

# The European Pensions and Savings Revolution Our Vision of the Future

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New Europe: New Challenges, New Opportunities

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## Prologue – Europe in 2010: Video Diary of an Unknown Saver

**Please enter your charge code and press PLAY:**

“Don’t be fooled by the American accent, I’m a European.

I was born in the second half of the last century in the suburbs of one of our less prosperous industrial cities. I went to school at six and, after the third false start on my thesis, was finally eased out of the higher education system at twenty-six. I rode my luck in the dot.com revolution of the late nineties in the States and got out just too late to cash in my share options. I returned home in 2002 with a suntan and a suitcase full of crushed casual wear.

Since then I have had three jobs with five different companies, a wife, an ex-wife, a daughter and a mild nervous breakdown, not exactly in that order. Currently I’m enjoying the benefits of flexible employment. I own my own bike, but rent my flat from a man with a mobile video-phone and an Eastern European business education.

As a middle-ranking civil servant, my father retired five years ago on a pension worth over 80% of his final salary. My mother worked for only around 20 years in total, much of that part-time, but she is still getting a larger state pension, relative to her earnings, than I can expect if I work until the new statutory retirement age of 67. That’s assuming it stays that low and I remain marketable that long

According to yesterday’s paper, by the way, a typical non-smoking male of my generation has a life expectancy of 83. How typical am I? Maybe I should take that confidential DNA test my insurance company keeps offering me?

I am a deferred member of three occupational pension schemes but, since two of the companies concerned are no longer trading, I am not banking on big pay-outs. I am a bit worried that I have a hotch-potch of individual investments – deposit accounts, insurance policies, unit trusts, a couple of privatisation stocks – that reflect an occasional weakness for junk e-mail rather than any coherent investment strategy. My home utilities packager, which has just been taken over by this new American outfit, is offering to do a free ‘investment portfolio consolidation’ for me if I switch to their digital entertainment package. Apparently I just pay each month by direct debit to one of their new multi-product accounts and their automated search system seeks out the best deal on the web for each individual product given my particular financial needs.

I have to admit, I’m tempted.”

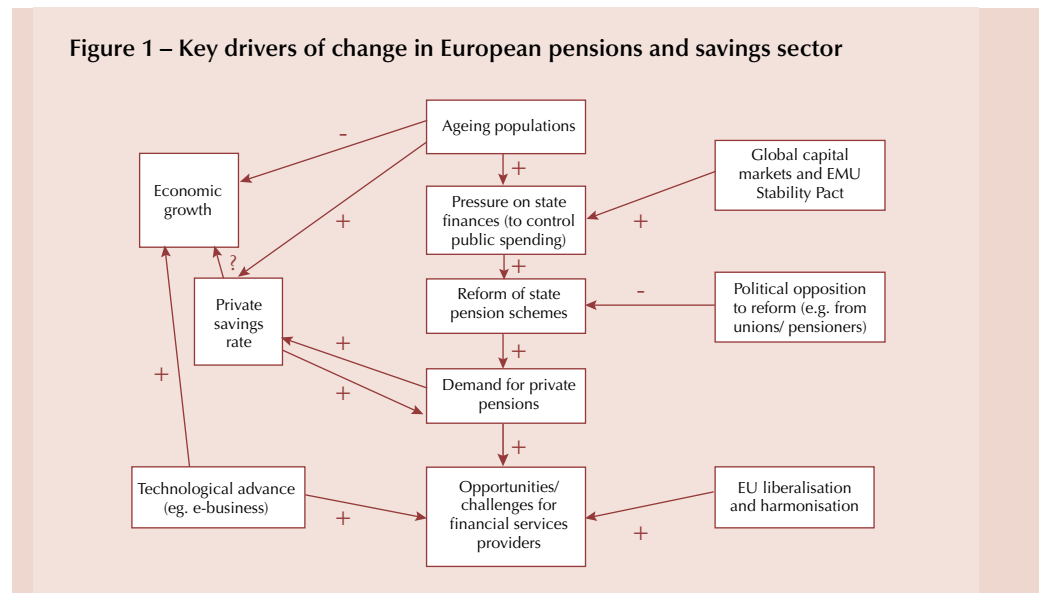
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USER NOTE: This DVD recording was recovered from an Internet webvert released in the early part of the last century (c.2010). The original recording was damaged by a virus but enough survived for the extract you see today to be digitally reconstituted. The identity of the speaker is unknown. His smooth delivery to camera suggests he may have been an actor working for the company in a promotional capacity.

# The European Pensions and Savings Revolution – Our Vision of the Future

## Overview

Our video diarist may be fictional, but the extract gives a flavour of the kind of demographic, socio-economic, technological and government policy trends that we expect to shape European pensions and long term savings provision over the next ten years. **Figure 1** illustrates more formally the key drivers of change that we believe will produce a revolution in the way in which governments, employers and financial services companies help individuals to provide for their retirements and their other long term savings needs over the next ten years. In summary, the story is as follows:



- the rapid ageing of the European population over the next 30 years will, other things being equal<sup>1</sup>, **reduce the size of the labour force and so decrease trend economic growth rates and put severe strain on existing pay-as-you-go (PAYGO) state pensions schemes;**
- these strains will be **particularly severe in countries such as Germany and Italy** where state pensions are relatively high compared to average earnings at present and where previous pension reforms, in contrast to the UK, have not fully defused the potential impact of the demographic time bomb on the public finances; pressure from global capital markets and the EMU Stability Pact to keep budget deficits low will also require governments to make state pension schemes more affordable in these countries;
- despite political opposition from interest groups, future pension reform efforts in these countries are likely to result in **less generous state pension schemes paid from a**

