2008. “The current economic and financial crisis has reduced the value of assets accumulated to finance retirement by around 20-25% on average according to the latest OECD figures.” (Antolin/Stewart 2009: 4) Until the end of 2008, private pension assets shrunk by 5,4 trillion USD. “By October 2008, total OECD private pension assets were down to about US 23 trillion, or about 90% of the OECD’s GDP” (OECDa: 2), while it was 111% only ten months ago.

Ireland suffered most loosing more than one third, followed by the US with almost one forth. “Public pensions in the U.S. had total liabilities of $2.9 trillion as of Dec. 16… Their total assets are about 30 percent less than that, at $2 Trillion. With stock market losses this year, public pensions in the U.S. are now underfunded by more than $1 trillion.” (Evans 2009) In Europe, Belgium and the Netherlands[1] are severely affected (17-18%), followed by the UK (14%). Interesting to note that Scandinavian countries – Denmark, Sweden and Iceland – lost more than 10% of the assets hold by private pension funds (as well as Austria and Portugal).

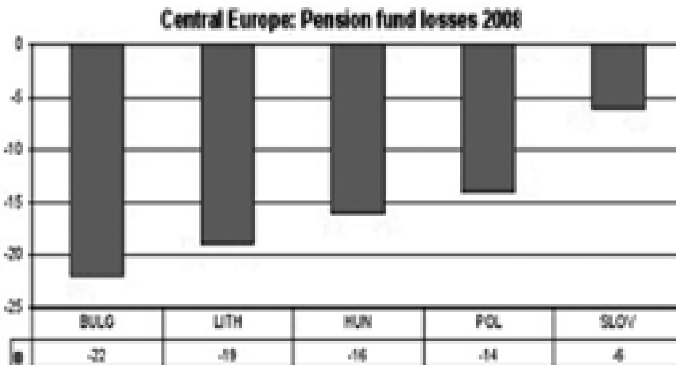
Comparing losses in 2008 with the asset-to-GDP-ratio the following states have to suffer most: the Netherlands, Ireland, UK, Iceland and Denmark.

In the new EU-memberstates pension fund assets fell by 20% in Bulgaria and Lithuania and by 15% resp. 14% in Hungary and Poland.

The situation has already become crucial in the U.S.. A couple of life insurance companies had to apply for financial support out of the Tarp-programme and the U.S. government agreed to spent up to 22 bn USD. Tarp was originally



1 “… the Netherlands has the most internationally diversified pension fund portfolio, with 82% of total assets issued by entities located overseas and nearly 40% in currencies other than the euro.” (Antolin/Stewart 2009: 13)



reserved to banks only. Support became necessary after speculations have been made that these companies wouldn‘t be able to serve their pension obligations due to heavy losses of capital in declining stock markets. “Most effected are those life insurance companies which are strongly engaged in dealing with fund-tied pensions. Their capital investment is linked to the stock markets while the insurance companies guarantee a minimum rate of return… ‚If some of these companies get into a downward spiral, this would cause a panic‘, according to Robert Haines from Credit Sights.” (FAZ, 16.5.2009)

This makes clear: The systemic crisis of finance market capitalism is also a systemic crisis of private pension schemes. Funded pensions have become a cornerstone of the accumulation regime led by the financial markets.

Due to a high percentage of “conservative” investment-strategys the losses of pension funds are smaller than the losses of stock markets. But: “A separate risk is pension fund exposure to potentially ‚toxic‘ assets, such as mortgage-backed securities and credit default swaps. The OECD has estimated average holdings of 3 percent of such assets in the portfolios of pension funds that member countries have… Structured products – the class of assets within which toxic assets fall – represent about 8 percent of pension fund assets worldwide. The risk is concentrated in the U.S., Sweden, and Japan.” (OECD 2009b: 18)

4. Company pensions: growing problems to be financed

The financial situation and the perspectives of company pension plans don’t look better as data from the U.S. demonstrate. Indeed: “Record losses in pension funded status during 2008. The ongoing financial crisis drove the 100

largest corporate pension plans to a record $300 billion loss of funded status in 2008. Asset losses fueled a decrease in funded status from about 106% at the end of 2007 to under 80% at the end of 2008. Losses continued into 2009 with a $30 billion decrease in funded status in the first two months.” (Milliman 2009). From the peak in October 2007 to February 2009 asset levels fell by 35%.

