Yannis Stournaras: The metamorphosis of Greece and the role of the insurance industry - guardians of the future?

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at The Economist First Insurance Forum, Athens, 30 March 2017.

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It is a great pleasure to be here today and have the chance to share with you my thoughts on the role of the insurance industry in the midst of challenging times lying ahead, not only in Greece, but in the entire world.

Over the past seven years Greece has indeed undergone a profound change in form, as the Greek word metamorphosis succinctly describes. Policies implemented in the context of the three adjustment programmes since 2010 have helped address large fiscal and external imbalances, turning double-digit deficits to positive balances in recent years. I would like to draw your attention to just two of them. First, adjusting for the effect of the recession, the improvement in the "structural" primary balance over the period 2009–2016 reached 17 percentage points of potential GDP, twice as much as the adjustment in other Member States that were under EU-IMF programmes. Second, the current account in the last two years has been effectively in balance. This marks a significant turnaround of the current account balance by about 15 percentage points of GDP since 2008.

Alongside this impressive performance, remarkable structural improvements have been achieved in labour and product markets, as well as in public administration. These reforms are expected to boost the growth potential of the Greek economy in the long-term through higher productivity and employment growth.

The metamorphosis, however, is not complete. Greece has not as yet managed to return to sustainable growth and a prerequisite for this is the completion of the second review with no further delays and the consistent and determined implementation of the programme. This is the current challenge as the intense reform effort has taken its toll on society, making the implementation of structural reforms difficult and at times even leading to policy reversals.

The long-suffering Greek pension system is a prime example in this respect: while at least three notable reforms have been legislated since 2010, many provisions remain to be fully implemented, while the system remains costly, distortive and unfair. This is the topic I would like to focus on during the first part of my speech, as I believe this is one of the areas where the insurance industry may have a major role to play in the future.

In doing so, I will start by outlining the key characteristics of the Greek pension system and offer you a brief review of recent reforms.

Although an institutional basis for the development of a multi-pillar system exists since 2002 (Law 3029/2002), the Greek pension system essentially remains single-pillar, with a mandatory first pillar providing main, auxiliary and other pension benefits; it works on a pay-as-you-go basis, with revenue shortfalls financed by the State budget. It is thus predominantly public in nature.

Concerns over the long-term explosive path of pension expenditure alongside strong fiscal and financing pressures brought about a comprehensive reform of main pension schemes in 2010. The 2010 reform tightened pension entitlement rules (e.g. it increased the early and statutory retirement age to 60 and 65 respectively, raised the required years of contributions from 35 to 40) and also introduced a structural change via the specification of a unified, less costly, pension formula that was prescribed to be applied as of 2015. This formula specified a basic, essentially universal, component and a proportional one corresponding to the amount of insurance

contributions pertaining to lifetime earnings (rather than the best five of the last ten years of service that was earlier the case). All in all, the reform strengthened the link between contributions and benefits and decreased the generosity of pensions.

Further reforms in 2011 and 2012 were legislated in order to contain pension expenditure. These included: (i) abolition of the 13th and 14th pensions for all pensioners ; (ii) a freeze on nominal pensions up to 2016; (iii) pension cuts affecting monthly amounts over €1,000 ; and (iv) an increase in early and statutory retirement ages to 62 and 67 years, respectively. Furthermore, in 2012 auxiliary pension funds were merged into a single entity (ETEA), which was to operate on a Notional Defined Contribution (NDC) basis as of 2014. The NDC system included a sustainability factor, which under a full pay-as-you-go principle required maintaining a zero deficit every year.

The 2010 and 2012 pension reforms were expected to lead to a substantial correction in the financial course of the social security system, reducing the projected increase in pension expenditure for the period 2010–2060 from 12.5% of GDP (2009 EC Ageing Report) to just 1.3% of GDP (2015 EC Ageing Report). The gross replacement rate (the ratio of the average pension of new retirees to the average wage at retirement) was expected to fall from 64% to 49% for main pensions and from 15% to 8% for auxiliary pensions in the period 2014–2060 .