<sup>1</sup> We consider further below the possible offsetting effects of increases in labour force participation rates, lower unemployment rates and/or higher productivity growth. There could also be effects from changes in labour force participation rates for different age groups over the working lifetime, although these are hard to predict.

later statutory retirement age; this will lead to an increasing demand for private pension provision, whether from employers or by individuals purchasing pensions and other long term savings products from financial services providers;

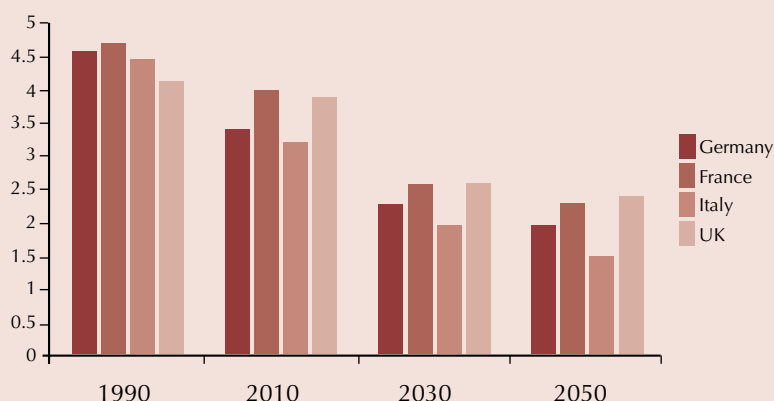
- there is likely to be a **marked increase in European private savings rates over the next 10-15 years** as the baby boom generation passes through middle age; this will be particularly positive for equities but the implications for real interest rates (and so bonds) is less clear; and
- these demographically-driven long-term changes in the savings market may, however, be **overshadowed in the short term by the effects of EU market liberalisation and advances in information technology and communications (notably in relation to the rise of e-business)**; these changes are likely to lead to a **radical restructuring** of the European financial services industry as a combination of new entry and consolidation of existing players transform the competitive landscape in this sector; the **slow pace of tax and regulatory harmonisation** may, however, mean that a genuinely pan-European pensions and long-term savings market takes a long time to emerge.

This report explores in turn each of the key elements of this ‘savings revolution’, drawing on the findings of a detailed research programme that PricewaterhouseCoopers has carried out in this area. While many other reports have looked at particular aspects of this topic, our research is distinctive in covering the full range of issues from macroeconomic effects of ageing through pension reform options to the practical implications for occupational pensions and financial services providers across Europe.

## How great a threat is the demographic time bomb to Europe?

The proportion of the European population aged 65 or over will increase from around 16% at present to around 25% by 2030 and 28% by 2050<sup>2</sup>. **The ratio of the working age population to those over 65 will fall from over 4 on average today to 2.4 in the UK, 2.3 in France, 2 in Germany and only 1.5 in Italy by 2050.** The change in this ‘support ratio’ is particularly marked in these latter two countries. In this sense, the

Figure 2 – Support ratios in major EU countries (working age: over 65)



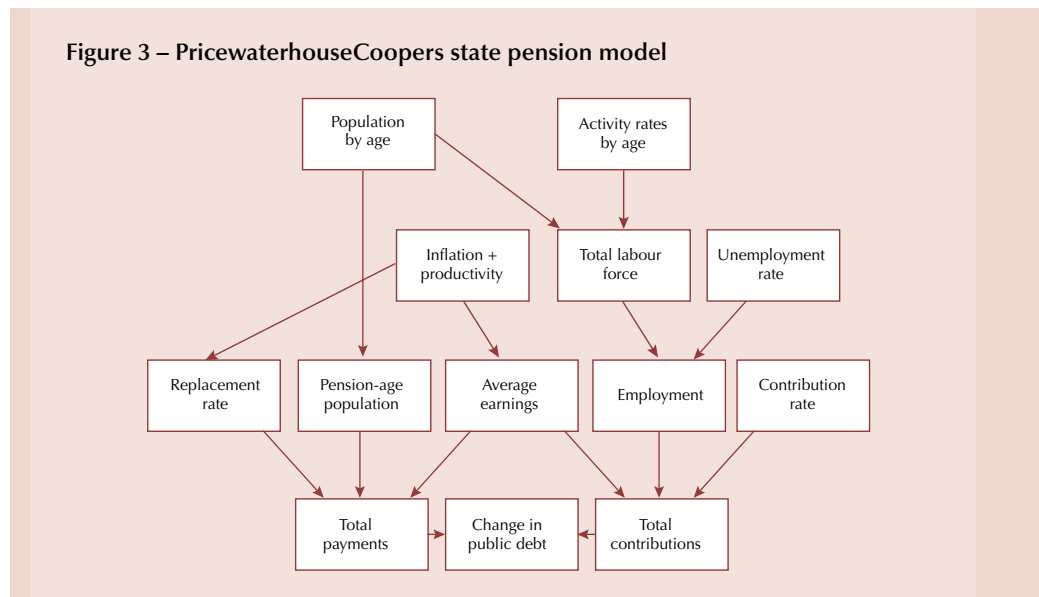
Source: UN – defined as ratio of working age population (15-64) to those aged over 65

<sup>2</sup> Based on the latest (1998) United Nations population projections. We use the central projection in most of our analysis but alternative cases are considered in Figure 5 below for Germany.

demographic time bomb is real enough – from 2010 onwards it will begin to explode (see **Figure 2**). This is true to varying degrees in all Western and Eastern European countries, reflecting a combination of:

- the particular impact of the ageing of the post-war baby boom generation, which is set to reach state retirement age progressively from 2005 to 2030; and
- longer term trends towards increased longevity and reduced birth rates, which mean that the ageing of the European population is set to continue at a less dramatic rate until 2050 and beyond.

