COUNTRY SPOTLIGHT | FINLAND

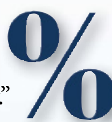
Sustainable for generations

Tasked with finding savings of €1 billion by the government, Finnish social partners are locked in negotiations, exploring every avenue of pension reform. But what are the key proposals, and which direction is favoured? Natalie Tuck **reports**

There's a Finnish word – sisu – that captures the essence of Finnish character. While it lacks a direct English equivalent, it represents a blend of stoic determination, purposeful tenacity, grit, bravery, resilience, and strength.

And as the country looks at ways to reform its pension system, it is this sisu-like resolve that will drive it forward. Finland's pension system is counted as one of the best in the world. Indeed, the *Mercer CFA Institute Global Pension Index 2023* placed Finland's retirement system sixth out of 47 countries analysed. It's a notable achievement, but a closer look reveals that the sustainability of the system lets it down – with a score of 65.6 – compared to adequacy (77.4) and integrity (90.9).

There are several drivers behind its low score in sustainability, such as its ageing population, declining birth rate and a spluttering Finnish economy. Elo director of PR and sustainability, Katja Veirto, says: "Our pension system is one of the best in the world but, for example, the declining birth rate and the



ageing population challenge long-term sustainability."

Still, the government's decision came as a surprise to some who believe it should not meddle in the earnings-related pension system. However, Finnish Centre for Pensions (ETK) managing director, Mikko Kautto, explains the government's interests are related to the country's overall welfare spend and deficit. "Pensions, paid mostly through contributions on earnings, fall under the broad general government expenditure umbrella," he says.

"From the Ministry of Finance's perspective, it is a statutory system, it's mandatory, it's legislated and it is part of our broader public finances. The more the pension sector demands contributions from employers and employees, the government thinks the less it has room to manoeuvre for taking care of other public expenditure. The [*pension*] contribution rate is calculated in our total tax rate and there's a willingness in Finland not to increase the tax rate."

As the country's demographic pyramid is expected to become increasingly top-heavy with an ageing population, pension expenditure is projected to rise, Kautto notes. The pension system thus needs to secure its financial sustainability. This, in turn, helps determine resources for other critical welfare areas, but also the intergenerational fairness of the system.

On the other hand, Finnish Pension Alliance (Tela) manager, public advocacy, Janne Pelkonen, argues that the pension system itself is not the real issue. "We need a pension reform, but the main problem lies within the public economy, which now seeks support from the pension system. That's the current narrative, and it's a significant shift from previous pension reforms," he says.

Reforms

In the face of this, and a wider welfare cost-saving initiative, the country's Prime Minister, Petteri Orpo, set out his plan for reform in the June 2023 *Government Programme*, tasking the social partners with making reforms equating to 0.4 percentage points of GDP, around €1 billion.

In the October, the social partners and ministries formed two working groups and they have until 31 January 2025 to present their agreement. If no agreement is reached, then the government has said it will implement its own proposals, but Finnish Business and Policy Forum (EVA) head of research, Ilkka Haavisto, says this would be an "unprecedented crisis in the field of the Finnish pension system".

The pension negotiation group is chaired by the Confederation of Finnish Industries director, Ilkka Oksala, and is made up of representatives from the central employer and employee organisations. In addition, the Ministry of Social Affairs and Health and the Ministry of Finance have established their own working group, chaired by Ministry of Social Affairs and Health director general, Liisa Siika-aho.

These two working groups make up the tripartite model of the pension reforms. The earnings-related pension insurance companies are not included in any of the working groups, instead providing expertise to the groups along with Tela.

"Elo and other pension companies are used as expert help in the background preparation, and we are asked for views. So, we provide our contribution this way. We have a lot of information that cannot be found elsewhere other than in pension companies," Veirto says.

Kautto adds: "[*The reform*] is a big thing for the pension companies. Of course, they are interested in what kind of agreement will come out. They would like to be heard in the process. It's up to the social partners to listen to them. To some extent, they consult and ask them. We also work together with the pension companies, the actuaries from there, so that we get their feedback on our models and outcomes."

Haavisto points out the pros and the cons to this approach of pension reform. "I think it has its good sides, in that the pension system is, in a way, isolated from day-to-day politics. But, the fact also is that Finland had extremely large Baby Boomer age cohorts in the '40s and early '50s.… I think people should have understood that we were going to be in trouble since those Baby Boomer classes are so large."

He continues: "[*It would have been better*] if they had designed and implemented changes in the system that meant Baby Boomers would have stayed in working life longer… as they are all now retired. I would say – crudely – that they made a system to work the best for them and left the problems to the coming generations and that's what we are dealing with right now."

On the other hand, Pelkonen disagrees, instead arguing that the "current shortfall on pension contributions in the long run is caused by the declining birth rate since 2011, which has fallen by approximately 25 per cent since 2011".

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White smoke

Haavisto describes waiting for the negotiations as like waiting for the white smoke from the Vatican to appear when the Catholic Church is appointing a new Pope. Nothing is discussed with the exterior world; it is, he says, "very tight knit".