However, these reforms, as judged ex post, were not consistently implemented; neither the unified benefit rule for main pensions nor the zero balance rule for auxiliary pensions was applied as planned. The pension cuts (expected to yield 2¼% of GDP in gross fiscal savings) were ruled unconstitutional by a Council of State judgment in 2015. The increases in the retirement age thresholds lacked effectiveness in the presence of extensive grandfathering of previous early retirement options, which led to a massive wave of early retirements to take advantage of the previous more generous rules. Such spending pressures combined with falling contributions due to high levels of unemployment put the system under financial strain, requiring significant annual transfers from the State budget; according to Eurostat (ESA 2010 data), total payments made to social security funds by other sub-sectors of general government amounted to 7.1% of GDP in 2015 (compared with a euro area average of 3.3% of GDP).

Alongside persistent costs, the system continued to face structural challenges, with merging funds retaining different degrees of autonomy (and own benefit and contribution formulas), while pension provision remained multiple-layer, with basic, contributory and minimum pensions in the main funds being topped up by auxiliary, lump-sum, dividend and/or targeted pensions (e.g. EKAS).

As part of the agreement to close the first review of the current programme, all of the above were addressed afresh by the 2015 and 2016 reforms which, among other measures, legislated: (i) simplification of the social security system via the consolidation of main funds into a single social security entity (EFKA); (ii) a unified pension formula which calculates pensions as the sum of a basic component (€384, corresponding to the 2014 poverty level, at 20 years of contributions) and a contributory component applying marginal accrual rates to lifetime pensionable earnings; (iii) new rules for calculating supplementary pensions applying, among other measures, selective cuts and freezing pensions as long as the funds remain in deficit; (iv) a change of the contribution base for the self-employed and farmers from notional to actual earnings from self-employment subject to a minimum income limit; (v) harmonisation of main pension contributions at 20% of earnings; (vi) an increase in health contributions for retirees to 6%; (vii) an increase in supplementary pension contributions until mid-2022; (viii) phasing out of the non-contributory social solidarity benefit EKAS by end-2019; and (ix) a new, less generous, formula for the calculation of lump-sum pension benefits.

This brings us to the current juncture, in March 2017, with the second review in progress and the pension system still high on the reform agenda. Why? Because, despite the numerous interventions outlined above, the system remains costly. According to the 2017 Budget report,

State budget transfers to social security funds/EFKA amounted to 7.6% of GDP in 2016 and are expected to reach 9.9% of GDP in 2017 as civil servants' pensions are now provided by EFKA. This amounts to more than a third of ordinary budget expenditure in 2017. Note also that this forecast is subject to upside risks as (i) there is currently a significant number of retirees with outstanding pension payments not accounted for in the projections; and (ii) EFKA revenue collection so far faces numerous challenges and is likely to fall short of the 2017 target.

Such budgetary pressures may inevitably have to be relieved via adjustments in certain pensions. This is because, on the one hand, in some cases pension benefits in Greece remain relatively generous both from a domestic and from an international point of view. Specifically:

- In several cases, they are high relative to the contributions that have been paid to acquire them. Recent research by the Policy Analysis Research Unit of AUEB shows that, prior to the various pension cuts legislated in the period 2010–2013, on average 50.7% of IKA pensions were financed by contributions, the remaining 49.3% being a social transfer, or else a State subsidy. Incorporating, the 2010–13 pension cuts the State subsidy falls to 35.8%.
- The relative generosity of the system is also reflected in high gross replacement rates compared with European peers: the gross replacement rate was about 81% at end-2013, the highest in the euro area, and almost 30 pp higher than the euro area average .
- More recently, data published by Eurostat showed that in 2014 expenditure on old age pensions in Greece is the highest among EU countries (13.3% of GDP, compared to an EU28 average of 9.8% of GDP).
- While the 2015 and 2016 reforms did attempt to further curtail pension benefits, they exempted old retirees until July 2018. As a result, the fiscal adjustment delivered by the latest reforms is borne by new generations of retirees with longer careers, thus worsening benefit-contribution links and raising issues of intergenerational fairness.

On the other hand, the system can no longer finance itself through rising contributions; high social security contributions increase the tax burden on labour and lead to a fall in GDP in the medium term. Note also that under the current supplementary NDC scheme they generate future pension obligations too.