### State pensions schemes – are they prepared for the blast?

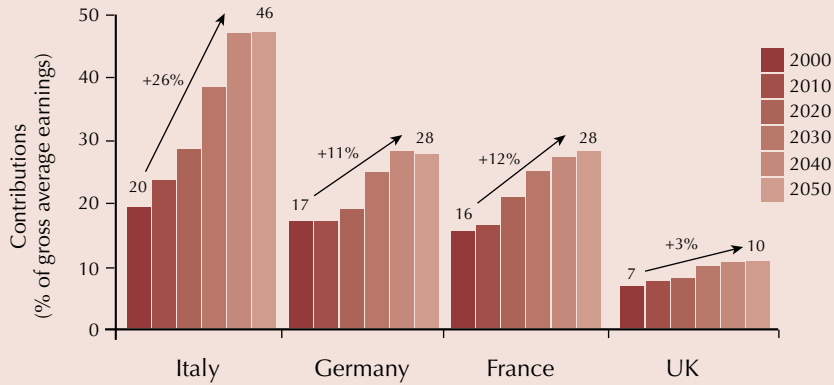


We have developed a **simulation model** (as outlined in **Figure 3**) that captures the key linkages between demographic trends, labour market developments and the sustainability of state pension schemes. Applying our model to the four largest EU countries shows that, if the current level of state pensions relative to average earnings is maintained and both unemployment and labour force participation rates remain constant, then **the ageing population would imply very marked increases in contribution rates in Germany, France and, most dramatically, Italy** (see **Figure 4**).

As shown in **Figure 5**, this conclusion is not much affected in the case of Germany if we use alternative high and low variants of the UN population projections, although the importance of the demographic assumptions used does become progressively more important after 2030. Similar conclusions apply to other EU countries.

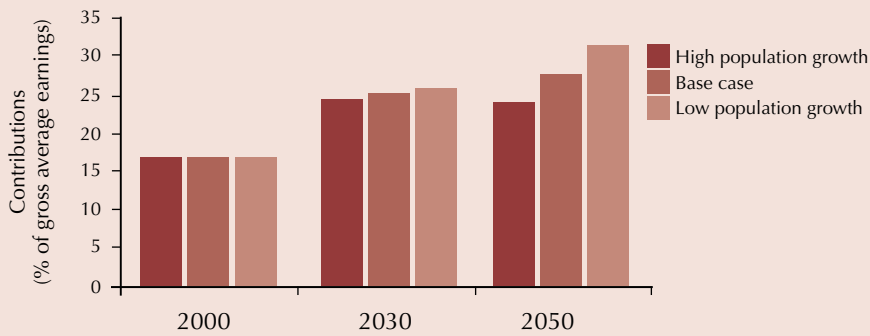
If increased rates are not acceptable given their already significant adverse effects on employment in many EU countries, **this would imply an explosion of government debt without other reforms.**

Figure 4 – Breakeven contribution rates with earnings indexation of state pensions



Source: PricewaterhouseCoopers

Figure 5 – Breakeven contribution rates with alternative population projections: Germany



Source: PricewaterhouseCoopers using UN population projections (assuming earnings indexation of pensions as in Figure 4)

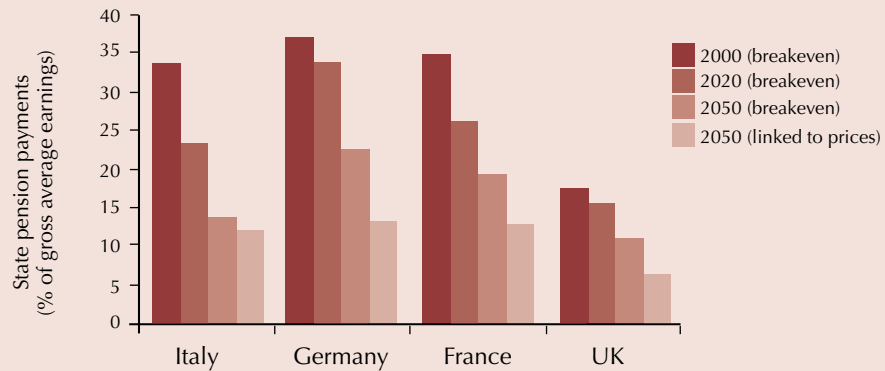
Our analysis suggests that **the need for higher contributions could be avoided by indexing<sup>3</sup> the level of state pensions primarily to prices rather than earnings**, but the implication would be a sharp reduction in the value of state pensions relative to earnings<sup>4</sup> (see **Figure 6**). The UK adopted this policy in 1980, as well as increasing the female retirement age to 65 from 2010 to 2020 and scaling down the State Earnings-Related Pension Scheme (SERPS). France also introduced price indexation for the basic state pension, but not for supplementary or civil service pensions, from 1993. These changes have **largely defused the potential impact of the demographic time bomb on the UK and French public finances**, but only by putting greater emphasis on additional provision by employers and individuals themselves.

Although there have also been some pension reforms in **Germany and Italy**, where the underlying demographic problems are most severe, our analysis suggests the actions

<sup>3</sup> This refers to the basic level of state pensions paid at the start of retirement. Some pensions in payment may allow for indexation to prices but that is a separate issue of more relevance to the private sector.

<sup>4</sup> Again, we assume constant unemployment and labour force participation rates here.