"No one from the committee, or the experts who give them advice, is really allowed to say anything in public. They have their internal struggles with themselves in the committee and, in the end, they come out with some kind of a resolution or proposal, which usually then is taken to the ministry and the ministry gives it to parliament and it is approved without making any changes or amendments," Haavisto explains.

Solvency ratios

However, several objectives set out in the mandate for the working group provide a glimmer of insight into some of the key proposals up for consideration. One of those is to amend the solvency margins of the four pension insurance companies – Elo, Veritas, Ilmarinen and Varma – allowing for more risky investments.

It's a proposal that has a lot of support, not just from the pension companies themselves but from lobbyists. It's also already being done by the country's public sector pension organisation, Keva, (see page 22 for a Q&A on this) which revealed its intention of introducing riskier assets towards the end of 2023.

Kautto says changing the solvency limits has been a topic of discussion and investigation for several years and he believes the solvency rules are "too strict compared to the long-term liability" that the pension companies have.

"They have to be solvent each day, whereas the value of their investments change according to market development. Sometimes, due to the solvency rules, they are forced to sell some of their stock holdings. That in the long run may not be the best thing when you are looking for returns for your investments. Designing solvency rules that allow better long-term returns is a tricky issue," he explains.

Tela, which represents the interests of pension insurance companies, is also supportive, according to Pelkonen. In

The Finnish pension system

- The pension system is made up of three pillars: The national pension and guaranteed pension, including other state top-ups for eligible pensioners (first), the mandatory earnings-related pension system and other occupational pension schemes, of which there are few (second), and private pension savings (third).
- Finnish Centre for Pensions (ETK) managing director, Mikko Kautto, believes the Finnish pension system is "one of the easiest pension systems in Europe to understand".
- "The present system is 90-95 per cent earnings-related pensions, which is mandatory. The same accrual and benefit rules apply whether you're employed in the private or public sector, whether you're an employee or self-employed person, or even a farmer. In that respect, it's rather easy to understand," he explains.
- The driver of this system is, he says, that everyone should earn through their career and lifetime earnings "a decent enough pension that will be paid in case of disability, loss of a family provider, or when you reach old age".
- There are four pension insurance companies available for private sector employers to select for their employees' pension insurance – Elo, Veritas, Ilmarinen and Varma – which operate like a DB pension scheme. Public sector workers' pensions are managed by Keva, which is governed in a different way to the private sector, along with other sector specific schemes.
- As of 2024, contribution rates are set at 24.81 per cent in the private sector and 27.15 for Keva member organisations, and the contribution rates of sector-specific schemes also vary. Around a third of the contribution comes directly from employees' salary and two-thirds, approximately, from employers.
- The earnings-related pension system is partially funded at a level around 25-30 per cent of the pension liabilities invested. Currently, around 12 per cent of contributions across the public and private sector are allocated to the funded part of the system with the rest of the contributions funding current pension expenditure as part of the pay-as-you-go aspect of the system.
- The average replacement rate is around 60 per cent of average lifetime earnings. The coverage of the earnings-related pension is close to 100 per cent among wage earners, due to it being mandatory. For the self-employed there is a threshold for compulsory pension insurance, but even for them, the coverage is high. Those with little earnings-related pension savings are protected by the national and guarantee pension in the first pillar.

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practice, this could also mean allowing earnings-related pension companies to increase their equity exposure by around 10 percentage points, he says.

From Elo's perspective, Veirto adds: "As a long-term investor, Elo supports this type of reform. It makes sense to take advantage of the long term. The effects would be of the same type for all pension companies as equity investments increase."

Haavisto's organisation is also supportive, stating that under the current regulations a "big chunk" of investments have to be placed in government bonds and less risky assets. He highlights the Swedish AP Funds and the "stark differences" between how much they, and the Finnish pension companies, have made on their investments.

"Many Finnish pension company CEOs have been hinting that the situation is really not optimal. They have also alluded that the kind of old thinking that a big chunk of their investments would be done in the Nordics, or in the Nordic stock markets, is not a really good idea – that they need a free hand to invest more in either whatever they want and wherever they want," he says.

Automatic stabiliser

Another, more controversial aspect of the working group's agenda, was what Haavisto refers to as the social partners' "cryptic sentence", hinting at the introduction of a third automatic stabiliser.

Currently, the pension system has two automatic stabilisers in place: The Life Expectancy Coefficient and pension age.

"The life expectancy coefficient reduces the amount of the starting pension if longevity increases," Kautto says. In addition, a 2017 reform introduced a second automatic stabiliser that linked pension age increases to life expectancy; both mechanisms work on the basis of mortality development.

The potential introduction of a third automatic stabiliser has sparked considerable debate due to the lack of details on its specifics. Tela has previously warned that such a measure could pose a "serious risk" to the pension system. From a pension company's perspective, Veirto emphasises that any new stabiliser must be "understandable and treat different generations fairly". Meanwhile, Haavisto notes that there has been "total silence" regarding how social partners might define or implement this new stabiliser.