This context of unfolding pension cuts shows that an adequate and, at the same time, sustainable "social security only" system is not affordable under the present circumstances in Greece. Ownership of reform efforts is difficult, but may be strengthened by policies that increase incomes for pensioners in the future, thus providing appropriate social safety nets and mitigating socio-political resistance or the risk of reversal . Such policies include extending working lives and improving the employability of older workers, encouraging private savings or, most commonly and to the point, supplementing pension accumulation from public first pillar schemes with occupational pensions of second pillar and personal pension of third pillar schemes.

Retirement financial security should not, and cannot, be provided from one source: social security funds, employer-sponsored retirement plans and personal savings should all be seen as indispensable and complementary parts of a single system that secure its affordability, adequacy and sustainability.

In order to form such an integrated system, all stakeholders should understand their respective roles: the State should not insist on retaining the monopoly of retirement benefits; employers should cease misinterpreting their role in providing security to their employees only during their labour time but should extend it, most importantly, after their retirement; and citizens should not forget about the role their personal savings play in ensuring their own retirement financial security.

The benefits of an occupational pension system are obvious: first and foremost, it increases the post-retirement financial resources of the labour force. It increases the productivity of the workforce as it constitutes an efficient means of deferred remuneration and, finally, it increases the total investments in the country by being an alternative to banks, but very efficient, way of financing the real economy.

Occupational pension funds (or else called IORPs) were introduced in Greece by Law 3029/2002. Unfortunately, the current legislation does not include the subtle, but very important, distinctions of the different components of an effective occupational pension system: that of a pension institution, a pension fund, a pension scheme and the entity that operates the funds. In addition, it misinterprets the role of the pension institution with regard to its responsibility towards its members, giving them the false sense of "social security-like" full protection, irrespective of the financial capacity of the sponsor. Finally, the current legislation does not recognise Greek economic reality, as the economic burden of establishing an occupational pension fund is excessive, even for the bigger employers, let alone small and medium-sized enterprises, which constitute the backbone of the Greek economy.

The transposition, during the coming months, of the new EU Directive "IORPs II" to Greek legislation should be seen as an opportunity for a new metamorphosis, with a view to making the occupational pension system work properly and fulfil its purpose. I am confident that the Greek labour force could reap major benefits from the occupational pension system, should:

- the role of each distinctive component be identified and duly recognised;

- the role of the occupational pension institution be restored as a trustee of the employer's promises to its employees, discarding any "social security-like" features;

- in line with Greek economic reality, greater flexibility be introduced. For example, the law could allow more than one employers (even from different industries), each with its own pension scheme, to contribute to the same pension fund that is operated jointly with other funds by a single entity;

- it be acknowledged that an authorised entity may be responsible for operating a pension institution;

- due recognition be given to the very important notion of the mobility of pension rights;

- procedures be determined for an orderly liquidation or disbursement of benefits in case of insolvency of an IORP, its sponsor undertaking or the entity that operates the IORP; and

- last but not least, the unnecessary fragmentation of IORPs supervision be eliminated.

It is only under such conditions that the occupational pension system would serve its purpose and that the private insurance sector could assume its role in operating IORPs by lending its expertise and experience to the IORPs (in areas such as underwriting risks, collecting contributions, disbursing benefits, designing and implementing liability-driven investment strategies) and provide actuarial and accounting services; that is, provide added value to the members and beneficiaries of the system.

The third part of the retirement financial security system is related to the third pillar personal pension products. Since 2012, a debate has been initiated at EU level on developing an EU Internal Market for personal pension schemes or products. Currently, the discussion has intensified and the debate is now focusing on the development, with the active involvement of EIOPA , of a so-called pan-European personal pension product (PEPP). Unfortunately, this is an area where Greece does not have any significant progress to report, as it lacks a relevant legislative framework. I am confident that Greek citizens would surely benefit from the

introduction of a tax-incentivised simple framework for personal pensions, allowing for reduced cost structures that will be managed using robust and modern risk management tools. Full transparency to its members and beneficiaries should be considered as a prerequisite. Finally, the Greek economy would benefit as a whole, as these products may focus on long-term investments, thus contributing to sustainable economic growth. I consider the following period to be very critical for the effective design of such a system, as it is aligned with the current debate at EU level that I mentioned previously.