**Figure 6 – Required reductions in state pension replacement rates to keep contribution rates constant at 2000 levels**



Source: PricewaterhouseCoopers based on constant breakeven contribution rate at 2000 level

taken so far fall well short of a complete solution. One possible reform might be to **increase the state retirement age**, but our model suggests that this would need to increase **to around 70 in Germany and around 72 in Italy to allow state pensions to continue to be linked to earnings** with unchanged contribution rates, and employment rates. Political opposition to such changes remains significant, but further delays will only make the required reforms more painful in the long run as contribution rates and/or the public debt burdens are set to rise sharply as the baby boomers retire after 2010 if no action has been taken by then.

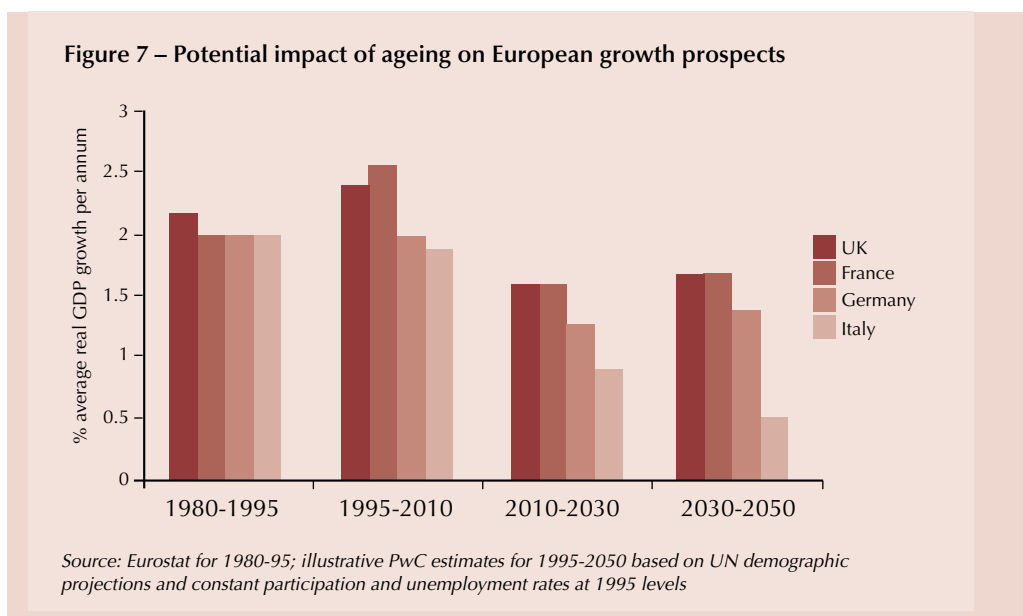
Ultimately the choice for all European countries is stark: higher taxes and social security contributions, or less generous state pensions. The latter will probably involve a combination of increased retirement ages, at least partial indexation of state pensions to prices rather than earnings, less generous formulae for calculating pension entitlements, means-tested top-ups and encouragement of private provision through occupational and personal pension schemes.

Switching to a **funded scheme**, whether in the public or the private sector, can shift the timing and incidence of the burden of an ageing population and may have beneficial implications by allowing greater international asset diversification and reducing social security contributions that have tended to reduce EU employment levels in the past. On its own, however, funding cannot entirely solve the more fundamental problem that fewer workers will have to support more pensioners in the future. Indeed, in the short term, a shift to funding may impose even greater pressures on the public finances and the current generation of taxpayers because of the transitional costs of meeting accrued benefits under existing pay-as-you-go (PAYGO) schemes<sup>5</sup>. Although the return on funded scheme assets may be higher than the implicit return on PAYGO schemes (which approximately equals GDP growth), funding schemes also involve investors taking on more risk, not all of which will be diversifiable. This is particularly true if pension funds invest mostly in equities rather than bonds. Partial funding of pensions may, therefore, well be desirable on microeconomic grounds, but it is **no miracle solution** to the demographic time bomb<sup>6</sup>.

<sup>5</sup> The scale of these transition costs means that the Chilean 'big bang' solution of an immediate switch to funded private pensions is not realistic for most developed countries (see Chand and Jaeger, IMF, 1996).

## Does an ageing Europe imply slower economic growth?

As noted above, the **deeper problem** underlying the pension reform debate is that an **ageing European population implies** – all other things being equal – a reduction in the size of the labour force and so **slower economic growth**. In the UK and France, this might involve trend real GDP growth decelerating from around 2.25-2.5% over the next decade to an average of only around 1.6-1.7% in the forty years after 2010. For Germany and, in particular, Italy, the implied deceleration of growth is even more marked (see **Figure 7**). GDP per capita growth is also projected to be slower, although to a lesser degree as the total European population begins to fall from around 2020. The decline in growth may be slightly less marked up to 2020 if we allow for higher savings (as discussed further below) to reduce real interest rates and so boost investment, but our macroeconomic modelling suggests that these offsetting effects are unlikely to be very strong. Indeed, the major impact of higher European savings rates over the next few decades may be capital outflows, real exchange rate depreciation and an increased current account surplus for Euroland up to at least 2030 according to our simulation results.

