

# **SOCIAL AND SALES MODELS OF PENSION SAVINGS AND INSURANCE**

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## **Abstract**

In the latest decades there emerged tens of pension savings and insurance concepts. Our paper tries to classify them. Due to the fact that the “public choice” decides the introduction of any of these concepts, we analyze them primarily from the view of the general social models (welfare regimes). We continue then with the analysis of the sales / provision models of the pension insurance and savings which leads to a more detailed classification of the pension savings and insurance concepts. We conclude that life insurance sales model is not suitable for efficient pension savings; Czech pension pillars need substantial reforms.

## **Keywords**

Social models, pension savings, occupational schemes, sales models, annuity markets, soft compulsion.

## **JEL Classification**

H55, G22, I38

## **Introduction**

We distinguish liberal, conservative, and social-democratic social models (welfare regimes) as defined by Esping-Andersen (1990). The pension model range is to be completed with a neoliberal social model that has evolved from the 1980s.

The paper’s aim is to analyze sales / provision models of the pension savings / insurance and their ties to the mentioned social models. These analyses have been motivated by the discussion on the “second” pension pillar in Czechia that has disclosed fundamental differences between the proposed private pension savings concepts. Current discussions on the third pension pillar in our country have disclosed key differences within the pillar in its existing form. Our ambition is to make at least some contribution to the given pillars’ reform in Czechia.

## **1 Social models of pension insurance and savings**

The modern liberal social model comprises universal or means-tested public pensions and supplements to them, all non-contributory and tax-financed. Other pension pillars were formed in liberal countries; however, they cannot be considered a part of the modern liberal social model.

The conservative model is another important social model that includes a range of models for individual social groups. The social stratification is fundamentally reflected in these models – as well as in different methods of funding. Civil servants were the first social group, which

received privileged pensions, non-contributory and tax-financed, without employees' contributions. Today, 13 (of 25) OECD countries feature separate pension systems for civil servants (Whitehouse, 2014). The most significant conservative pension model is the segmented social pension insurance. Its origination is associated with the Bismarckian blue-collar pension insurance, effective from 1891. Conservative policy was also applied in respect of elite employees within the private sector, with different constructions and much higher benefits, and other social groups or even individual professions. The segmentation may reflect the specifics of individual professions. Conservative pension models include also occupational and personal pensions, applying one of the tax policy approaches, according to which pension savings contributions should be deducted from an income tax base, with benefits being fully taxed.

A social-democratic social model tends to be characterized by the dominance of universal benefits, including universal pensions with higher pension level in relation to average nationwide wage. The modern social-democratic policy largely focuses on the middle class, using universal social insurance. A key component of modern social-democratic pension schemes is also a robust solidary pillar – in contrast to the conservative pension model. Senior housing benefit tends to be an important supplement. Moreover, quasi-mandatory occupational pension schemes that cover more than 90% of employees play an important role in the respective countries. The social-democratic social model does not assume government support of the third pension pillar.

The original neoliberal pension model comprises two characteristic pillars: private pension savings or insurance (with hard or soft compulsion) and some of the solidary pillar forms (universal pensions, means-tested pensions, or government guaranteed minimum pension from the private pillar). In practice, the generation of substantial (additional) public debts during the privatization of public pension schemes led to the “diversified” neoliberal pension model, which consists of two earnings-related pillars, one being a public (mandatory) and the other one being private (soft or hard compulsion), and of a solidary pillar. Voluntary private pension savings or insurance represents another pension pillar in all modern pension models.

## **2 Sales models of pension insurance and savings**

Each pension social model is associated with a different mix of the public and private pensions as well as different forms of products, with different costs and margins of pension institutions.

The costs of public pension institutions roughly amount to 1% of the sum of expenditure on pensions and on their administration. In case this pension pillar is funded, the costs of funds' administration should also be taken into account. The most convenient solution is to invest in government bonds, as is the case of the basic public pension system in US – asset management costs are negligible; however, the government bond yields are very low. Pension funds may also be invested in financial markets – either directly by the public insurance company (Swedish NDC scheme) or by private financial institutions based on a tender (e.g. TSP in US or NEST in UK). The average fees for NDC funds in Sweden were 0.2% of assets in 2013. (Ehnsson, 2014).

