

PENSIONS IN EUROPE: THE ROLE OF FINANCIAL SERVICES

Summary: Removing the barriers to cross-border European pension provision has proven to be one of the most elusive single market goals. European legislation in this area has been attempted many times over the past ten years but none has made it on to the EU's statute books. As a result, pension funds remain the only major financial services entities without a 'European passport'. The value of supplementary pension assets across Europe currently stands at around €2 trillion, corresponding to approximately 25% of the Union's GDP. If EU countries were to converge to US levels of funded supplementary pension assets, this figure could be expected to double.¹ In the context of integrating financial markets accelerated by the single currency, it is anomalous that such an important sector should still fall outside the mainstream of EU legislation. The draft directive on institutions for occupational retirement provision (IORP Directive) seeks to resolve this by providing for common European standards for prudential supervision of occupational pension schemes.

Establishing such a prudential framework would increase supply and competition in the provision of and demand for funded supplementary pensions. It would also increase supply of long-term funds to capital markets, helping to stimulate economic growth and job creation. Financial services providers will be able to play a key role in realising these benefits. Using the directive's enhanced flexibility, they can deploy their financial expertise to advise occupational pension schemes and manage their assets to generate optimal returns appropriately tailored to beneficiaries needs.

Pension reform has proven to be one of the most elusive single market goals. Most economists and other experts agree that all EU member states need to take strong policy action to encourage adequate funding of both public and private sector pension provision for future generations. Already, it is evident that public pension schemes in a number of EU countries are unsustainable in the longer term. While pension reform continues to be cited as an urgent priority by European politicians and policy makers, little has been achieved so far. The current and foreseeable fiscal situation indicates there is little scope for governments to finance obligations by running large budget deficits when ageing becomes an acute problem. A move to funded schemes and encouraging the growth of private (occupational and individual) pension schemes as a supplement to state schemes are therefore generally recognised as the key options to significantly improve the situation.

Pension funds are the last major financial services entities lacking a single European 'passport'. Rapidly integrating financial markets accelerated by the single currency highlighted the anomalous position of these important economic actors. Adoption of the draft IORP directive² would go some way to remedying this situation by providing a basis for common European standards for prudential supervision of European occupational pension schemes.

¹ Pensions Fund Reform and European Financial Markets: E Philip Davis, Bank of England, 27 April 1999, Chatham House, London.

² COM (2000) 507 final, 11 October 2000; PE T5-0380/2001, 4 July 2001; CSL 11212/4/02. 5 November 2002.

The “Cost of Non-Europe” for Pension Funds

For companies with operations in more than one EU country, it is currently impossible to have a centrally managed pension fund for all their European employees. This means that separate funds have to be established for each Member State, increasing management costs and making it difficult to transfer staff or provide comparable benefits to all staff. Industry and Commission estimates put the potential cost-savings that might be achieved by a pan-EU company through running a single pension scheme for all its EU employees at €20-40 million per year. For companies competing in world markets, such a reduction in administrative costs would represent a welcome increase in competitiveness against non-European (especially US and Japanese) corporations.

The debate on pension reform in Europe has highlighted the importance of improving choice in the mix of products available in the market and the optimum desired mix between performance and risk. A growing shift towards the *prudent person* approach implies a review of certain quantitative limits and restrictions imposed in some EU member states, such as ceilings on equity investment or investment in foreign assets in excess of prudential soundness, which can engender sub-optimal returns and higher costs. Some Member States have been unwilling to abolish these restrictions in part because to do so would mean giving up a captive market for government debt. Limits placed on asset diversification or investments outside the home Member State can complicate risk management and even reduce investment portfolio security.

Perhaps the biggest obstacles to cross-border labour mobility in the single market - other than language - are tax-related barriers on pension provision. Most Member States confer tax privileges on supplementary pensions schemes, and each state has its own specific rules. There are three main stages at which pensions can be taxed. The most common system is EET (Exempt-Exempt-Taxed) i.e. contributions are exempt, accruals to the fund are exempt and payments out of the fund are taxed. Problems arise when one country has an EET system and another country has an ETE or TEE system, then people moving between those states will often be subject to double taxation or no taxation. The EU has recognised that eliminating tax obstacles is key to creating pan-European pension funds. In April 2001 the Commission published a communication on eliminating such obstacles and in December 2001, the European Parliament broadly endorsed the Commission’s approach and called on Member States to cooperate in removing tax obstacles. In April 2003 the Commission is expected to present its ideas for non-legislative initiatives to cooperate in this area.³

What About the Broader Economic Implications?

Pension assets can contribute very significantly to European capital market development. The more flexibly and efficiently pension assets can be invested, the better for the markets and the consumers (pension plan members and plan sponsors). Apart from the inefficiencies and additional costs to sponsors and beneficiaries that currently result from the lack of a European legislative framework for pensions, wider economic benefits can be achieved by making it easier to develop pan-European pension funds. For example, a large expansion in funded occupational retirement plans can greatly increase the size, liquidity and attractiveness of Europe’s capital markets. European companies would benefit from cheaper financing through greater access to an important source of long-term investment capital and other investors would

³ COM(2001) 214, 19 April 2001; PE T5-0704/2001, 13 December 2001.

derive benefits as a result of greater market liquidity and lower overall costs. Market participants and institutional investors believe that adoption of the directive would be a significant step to integrate Europe's capital markets and thus boost overall competitiveness. The ability to move from one country to another without forfeiting un-vested pension rights would boost labour mobility and increase the competitiveness of the EU economy.