When pension plans are underfunded, compapies are required to invest fresh capital into the funds to correct the imbalance in the forthcoming years. This means that companies will have to double their contributions to pension plans to estmated more than 110 bn USD this year. Here the effects of the “double crisis” - recession and crisis on the financial markets – increase. “Ballooning pension deficits will leave some companies with diminished profits, weaker credit ratings and higher borrowing costs, which ca translate into lower stock prices”. (Hilzenrath 2009) For some companies it will be hard to get out of this vicious circle.

In Germany, the 30 biggest companies listet in the DAX (German Stock Market Index) manage 125 bn Euro for future expenses to their pensioners at the end of 2008. That is 13 bn Euro less compared to one year ago. The obligations amount to 191 bn Euro (end 2008): that is 65% to meet the demands (ZEIT, 2.4.2009). Some companies – like VW – are far underneath this margin. In the German case one of the consequeces is: companies suspend the indexation to inflation or to the increase of wages. That means that corporate pensions will shrink in real terms. This may proved to be a soft reaction as the example of General Motors and Opel demonstrate. In these cases corporate pensions may

be regarded as an object of negotiation: employment instead of pension claims. Provision for one‘s old age become a object of corporate negotiation.

5. Risky management

People have been told that their assets given to private pension funds are secure because of "conservative" investments with very low risks and therefore not affected by the financial crisis. But this is only true for half of the investments.

Indeed, the losses of pension funds are half as big as those at the stock markets which amount to more than 50%. This is due to the fact that more than 80% of the total portfolios have been invested in bonds and equities with goverments bonds as the most stable investment up to now. "In October 2007, in 13 out of 22 OECD countries for which information was available, over 50% of assets were invested in bonds, and around 60% of these investments were in government bonds." But: "The impact of the crisis on investment returns has been greatest among pension funds in countries where equities represent over a third of total assets invested" (OECD 2008: 3, 4) This is first and foremost the case of the Irish pension fund spending two third of it's assets in equities – followed by the US and the UK. In 2008 also high-quality corporate bonds proved to be risky, "when even large, well-established firms got into trouble". (ibd.: 6)

But up to now it's still unclear how many toxic papers are hold by pension funds. The estimation by the OECD from October 2008 was not more than 3%. But: "In particular, there is a lack of clarity over the valuation of some illiquid assets – those that cannot be turned into cash quickly – such as real estate or so-called structured products". (ibd.: 4)

Shrinking assets is only one source of financial instability for future retirement. The second source is unemployment. Rising unemployment will reduce the amount of pension's savings which will negatively affect the ratio of assets to expenses.

The third source is the growing inability of companies to pay into pension funds as they agreed to do – worst in case of bancrupts. The funding levels went down by 10%. The gap between receipts and expenses widens. At the end of October 2008 the funding gap was as high as USD 2 trillion.[2]

2 It's unclear what the OECD means by emphazising that »pension funds have very small liquidity needs in relation to their total assets under management. This means that they do not need to sell assets at current low prices to meet benefit payments and other expenditures as they can rely on the regular flow of contributions and investment income, even if the latter is reduced.« (OECD 2008: 4)

When – and this can be taken for sure – company bankrupts increase, benefits to company pensions will be cut. Precisely this is the case in negotiations between the Big Three in the US-Automobile Industry and trade unions. According to a Standard & Poor's study company pensions will be hit most severely.

6. Pension schemes

A differenciation has to be made between two types of pension schemes: defined benefit pensions (DB) and defined contribution pensions (DC).