Pension insurance is one of the life insurance branches. The standard private life insurance sales model is associated with a wide product portfolio, which are difficult to navigate for clients. The sale of most life insurance plans requires qualified, broad-spectrum consulting, the sales force networks, remunerated through commissions. This provides ground for mis-selling with a view to get commission at virtually any price. There were extensive mis-selling campaigns in UK in the 1980s and 1990s, especially when the Cabinet of Thatcher motivated employees of opt-out of occupational schemes into personal pensions. In our country – the client “re-coverage” is a widely known mis-selling practice; it consists in the fact that an adviser convinces clients to withdraw from an older life insurance policy and take out new, allegedly more beneficial life insurance policy. Similarly important is clients’ inertia – e.g. decision-making processes on annuitization of savings in UK. This leads to high concentration of the life insurance market and high margins of life insurance companies. This has actually led to a recent ban on the provision of commissions by insurance companies in UK. Moreover, there have been long-term efforts aimed at standardizing basic life insurance products in UK so that clients can effectively compare them. The life insurance sales model is not suited to support mass pension insurance. Competition generally proves an ineffective instrument to control costs. UK now relies more on caps than competition to keep charges in check (Casey, Whiteside, 2014).

Occupational pensions, in their initial and basic form, are managed by foundations or trust funds in the interest of employees. Employers act as sponsors. This does not rule out employees’ contributions, which may actually be a precondition to employers’ contributions; these schemes also use auto-enrolment etc. Defined benefit pensions were typical, fully-funded, similarly as original social pension insurance schemes. This was in fact a collective pension insurance managed by a nonprofit institution. Occupational schemes exist in different sizes and – also for this reason – they tend to use outsourcing: for asset investments and standard fund administration, generating potential conflict of interest with administrators and investors. The standard occupational pension provision model does not need sales force. In some countries it became significantly consolidated in the form of nationwide schemes resembling social insurance (e.g. in Finland), while in Switzerland and Australia, occupational pensions simply became mandatory. In the course of the process, there were significant product changes in most countries. In defined benefit (DB) occupational schemes, the key portion of the financial risk is borne by employers, whereas employers “only” make contributions in defined contribution (DC) occupational schemes – and investments risks are borne by clients. In case the critical risk is borne by clients, it is systemically logical that they should be able to choose a pension fund, in which “their” pension savings are invested: collective pension schemes have thus been transforming into individual retirement accounts, which represent personal pension savings, an entirely different provision model.

The major involvement of private financial institutions within existing occupational pensions considerably modifies these schemes and consequently the given country’s entire pension system. In UK, many fundamental reformatory changes were adopted, with a view to increase transparency, lower administrative and other costs; occupational pensions have been transforming into “workplace pensions” – with soft compulsion (auto-enrolment), low-cost national pension company NEST (competing with private companies as well as occupational

funds), and annulment of the annuitization obligation. The reason was also mis-selling on the part of dealers. Basic services should newly be provided by employers, including the use of a default fund and the possibility to use NEST. Products should be simple – the system is reduced to pension savings. The government decided to eliminate all annuity-related problems through a point-blank liberal measure: by introducing “freedom and choice in pensions” – while annulling the annuitization obligation for DC pension pots, from April 2015. The mandatory pension savings model, without mandatory annuitization, has a significantly lower quality – it does not cover the longevity risk. A globally known solution to the problem is an establishment of a national pension insurance institution – as is the case in Sweden. Workplace pensions represent a solution in the area of provision of occupational pensions on the basis of soft compulsion – however, it is already a different model. Several soft compulsion methods are used: opt-out, auto-enrolment and matching contributions, including government contributions. Under the neoliberal social model, with soft compulsion pensions pillar, no one (e.g. poor individuals) could make excuses that they “have” to take part in savings even though they do not have the money or simply do not want to do so, e.g. for ideological reasons.