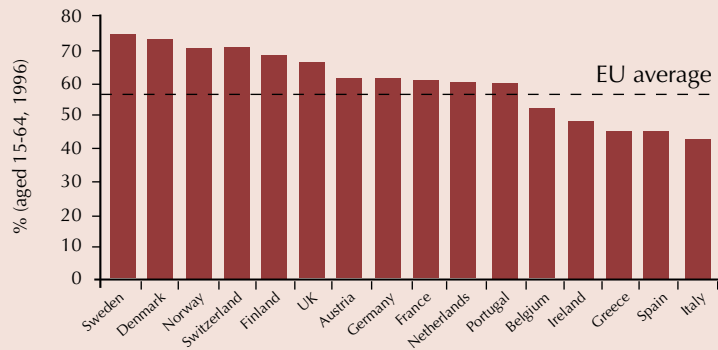


If the overall economic cake is growing less rapidly because of fewer workers, then pension reform can (aside from possible second order efficiency effects) only be a way of spreading the adjustment burden differently across current and future generations of taxpayers and pensioners. The more fundamental challenge is for governments to pursue **labour market reform policies** that will:

- **increase participation rates in the labour force**, notably with the aim of bringing female activity rates in Southern Europe up to Northern European norms (see **Figure 8**)

<sup>6</sup> See, for example, the discussion of European pension reform options in Miles and Timmermann (Economic Policy, September 1999), as opposed to the very significant benefits of a switch to a private funding system claimed by Feldstein and others (e.g. in *Privatising Social Security*, University of Chicago Press, 1998) for the US. Orszag and Stiglitz (World Bank conference paper, September 1999) argue that higher returns from funding in the long run can only be obtained at the expense of reduced consumption and returns for intervening generations. They also argue that higher administrative costs may offset any gains from greater international asset diversification under a private funded system as opposed to a public PAYGO system.

Figure 8 – Female labour force activity rate



Source: Eurostat

and reversing recent trends towards early retirement among men aged 55 and over in all major EU countries;

- **reduce unemployment rates**, which are much higher in Germany, France, Italy and Spain than in the US, the UK or smaller EU countries such as the Netherlands, Portugal, Denmark and Austria.

**Table 1** below summarises our estimates of how these kind of changes might impact on the required ‘breakeven’ contribution rates with earnings indexation of state pensions for Italy, Germany and France in 2050. Our conclusion is that even a very marked improvement in labour market performance, although clearly very desirable, can only mitigate the scale of the problem to some degree rather than solving it entirely.

Table 1 – Impact of labour market reforms on breakeven contribution rates in 2050

	Germany	France	Italy
Breakeven contribution rates in 2000	17.1%	16.0%	20.0%
<b>Base case with earnings indexation</b>	<b>27.9%</b>	<b>28.0%</b>	<b>47.5%</b>
Unemployment rate reduced to 5% (from 9% in base case)	26.8%	26.8%	45.5%
Active labour force increased by 10% through higher participation	25.4%	25.4%	43.2%
Both reforms	24.3%	24.3%	41.4%

Source: PricewaterhouseCoopers model estimates of contribution rate needed to exactly match pension payments

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We note from Table 1 that the figures for Germany and France<sup>7</sup> are very similar, while the required rise in contributions in Italy is much larger. The effects of labour market reforms are broadly similar in each country. The implied increase in contribution rates is still significant in all three countries, however, even with the unemployment rate reduced to 5% by 2050 and the active labour force increased by 10% through significantly higher participation rates in 2050 than in 2000.

Wider economic policies aimed at **increasing labour productivity growth**<sup>8</sup> (e.g. increased competition in product markets and promotion of innovation) could also help to offset the impact of an ageing population on absolute living standards. In this case, however, both the level and the growth rate of GDP would be permanently higher, but this would not solve the problem of how to redistribute this larger cake from a smaller number of workers to a larger number of pensioners. The latter might still be relatively less well off if contribution rates are unchanged. A higher employment rate<sup>9</sup>, in contrast, only increases GDP growth temporarily during the period of the change, but would result in a permanent increase in the ratio of workers to pensioners.

Our conclusion from this analysis is that no single policy reform initiative is likely to resolve the demographic time bomb problem in countries such as Germany, France and Italy. Rather, what is needed is a combination of:

- reforms to existing state pensions schemes to make them more affordable;
- encouragement of increased private pension provision, so as to allow some reduction in social security contribution rates;
- structural reforms to the labour market aimed at increasing participation rates and reducing unemployment levels; and
- wider economic reforms aimed at promoting competition and innovation and thereby increasing productivity growth rates in the long run.

None of these changes will be quick or easy to achieve, but there are some encouraging signs that governments around Europe recognise the need for structural economic reforms and are beginning to make progress in at least some of these areas. Recent German tax reforms and moves to make labour markets more flexible in France to offset any adverse effect from the 35 hour week are examples of such developments but more is clearly needed, not least on pensions reform itself.

## What will happen to private savings rates in an ageing Europe?

Our econometric model suggests that, other things being equal<sup>10</sup>, demographic trends will **push up the average private sector savings ratio in both Euroland and the UK by around 2-3% of GDP between 1995 and 2015**. After around 2020, the Euroland savings

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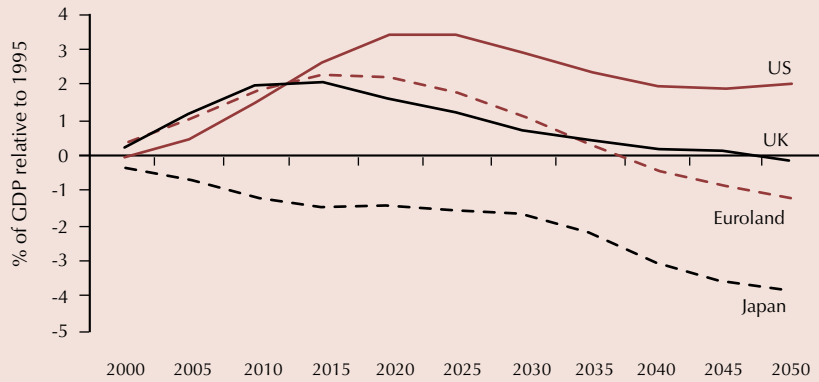
<sup>7</sup> Assuming earnings indexation; France has already moved away from this for basic state pensions so its underlying financing problems are less severe assuming this policy is maintained.