The Draft Directive

The objectives of the draft IORP Directive are threefold and can be summarised as:

- 1) *Creating a single market for supplementary pensions in Europe*: Occupational pension funds are managed by different providers – pension funds, asset managers, insurance companies, banks, etc. Competition creates new and efficient solutions for financing pensions and offers increased choice and flexibility for consumers (sponsors and beneficiaries). To increase competition, the directive should provide maximum choice to consumers, by facilitating cross-border activities and ensuring a level playing field between all service providers.
- 2) *Creating common prudential standards for pension financing*: The directive is intended to create a framework providing legal security, flexibility, proper risk management, transparency, information, and stable and adequate returns to plan sponsors (be they governments, corporations or individuals). The proposal envisages a *prudent person* approach to investment decisions on the grounds it offers better prospects for higher returns, especially over the term of pension accumulation and would enable choice of the desired optimum mix of performance and risk appropriate to the circumstances.
- 3) *Ensuring secure and affordable pensions*: The higher the account value at retirement, the more flexibility is available for plan sponsors and beneficiaries at that stage. Minimum prudential regulatory standards can help ensure optimal returns and thus help to finance the increasing pension gap resulting from the unfavourable demographic environment of the coming decades. Pension plan sponsors should therefore have flexibility to design and fund their liabilities for both “defined contribution” and “defined benefit” schemes according to the particular needs of their workforce, which can vary in terms of age, expected retirement age, etc.

The Commission intentionally limited the directive's scope to cover only key prudential rules, opting not to dictate product specifications, or attempt to resolve tax or labour mobility issues. These other important issues will be handled via separate legislative initiatives, at EU or Member State level as appropriate.

The proposal concerns institutions for retirement provision that are linked to employment and operate on a funded basis, such as pension funds, "Pensionskassen" and the occupational pension products of life assurance companies. These institutions currently hold assets that amount to over €2 trillion (approx 25% of EU GDP) and cover 25% of the EU population. These institutions are very well developed in Belgium, Denmark, Ireland, the Netherlands, Sweden and the UK. They are becoming increasingly important in Italy, Spain and Germany. The proposal does not cover basic state pay-as-you-go schemes, nor does it deal with individual pension saving plans. Book reserve schemes (common in Germany and Austria) are also excluded from the scope of the Directive.

The Commission has emphasised that the proposal does not seek to regulate the ways in which Member States organise their pension systems. It is up to Member States to decide whether and how they adapt their pension systems to cope with the ageing population and the decrease in the proportion of the labour force in relation to the number of retired people.⁴ Member States will still be free to decide on the extent to which they wish to rely on state pensions and the extent to which they wish to encourage the use of funded pension schemes. It is also up to Member States to decide which pension schemes may qualify as an "occupational pension", leaving Member States full control of their public and private pension systems.

The European Parliament's first reading Report (adopted on 4 July 2001) endorsed the Commission's approach of qualitative investment rules (*prudent person* approach), equality between providers and focus on risk diversification and supervision of managers. In addition, the Parliament introduced amendments: to underline home country rule for cross-border activities of pension funds and home Member State supervision; to increase the rules on information to be provided to beneficiaries; and to require pension fund managers to offer bio-metric risk cover as an option to all members.

After lengthy negotiations, EU Member States agreed a Common Position on the proposal in October 2002. The main component of the compromise was agreement on the importance of consumer choice including recognition of the *prudent person* principle while permitting some quantitative investment restrictions to continue at the discretion of individual Member States. As for the cross-border activities of pension funds, the competent authority of the host Member State may ask the competent authority of the home Member State to oblige the pension fund in question to apply the quantitative restrictions that have been laid out by the host Member State.

Member States would be limited in what additional rules they apply: a 30% cap for investment in unregulated markets; a 10% cap for investment in a single issuer; and a 5% cap for investments in shares or other securities from the same company. They may also introduce a 30% cap for non-matching currencies. Pension funds will therefore continue to face investment rules in each country they operate in. The compromise text also calls for full funding at all times of cross-border activities, whereas the approach is more flexible regarding domestic pension practices.

In summary:

- Pension reform is a vital social and economic objective for Europe in order to assure its citizens of adequate pension provision upon retirement and to reduce unsustainable fiscal pressures.
- Pensioners stand to benefit significantly from a wider choice of pension products and more flexibility in rules that apply to pension plans that aim to provide an adequate, secure post-retirement income.
- The scope for growth in Europe's funded occupational retirement plans is very large provided the conditions are created for pro-growth policies, including greater consumer choice within a sound prudential regulatory framework.

⁴ Commission Communication on Adequate and Sustainable Pensions, 17 December 2002.

- A large expansion in funded occupational retirement plans can greatly increase the size, liquidity and attractiveness of Europe's capital market providing European companies with improved access to sources of finance and boosting Europe's international competitiveness.
- Market participants and institutional investors favour the adoption of the draft directive on institutions for occupational retirement provision as they believe it will be a first significant step towards laying the foundation for a workable pan-European funded private pension system

Briefing notes are prepared by the Industry Advisory Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Advisory Committee.

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