A variety of complex options could be introduced for an automatic balancing system, but how would it function? Essentially, if the earnings-related pension system were projected to face a long-term deficit, the mechanism would activate and implement its predefined measures to address the shortfall.

"Depending on your political choice," Kautto says, "it could affect the pension formula for the future pensions, or the pension accrual rate of that specific year. You would adapt a little – for example, pension accrual is not 1.5 but it's 1.48 during that year – or something like that. You could also agree to move the contribution rate a little." He believes that any new automatic stabiliser should be developed in relation to the total balance sheet of the pension system, rather than a single aspect, like the mortality of the system.

Pelkonen is concerned, though, that a new balancing mechanism might lead to reductions in current benefit payments through an adjustment to the index.

"There would be some type of break on the annual indexation of pensions until the balance would be achieved. We are critical of this, because if we fix the contribution level, the system is no longer a defined benefit system. That would be a systemic change. We haven't had that type of public discussion until now. The general public is not aware of this [*potential*] looming systemic reform," he says.

However, Haavisto argues that it would be difficult to cut benefits already in payment due to the Finnish constitution and pension benefits are protected as property rights under the country's law.

But could public perception of pensions pave the way for a significant change like this in the future? Haavisto thinks so: "I think most Finns now think of their pensions as investments and savings made on their behalf and partly by them. So, I think people's mindsets have changed along the way and, in future, they might be more interested in viewing the pension system more as an investment instead of an insurance scheme."

Speculating, Haavisto also believes that "difficult discussions in the committee" will have taken place on the elimination of pension accrual during periods of earnings-related unemployment benefit. Despite this, he believes "labour unions are vehemently against that kind of proposal" as unemployment benefits have recently been cut.

Another option potentially up for discussion could see pension accrual whilst in education or for those undertaking qualifications scrapped. "I think several people have suggested that that should be eliminated," Haavisto says, "because that would incentivise people to study faster and enter working life sooner. And there's no logical connection between studying and the pension system either."

Public perception

Regardless of the outcome, Pelkonen warns that any automatic stabiliser is a matter of fairness. "It will affect the trust that people have in the Finnish system. The balancing system – the third balancing system – is really tricky, because we already have two. He also insists that the replacement rate should be adequate also for younger generations in the future, since their pension levels are cut by the existing life-expectancy coefficient stabiliser."

However, public discussion is intensifying, and the Finnish National Youth Council has held its own pension negotiations, recently publishing a report calling for intergenerational fairness.

At the time of the report's launch, Finnish National Youth Council advocacy expert, Titta Hiltunen, stressed that the pension reform "must focus firmly on the future" with the students proposing the idea of introducing generational funding to the earnings-related pension system.

"The system must treat different generations equally and fairly if it is to be widely accepted and sustainable, now and in the future. Young people must be consulted on the reform," she said. The council's report was welcomed by Finnish Social Security Minister, Sanni Grahn-Laasonen, who also called for intergenerational fairness in the pension reform.

As we move swiftly into autumn and the final quarter of 2024, the January deadline feels just around the corner, barely beyond the holiday season. Indeed, those anticipating the outcome of the negotiations will soon see their 'white smoke'.

Taking the lead

Last September saw Finland's public-sector pension provider, Keva, announce its decision to increase the risk level in its investment portfolio. Its communications specialist, Kaija Karjalainen, tells *European Pensions* about the decision

Keva announced in September last year its decision to increase the risk level of the investment portfolio. Can you tell us the reason?

» The decision to increase the risk level of Keva's investment portfolio was a logical progression from the earlier developments that commenced in 2017, when the current investment strategy was approved by Keva's board. Over the years, the board had gradually increased the equity weight in Keva's Reference Portfolio, which serves as the board's main tool for defining the baseline investment risk.

The actual portfolio is then managed in relation to this risk anchor, with a relatively large deviation mandate. The board's decision in June 2023 recognised that, despite the measures taken, the primary risk to the pension system – namely, the risk of not achieving the long-term required return, also known as the long-term shortfall risk – remained too high. As a result, a multi-year plan was devised to further raise the risk level of the Reference Portfolio.

Has work already started on this strategic decision? If so, what has changed so far in terms of asset weighting?

» The equity weight in the Reference Portfolio has been progressively increased in accordance with the outlined plan, with a total increase of 6 percentage points across three increments. The actual portfolio has generally mirrored these changes, although the timing and instruments used may not always align perfectly with those of the Reference Portfolio. The continuation of this trajectory is a crucial aspect of the ongoing investment strategy work. At least one more increase is anticipated based on existing decisions. Any further increments would require a revisit of the analysis on which the previous decision was based, followed by new decisions derived from this work in the future.

How will Keva manage the volatility that comes with increased investment risk in its portfolio?

» Keva's investment strategy is primarily focused on generating sufficient real returns, with short-term volatility being a secondary concern as shortfall risk management is the focus. This approach is enabled by Keva's independence from any external solvency regime, which often include pro-cyclical elements that can make it challenging to sustain risk-taking during market fluctuations. However, Keva aims to dynamically and counter-cyclically adjust its investment risk level and explore the inclusion of more convex payoffs in its investment mix.