<sup>8</sup> The growth of e-business and related technological developments could also increase productivity growth, although there is little hard statistical evidence of this as yet in Europe, as opposed to the US.

<sup>9</sup> Whether this is because of greater participation in the labour force or a lower unemployment rate amongst these participants.

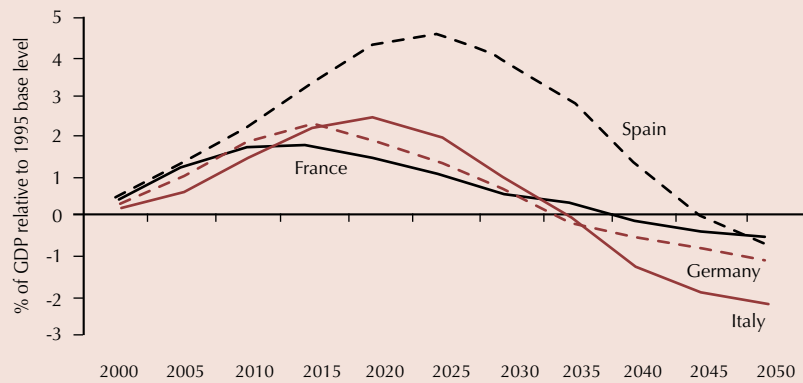
<sup>10</sup> This is, of course, a strong assumption, as witness the significant decline in the US savings ratio in recent years, despite an ageing population, which reflects the strength of the US economy and wealth effects from the consequent high value of the stock market. In the long run, however, demographic factors should be a key determinant of underlying trends in savings ratios, although by no means the only relevant factor.

Figure 9 – Projected changes in OECD private savings rates



Source: PricewaterhouseCoopers – US and Japan shown for comparison

Figure 10 – Projected changes in Euroland private savings rates



Source: PricewaterhouseCoopers

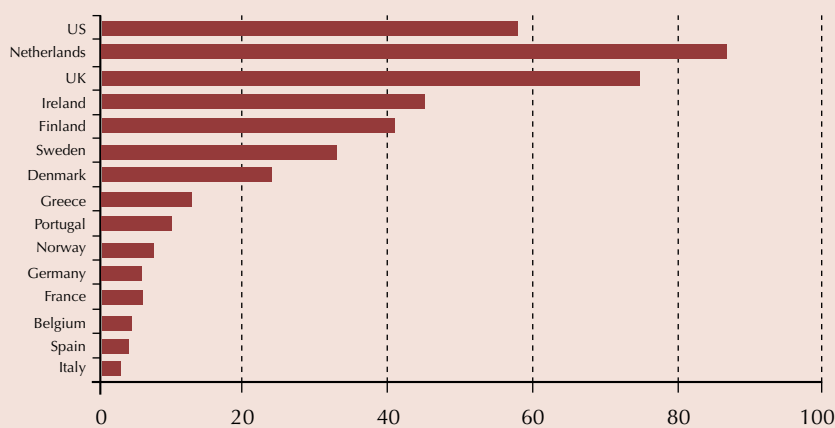
ratio is projected to fall back gradually to below current levels as the baby boom generation retires (see Figure 9). Qualitatively similar trends are projected in individual Euroland countries, with Spain having the most marked increase in savings rates of the larger economies (see Figure 10).

Less generous European state pension schemes and greater job insecurity in a more flexible labour market will add to the upward pressures on private sector savings rates over the next 15 years and could offset the decline predicted after 2020 based on demographic factors alone. Individuals will be forced to look increasingly to employers and financial service providers to meet their retirement savings needs over the coming decades.

Higher savings rates will boost demand<sup>11</sup> for a range of asset types but are likely to have a particularly large positive impact on the growth of European **equity markets**, which are already growing rapidly but are still much smaller relative to GDP than in the US in most EU countries. There are, of course, some exceptions such as the UK and The Netherlands, where private pension fund assets are a much higher proportion of GDP

(see **Figure 11**) and equities make up a high proportion of these funds. We expect that equities, with their higher potential returns, will account for an increasing proportion of EU pension fund assets in the future as regulatory restrictions on asset allocation that previously favoured bonds in several large EU countries such as Germany and France are lifted<sup>12</sup>. Wholesale financial markets are also already becoming more integrated across the EU, in part due to the catalytic effect of the euro. This has already given a particular boost to corporate bond issues, which approximately doubled in Euroland in 1999, in part reflecting the need to fund very large cross-border acquisitions in sectors such as telecommunications, chemicals, aerospace and energy. This trend is expected to continue.

**Figure 11 – Private pension fund assets as % of GDP**



Source: OECD (1997)

**Low inflation** is also likely to remain the norm in Europe, given that growing numbers of pensioners are likely to represent a powerful political force in favour of protecting the real value of savings and fixed interest incomes. Governments in some countries may give increased **tax advantages** to private savings products in order to encourage younger generations to opt out of state schemes. UK experience suggests, however, that such tax breaks need to be carefully designed if they are to be cost-effective, given the dead-weight costs to the government that arise if a significant proportion of the additional money going into pensions and other tax-favoured investments would otherwise just have gone into other forms of savings.

<sup>11</sup> Other things being equal, higher savings might be expected to increase asset prices and so reduce real interest rates and the real cost of equity. In the longer run, however, this may also generate increased capital expenditure, at least at global level, so the long run impact on global real rates of return on capital is unclear.

