

EPFSF Briefing: Pensions

Summary

One of the biggest and most complex challenges for the European Union in the next decade is tackling the extraordinary demographic changes occurring across member states and the potential effects on economic growth, labour markets and social protection systems. As Europe's population grows older, the financial strains on pension systems will intensify. The situation and outlook may differ between member states but ultimately there is a need to address the financial sustainability of pensions throughout the EU.

The financial services sector has played and will continue to play an important role in dialogue with the European Commission and the European Parliament and also in providing creative solutions and products for the long-term sustainability of pension systems.

Introduction

According to a joint report recently published by the Commission and the Economic and Policy Committee¹, by 2050 Europe will go from having four to only two people of working age for every elderly citizen. The detailed projections of the report confirm the validity of the Lisbon Strategy and reinforce the interdependence of pension reforms, increasing employment opportunities and sustainable growth.

Pension systems are very different from one member state to another although in general, they are divided into 3 pillars:

- Pillar 1 – State pension (majority of schemes are Pay As You Go)
- Pillar 2 – Supplementary (occupational) pension
- Pillar 3 – Private (individual) pension

With different pension models and varying levels of funding, comparison across the EU-25 is difficult. Furthermore, the relative importance of the pillars also varies across member states, for instance, some countries have moved further towards funded schemes in Pillars 2 and 3. These variations are driven by both budgetary pressures and public policy priorities.

Nevertheless, increased longevity and falling birth rates are major factors making many state pension systems across Europe unsustainable in their present form. Some member states have already introduced major reforms (e.g. Germany, France and Austria) others have continued to adapt their existing systems.

Recent market developments, including the implementation of the new International Accounting Standards, have all added pressure for company pension plans to be reviewed, particular in the case of defined-benefit arrangements. This has in turn resulted in employers in some member states gradually shifting their pension arrangements from defined-benefit plans (i.e. benefits are typically based on a formula linked to a members' salary and length of employment) to defined-contribution plans (i.e. benefits are based solely on the amounts contributed plus the investment return). This trend represents a shift of risk from employers to employees and therefore brings with it the need to educate people about the risks and returns of defined-contribution plans.

In line with the principle of subsidiarity, it is for each member state to decide a national structure for pension provision. Where the European Commission has Treaty competence, it has been very active in the area of pensions and long-term savings. In parallel, close co-operation between Governments has also been developing.

EU Initiatives

The European Commission, across a number of directorates (including DG Internal Market, DG Employment and DG Tax), has adopted measures and is looking at further initiatives to ensure the regulatory framework can support market-driven solutions to improve retirement financing

¹ Report of the Impact of Ageing Populations on Public Spending (February 2006)

- **Directive on Institutions for Occupational Retirement Provision (IORP)**

Also known as the Pension Fund Directive, the IORP is an FSAP measure adopted in 2003, which is intended to create an internal market for occupational pension funds by establishing a common prudential framework for IORPs as well as by substantially reducing national barriers against cross-border pension products and pooled pension products. The two are very different. Pan-European asset pooling of a number of schemes with typically one asset manager in one member state is different from cross-border products where members potentially in a number of countries all contribute to a single scheme. The IORP introduced a new regime and a new concept at EU level of the 'prudent person' investment principle (i.e. pension funds must invest in the best interest of members and beneficiaries to ensure the security, quality, liquidity and profitability of the portfolio as a whole).

Interpretation of the 'prudent person' and implementation of the IORP has been mixed across member states - 14 out of 25 member states failed to implement the directive by the deadline - which has done little to create a level playing field as yet. However, the CEIOPS Budapest Protocol setting out provisions for the cooperation of pension supervisors is an important step in the right direction. Implementation of this directive illustrates the difficulties of cross-border reform in the EU pensions regime, particularly when considering application of social and labour law to pension schemes.

- **UCITS Review**

In 2005, DG Market published a Green Paper reviewing the EU framework for investment funds – UCITS. The Green Paper proposed a number of targeted amendments to the UCITS Directive and launched a debate about the long-term role and significance investment funds can have on the provision of sustainable pensions in the EU. UCITS are seen as an appropriate vehicle for occupational pensions. Therefore, tackling current cross-border obstacles identified in the Commission's review will be an important development for the asset management industry.

- **Proposal for a Directive on the Portability of Supplementary Pension Rights**

DG Employment published proposals for a Directive on the "portability" of occupational pensions both within and between EU Member States in October 2005. Currently at first reading, the proposal unusually requires unanimity in the European Council, yet co-decision applies to the European Parliament.

The proposal establishes rules for the acquisition, preservation and transfer of employment related pension rights. In modern European labour markets where life-long job tenure is becoming very rare workers should not be penalised for changing jobs. However, it is not clear that the directive will significantly improve labour mobility across the EU, which not only depends on the future treatment of existing pension plans. As currently drafted the directive could significantly add to the cost of employers providing occupational schemes, which are generally provided on a voluntary basis, and could at worst result in a reduction of schemes offered. This would obviously go against all the current attempts to improve retirement financing.

- **Taxation of pensions**

European taxation rules for pensions are changing, particularly following recent ECJ rulings and the Commission's relatively successful attempts to remove tax barriers to cross-border provision of occupational pensions. The majority of member states tax occupational pensions according to the EET principle (Exempt contributions, Exempt investment income and Tax benefits). However, until recently a large number of member states did not allow tax deductions for contributions paid to a pension fund established in another member state. This barrier was identified in a Commission Communication back in 2001 and subsequent ECJ cases (Danner case - October 2002 & Skandia/Ramstedt case - June 2003) ruled against such discriminatory treatment. Since the rulings, the Commission has also instigated infringement procedures against a number of other member states. Acknowledging that completely uniform rules across member states will not be easy, this specific element is a positive step towards the realisation of pan-European pension funds.

- **Open Method of Coordination**

To help member states' convergence towards common objectives, in the area of pension provision, the Laeken European Council (December 2001), agreed the basis of inter-governmental co-operation. Referred to as the 'Open Method of Coordination', it is a voluntary process that all Member States have committed themselves to pursuing in the context of the Lisbon Strategy. This dialogue and co-operation on issues relating to the reform of pensions systems across the EU-25 should continue to be encouraged as an important means of mutual learning and exchange of best practices. This method of open coordination was initially launched in the area of the European Employment Strategy (November 1997).

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Briefing notes are prepared by the Financial Industry 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 Financial Industry Committee.

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