World Bank experts state that, in post-communist countries, the relatively high costs of the mandatory private systems are explained by the emphasis on individual selection, by provision of costly and misplaced guarantees and by an industrial organization of the pension fund industry that facilitates oligopoly behavior. Pension fund management companies in the region are typically hybrids between account management (record keeping) and portfolio management (asset management). Account management is a business with scale economies and therefore there is not much room for competition. Full separation between the asset management and account management businesses, with centralized account management and competition in portfolio management, is a way of introducing efficiency to both functions. Swedish blind accounts are efficient in lowering the barriers to potential entry of new competitors, which in turn helps reduce fees (Schwarz et al., 2014).

The Czech system of the supplementary pension insurance, supplementary pension savings, and private life insurance meets the basic specific “parameters” of the neoliberal soft compulsion system: the number of participants exceeds the number of payers within the basic public “pension insurance”, with government support being intensively used. Therefore, it is actually a “second” pension pillar, whereas the key problem is the fragmentation and, consequently, considerable lack of concept of this second pillar. Instead of a single government support system or single pension savings tax treatment regime, as appropriate, we have several systems: one for supplementary pension insurance and supplementary pension savings with participants’ contributions, another one for private life insurance paid by insureds, and a third one for employers’ contributions under supplementary pension insurance, supplementary pension savings and private life insurance. This is an absurd system that must be united, disregarding the fact that we should follow a uniform concept of the entire pension system – select one of the social models and reform the government support system accordingly. The basic alternative should be the elimination of any state support of the mentioned products. In case our voters or political parties, as appropriate, still wish to operate government subsidies of the mentioned financial products, it would be advisable to not only newly and uniformly

formulate such state support, but to reduce it to a new simple, and basically uniform, pension savings product that would be beneficial for clients even without the state support.

Voluntary private pension savings products cease to make separate sense under the existence of a hard or soft compulsion pension scheme, as they are reduced to mere increase of contributions of participants (or third parties – employers, for example) over the mandatory or basic extent. In other systems, the form and tax treatment of the voluntary private pension savings should correspond to the relevant social model. Private pension savings sales models should correspond to the social model selected in the given country. Significant deviations from these models result in high overhead costs that are financed by clients and government contributions.

### **Conclusion**

The standard life insurance sales model offers fulfillment of all insurance needs of individuals and families, based on their individual needs. However, practical applications are associated with major problems in the form of market failures. This is most apparent in annuity markets. Government regulation could prove beneficial in this regard, e.g. in the form of ban on commissions provided by life insurance companies, government support reduced to simple and low-cost saving products, etc.; however, this leads to an entirely different sales model.

Occupational pensions have gained ground in most Western countries. Under a standard occupational pension provision model, employers act as sponsors and guarantors of defined benefit pensions, managed by a board in the interest of employees. This provision model has been substantially modified in many countries by outsourcing investments and management to the private financial sector, converting to a defined contribution pension savings, and transformation to workplace pensions, with employers paying contributions and providing basic information to employees, who can opt for external pension savings providers. These transformations may ultimately lead to soft compulsion personal pensions, foreseen by the neoliberal social model. Intensive government regulation may also comprise a low-cost national pension company.

The mandatory private pension savings sales model was constructed for the main pillar of the neoliberal pension model. Various soft compulsion methods prevailed in the practice of the relevant countries. This sales model also envisages further intensive government regulation, aimed at reducing otherwise high costs and margins of private pension companies.

Voluntary private pension savings and insurance products without any government support comply with the liberal and the social-democratic social models. With regard to the existence of the life insurance sales model, only low-cost personal pension savings with government support have its own separate design significance for most wage earners, i.e. consequently a soft compulsion system. The Czech system of parallel existence of supplementary pension insurance, supplementary pension savings, private life insurance is a chaotic and nontransparent soft compulsion system.

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