<sup>12</sup> Bonds will retain a role in portfolios as lower risk assets, however, particularly as pension funds get closer to maturity. This is because, as investment time horizons shorten, the well-known long run 'mean-reverting' tendencies of equity returns will no longer provide adequate protection to investors against the significant short-term volatility of these returns. Corporate bonds, where the value of euro-denominated issues increased to over 600 billion euros in 1999, may also become more important in portfolios relative to government bonds.

## Can occupational pension schemes meet the demographic challenge?

While the demand for occupational pension schemes to replace declining state provision seems set to increase in Europe, our experience suggests that this is far from being the only driver of change in occupational pension provision. Other important drivers include:

- the need for companies to change occupational pension provision to meet the new needs and demands arising from **the shift from traditional nuclear families with a single male breadwinner to the more varied and flexible work patterns and household units evident today**;
- changes in **national tax and regulatory regimes** that have stood in the way of certain forms of pension provision in some countries, although this will continue to be a slow process based on past experience;
- the increasing pressure on European companies to adopt, at least in part, the **shareholder value agenda** that has delivered such economic and business success in the US over the last ten years; one element of this has been an increasing desire of companies to get better value for money from their pension schemes, leading to a switch to simpler, more portable and lower cost pension schemes that are more flexible for employees who may move jobs more often, but also involve some transfer of risk from the company to the individual; and
- the gradual **convergence of European accounting standards** with international norms, which means that unfunded pension liabilities can no longer be ignored and that costs need to be reported on a realistic basis; this means that European Finance Directors – as the champions of the shareholder value agenda – will take a much closer interest in minimising both the cost and volatility of pension schemes; and
- **EU legislation**, which has already had a major impact in requiring any sex discrimination in occupational pension schemes to be eliminated, but has so far been slow to establish a regime that allows genuinely pan-European pension schemes to be established by multinational companies. A draft EU directive is, however, proposed for the first half of 2000 to agree common rules for investment and prudence for pension funds.

The key implications for European occupational pension schemes according to our research are that:

- there will continue to be a significant trend towards **decoupling of occupational and state pension schemes**<sup>13</sup>, which had previously been closely linked in many EU countries, reflecting the increasing cost to companies of maintaining these links; this trend has been particularly notable in France;
- associated with this, there will be a continued **move from Defined Benefit (DB) to Defined Contribution (DC) schemes**, which a recent world-wide PricewaterhouseCoopers survey found to be evident not just in Europe but in virtually every single country; this takes the form of new schemes being primarily DC, old DB schemes being closed to new entrants and existing DB schemes being re-engineered to introduce a significant DC element that allows employees more choice and flexibility; on the other hand, DC schemes also require employees to bear the risk of the ultimate benefit levels being less than expected (e.g. because of falling asset prices

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<sup>13</sup> For example, an employer may promise a defined benefit of 60% of final salary, less the benefit provided under the state pension scheme. If the latter is reduced, this would automatically increase the cost to the employer if the link is maintained.

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near the date of retirement, or low bond yields at the date when annuities are purchased, which has been a major problem in the UK recently); there are also some countries, such as Germany and Norway, where tax regimes continue to favour DB schemes, so pure DC schemes remain rare; and

- there will also be some trend, but at very different rates across Europe, towards occupational pension schemes being **funded from assets external to those of the company itself**; the situation ranges from that in Spain, where complete external funding is now required, to that in Germany, where the tax and regulatory regime continues to favour the use of 'book reserves'; France is an intermediate case where there has been a gradual shift from unfunded plans to the use of insurance contracts to secure pension liabilities.

In summary, European occupational pension schemes will evolve to meet new demands and challenges, but the speed and direction of change will vary greatly from country to country depending on local tax and regulatory regimes and past inheritances. Europe remains a long way from having a single occupational pensions regime.

### **What are the implications for European financial services providers?**

We have seen that governments across Europe are likely to be reining in state pension provision, while employers will be increasingly concerned about controlling the costs and risks associated with occupational schemes. In these circumstances, individuals are likely to be saving significantly greater proportions of their disposable income over the next two decades. As a result, the market for long-term savings products<sup>14</sup> will cover a much wider cross-section of the European population than the current situation, where demand (and supply) is effectively focused largely on the top 10% of the income distribution. These developments open up great opportunities for banks, insurers, asset managers and other financial service providers<sup>15</sup>. Together with ongoing trends towards consolidation, convergence and technological revolution through the rise of e-business, however, they also offer considerable challenges.

The key message to companies in this sector is that competition for customers will increase sharply over the coming five years across Europe, but that far fewer financial services providers will survive to 2010 than exist today. The sustainable middle ground between mass-market provision based on low costs and strong brands and small specialist niche market providers is likely to disappear over this period.

More specifically, our surveys and studies suggest that the following key developments are likely:

- the recent trend towards increased **domestic consolidation** of financial services industries through mergers, acquisitions and alliances will spread across Europe from those countries where it is furthest advanced (e.g. Spain, Switzerland, Scandinavia and Benelux countries) to those where the industry currently remains relatively fragmented

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<sup>14</sup> Note that, in many EU countries, this may take forms other than pensions such as mutual funds, life insurance products and other long-term savings vehicles. In Germany, France and Italy, for example, pensions currently account for less than 10% of total household financial assets, compared to around 25-30% in the UK and the Netherlands, although this could change as state pensions become less generous in the former group of countries.