DB's – most common in the U.S. and the United Kingdom – are confronted with the problem that the funding levels have fallen below 90% in most OECD countries from 2007 to 2008: in the U.S. from 100% to 92%, in the Netherlands from 105% to 95% and in the UK from 94% to 85% (Antolin/Stewart 2009). As a result, the value of the assets fails to cover the pension liabilities. When the benefit is fixed (with frozen accruals), funds have to run down their assets to meet the benefit payouts what is the case of many plans in the US and UK. The effect is a further decline of the value of the assets – propably the beginning of a vicious circle. In the the UK many DB schemes closed, "others changes to poorer Defined Contribution formula" (Ginn 2009).

DC-pensions depend directly on the current market value of the assets held in individual accounts. For older workers who are close to retirement this causes direct losses of their expected pensions. Severe problems for DCs – widespread in Eastern Europe and Latin America – arise when people have to sell their insurance policy in case of unemployment or lower wages or when they have to face the necessity to work longer to fulfill the defined contribution.

According to Ginn (2009), citing estimates by Price Waterhouse Coopers, in DC schemes

- most worker's accounts lost 30-40% in 2008
- DC funds performed no better than cash savings accounts, over past 20 years
- DC funds amount to less than total contributions over the past 10 years – even before charges are deducted."

7. High realization – a way into crisis

Pension funds can easily run into a vicious circle even before they were hit by the financial turmoil – as examples in the USA demonstrate. To close the

gap between assets and liabilities they issue pension obligation bonds which attract with a high rate of return. “The Teacher Retirement System of Texas, the seventh-largest public pension fund in the U.S., reports each year that its expected rate of return is 8 percent. Public records show the fund has had an average return of 2.6 percent during the past 10 years. The nation’s largest public pension fund, California Public Employees’ Retirement System, has been reporting an expected rate of return of 7.75 percent for the past eight years, and 8 percent before that… Its annual return during the decade from Dec. 31, 1998, to Dec. 31, 2008, has been 3.32 percent, and last year, when markets tanked, it lost 27 percent… Typically, public pension funds put 60 percent of their assets in stocks, 30 percent in fixed income, 5 percent in real estate and the rest in rikier investments such as hedge funds and commodities. That mix requires the nonbond assets to earn double-digit gains in order to reach expected rates of return.” (Evans 2009) On this way they even run deeper into losses.

8. Systemic change ahead?

Not only the world of anglo-saxon capitalism but also the European varieties of capitalism will be faced with a systemic crisis of private pensions when the financial crisis carries on or even gets deeper.

Although the leading political forces in the OECD-world still promote private pensions relying on capital markets, in some countries things have changed. “Some governments are – or are being pressured – to retreat from private pension provisions. For example, Argentina has de facto nationalized private pensions, and there are policy discussions about reverting back towards PAYG public pensions in some Central and Eastern European countries (allowing individuals to reverse their previously decisions…).” (Antolin/Stewart 2009: 5)

After spending enormous sums of taxpayers money for the stabilization of the banking system, the nation states have to cope with growing public deficits. One way to reduce the burden will be further cuts in public spending. It can be taken for granted that attacks on the welfare state get worse again. And the pension system is the biggest part of it. Banks, insurance companies and private pension funds are still strongly interested to continue privatization.

This means: There is no easy way back to a strong public pension system without hard and long lasting social struggles.

But it has become more difficult to argue that private pensions guarantee more social security in the future. The current crisis has shown: the opposite is true.

And: When private pension systems are a corner stone in the take-off of financial market capitalism, the strengthening of public pensions will be one of the most important arenas for the battle of social and economic transformation.

"What is needed is to rethink the whole model and to be sure that the people get something at the end. And I still think that this system that goes through the government (pay-as-you-go) is much more reliable than any other system that we know. We cannot transport this money, not productive(ly), into the future. We have to make a contract with the government and it gets a contribution and pays pensions now to old people and promises to pay to the then elderly again. This is the only way to do it reasonably well because all the private experiments have failed." (Flassbeck 2009)

A new political approach should be transnationally coordinated. The political struggle for a "new European social model" should be the battle ground.

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