But pensions is not the only area where insurance undertakings are active.

Another sensitive area that is related to the services of insurance undertakings and has undergone a major metamorphosis over recent years is the Greek health care system. All modern, well-developed health care systems share a common goal for those who depend on their services: hope for full and healthy lives.

However, it is unrealistic – if not impossible – to aim to provide "all possible health care for everyone". This is because not only the potential array of health care services grows worldwide, but also the cost of providing these services to everyone increases faster than economic growth. In this regard, governments increasingly reach fiscal limits on services they can afford to deliver.

As publicly funded health care systems are forced to contract and will hence not be able to provide full services to everyone, the private sector is expected to play an increasingly important role in meeting citizens' health care demand. If the first priority is to provide services to all, then not all health care services can be provided. An acceptable, but less comprehensive, standard would instead differentiate between medical care "needs" for citizens to achieve high-class outcomes and medical or non-medical "wants" that, while valued by patients, contribute only indirectly to population health. It is exactly at this juncture that private insurance is able to play a major role in the health system.

Designing a health care system inevitably requires choosing between or mixing public and private approaches, particularly in terms of financing. I am confident that Greek citizens would benefit from the introduction of a Greek public universal health care system that covers population "needs" and leaves funding for, and coverage of, population "wants" to an adequately regulated private health insurance market. If we reach consensus on this concept of a two-tier health care system, the next step will be to agree upon the differentiation of "needs" versus "wants".

Of course, we should not forget that private insurance markets are characterised by information asymmetry as buyers (consumers) know much more about their risks than sellers (insurance companies) do.

There are generally two alternative ways to overcome these market imperfections. The first approach makes participation voluntary and lets insurance undertakings cope with the above characteristics, by introducing, probably, aggressive risk management practices (e.g. rigid risk selection procedures or rate increase decisions). Under the second approach, participation is made mandatory: when the entire population is included in the risk pool, uncertainty about the level of risk caused by choice is totally eliminated.

Of course, if the choice is a mandatory private insurance market, law and regulation must be geared towards minimising and properly compensating for remaining aspects of risk selection, risk rating and renewal risk management that run counter to the smooth functioning of a universal health insurance system. This must be done in a thoughtful manner, which ensures effective government stewardship of private-sector health insurers and their use of risk management tools.

Last but not least, I would like to refer to natural catastrophes.

The climate of Greece can be characterised as Mediterranean, having mild winters, with sudden and heavy rainfalls and dry summers. In addition, Greece lies in a land that the mythical Giant Enceladus shakes very frequently. All three situations constitute physical hazards that intensify the perils of flood, fire and earthquake. These perils, fortunately, do not materialise frequently, but when they do, they tend to create catastrophic damages.

Historically, due to the characteristic low level of insurance penetration in Greece, the cost of damages is borne by citizens who suffer losses and whose compensation is dependent on politics and, most importantly, on available funds in the government budget. Undoubtedly, the State should care to protect its citizens. But its paternalistic services to citizens who suffer should be exercised in a way that protects taxpayers. One of the most efficient ways of achieving this goal is to create a mandatory, adequately regulated, private insurance market for these risks.

Concluding, I would like to emphasise that all of the above – pensions, health care and natural catastrophes – constitute very sensitive areas for the policymaker. But what I hope I have highlighted in my speech is that, despite their idiosyncratic features, these are areas that will benefit from synergies between the public and the private sector. Needless to say, such collaboration should not depend on the short-term goals of each government, but rather be part of national policies designed with a long-term perspective. It is also imperative that the terms of this collaboration are clear to all participants and transparent to the members and beneficiaries of each system.

Of course, such systems should be reinforced with minimum legislative requirements for best-class standards with regard to the insurance undertakings that would be allowed to participate. Proper authorisation, adequate additional capital buffers, employment of best practices in risk management, high credit rating obtained from a recognised credit rating institution, all constitute effective gatekeeping tools that should be tailor-made, taking into account the specific roles that private insurance would assume.