<sup>15</sup> There may also be an increased role for intermediaries who can manage out-sourced pensions and other HR benefits functions for companies and also give employees a list of 'approved' providers for these benefits from which to make choices. E-business has the potential to make this kind of service, which is already developing rapidly in the US, very cost-effective.

but where merger activity began to accelerate sharply in 1999 (notably Germany, France and Italy);

- the **retail banking and insurance** industries will see an increasing trend towards pan-European consolidation, where the recent acquisition strategies of certain Dutch banks and French insurers serve as a possible model for the future development of the industry; differences in regulatory regimes may mean, however, that these sectors do not become truly global – US firms may well expand their operations in Europe, but they will need to do so in a way that is closely tailored to local tax, regulatory and customer requirements; over time, however, the barriers to an integrated EU market will be gradually eroded;
- in contrast, **global business models** are already becoming more and more dominant in investment banking and, most notably for pensions and long-term savings provision, could also eventually become the norm in **investment management**<sup>16</sup>; the latter area will increasingly also be a focus for banks that see their traditional deposit and loan businesses offering much less growth potential than long-term savings products where effective asset management is critical to success;
- for the mass market, **trusted brands** will be critical as low cost, low margin products, based increasingly on passive rather than active fund management (i.e. index trackers), become the norm;
- in this **tough new world**, successful providers will increasingly specialise either in ‘manufacturing’ these products in the most cost-efficient way, or in delivering products to consumers, which may involve selecting the best of a range of products for a particular consumer<sup>17</sup>, rather than simply selling them in-house solutions;
- since financial services are an example of a pure **digital product** that can, at least in principle, be delivered entirely electronically, this sector will be among those most dramatically affected by **e-business**, assuming that potential tax and regulatory barriers to cross-border services can be overcome; in particular, these new technologies are facilitating new competition from within and outside the existing financial services sector (based particularly on strong brand names in the latter case) and accentuating the potential advantages of scale economies and critical mass from mergers and acquisitions; new technologies will allow better customer service, although the norm will be to allow customers multi-channel access, rather than requiring them to use the Internet if they prefer the telephone or traditional face-to-face service; fully integrated customer information systems will become critical in managing relationships, particularly with those customers and prospects of greatest long-term value to the business<sup>18</sup>.

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<sup>16</sup> The move to global business models is discussed further in our recent report on Tomorrow's Leading Investment Manager (jointly with the Economist Intelligence Unit).

<sup>17</sup> The PricewaterhouseCoopers 1998/99 European Private Banking Survey and our 1999 Investment Management Survey both point to customers now demanding higher performance, better value for money and improved service from providers than in earlier years.

<sup>18</sup> The challenges of creating genuinely customer-centric web-enabled retail banks are explored in more detail in a recent joint PricewaterhouseCoopers/Economist Intelligence Unit report (for a summary, see our website on [www.pwcglobal.com/TLRB](http://www.pwcglobal.com/TLRB)). A joint PricewaterhouseCoopers/CBI e-business survey of financial services companies in November 1999 found that 50% of respondents expected e-business to reshape the industry (which, if anything, is surprisingly low) while 89% saw this as a key element in their own business strategy.

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## Conclusions

Demographic pressures and likely policy reform will mean that the European pensions and long-term savings market of 2010 will be much larger than at present, with growth over the next decade comfortably exceeding that of total GDP and a much greater role for private sector provision. Based on our simulation results, we believe the increase could be as much as 2-3% of GDP for the EU, comparing 1995 savings levels to the savings levels predicted by our model in 2015. In real terms, allowing for 2% per annum GDP growth<sup>19</sup>, this would imply an **increased annual flow into EU savings of the order of 200-300 billion euros**. We would expect the great majority of this inflow to be into long-term savings products, given that long-term demographic changes and a reduction in the level of state pensions will drive the upward trend in total savings. Indeed, there could also be net shifts out of short-term deposit accounts that offer relatively low rates of return to investors.

This rapid growth rate will inevitably attract many **new entrants** into the long-term savings market, both from outside the EU and from outside the traditional financial services industry, facilitated by **the rise of e-business**. Many of these new entrants may not succeed, but the market will remain contestable even if a few large 'winners' achieve temporary dominance in particular market segments. Growth and size will not guarantee profitability in such a market, which will instead depend on continually updating and upgrading a company's sources of competitive advantage and defending the trustworthiness of its brand. There are likely to be several new names in the list of the top ten European financial service companies in 2010 and **some notable casualties of change** that do not succeed in adapting to the new customer-centred way of doing business.

The precise direction and speed of change in the European savings industry will, however, be conditioned in part by changes in state pensions policy, tax and regulation. Particularly in countries such as Germany, France and Italy, where the state pension has traditionally had a predominant role in retirement provision, our analysis confirms that **the status quo is not an option for governments**.

We believe, therefore, that the next ten years will see a real revolution in the way in which Europeans will provide for their retirement in the 21st century, which is likely to involve a wide range of long-term savings products not just traditional pensions. Our Unknown Saver will not be alone in seeking help from any financial service provider that they can trust to help them through this maze.

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<sup>19</sup> EU GDP is estimated at around 8 trillion euros in 2000, which would increase to around 10.8 trillion euros by 2015 based on 2% per annum real growth (at year 2000 prices).

## About the authors

**John Hawksworth**, who is Head of our Macroeconomics Unit, managed the research programme and drafted this summary report based on the work of the whole research team.

**Nicholas Vause**, who also works in the Macroeconomics Unit, was responsible for developing our model of the state pension system in Germany, France, Italy and the UK and analysing the financial implications of alternative pension reform options.

**David Pettitt** and **Jenny Lee**, who work as actuarial and benefits consultants within our Global Human Resource Solutions practice, were responsible for conducting research on recent trends and possible future developments in European occupational pensions.

**Travis Barker**, who works in our Tax and Legal Services practice and specialises in the Investment Management sector, was responsible for research on the strategic implications for European financial services providers of the changes discussed in the report.

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