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# **Supplementary Pensions in the Single Market**

## **A Green Paper**

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## Introduction and executive summary

The provision of pensions is a fundamental aspect of social protection in the European Union. This is made clear in the Commission's communication on Social Protection<sup>1</sup> the present paper seeks to build on that communication by developing a number of ideas relating to certain aspects of supplementary pension provision. Currently there are 4 people of working age to support each pensioner in the EU. By 2040, there will be 2. This prediction is the result of greater longevity and the decline in birth rates in Europe. The average number of births per female in Europe has declined from 2.5 in 1965 to 1.8 in France and the UK to less than 1.5 in Germany, Italy and Spain. This phenomenon is not confined to the EU but is also found to a greater or lesser extent in most developed countries.

Statutory state pensions in the EU are mostly paid by the state out of current revenues ("pay as you go"). There are at present in general no earmarked investment funds for state pensions. If current policies towards pensions are not changed, there will be an inevitable increase in state spending on pensions to pay for the increased number of pensioners. At the moment state pensions account for 10% of GDP. Without changes in policy this will increase significantly by 2030. It will be difficult for Member States to meet these increased demands in view of the already high level of public spending in the EU and their commitment to budgetary rigour.

Several Member States have already initiated reforms to ensure the sustainability of state pension provision, and further reforms are being considered. Currently state pensions (pillar 1) account for the bulk of pension payouts (88%), but the need to maintain levels of income in retirement is likely to result in greater reliance being placed on the other main sources of supplementary retirement income:

- pension schemes linked to employment (pillar 2);
- pension schemes taken out by individuals, usually with life insurance companies (pillar 3).

The Commission clearly recognises that policies in relation to pillar 2 and 3 supplementary pension schemes discussed in this paper are by no means a panacea for the difficulties which demographic change is expected to raise. Member States' social security systems will continue to provide the bulk of pension payouts, with the emphasis on social solidarity within and between generations.

Consistent with the principle of subsidiarity, it is for Member States to decide on the role they wish each of

these three sources of pension provision to play in providing retirement income. They can alter the balance between the sources directly, by changing the rules for state pensions or by making work-related schemes compulsory, or indirectly, through fiscal incentives. But given the existence and likely growth of funded supplementary schemes, the Green Paper explores how the Single Market can enable these schemes to operate more efficiently.

In contrast to state schemes, most pillar 2 and 3 schemes are funded: that is to say they are backed by assets which are invested to provide future pension payouts<sup>2</sup>. Even though the contribution of these schemes to total pension payout is currently relatively small, the funds invested to meet future pension liabilities are enormous: in 1993 there were 1 200 bn ECU invested on behalf of supplementary schemes; of the 1 600bn ECU of life insurance assets, a small but significant proportion represents pension provision.

They are likely to continue to grow in the future. Even if pillar 2 schemes in all Member States only grow to half the current coverage in the Netherlands and the UK (the Member States with the highest coverage at the moment), these funds would increase to 3 000 bn ECU.

The growth in these funds is one of the possible elements in maintaining the level of retirement income. They present an opportunity for the EU economy; the Green Paper asks how these benefits can be delivered through the EU capital market, particularly in the light of the positive impact of the introduction of Economic and Monetary Union. At present, employment and life assurance linked pension schemes in most Member States invest a large proportion of their assets in domestic government bonds. In view of the commitment of Member States to financial stability, it is likely that the capacity for growth in government bonds will be limited. This means that the supply of equities and private sector bonds is likely to grow if the increase in available funds is to be taken up by the EU capital market. The EU capital market will be transformed as a result, in particular, of the increase in the supply of long term capital. This could have with beneficial effects on EU industry and infrastructure.

Some of the rules currently imposed by Member States as part of their prudential supervision of these funds seem to go beyond what is objectively necessary and prevent the freedom of movement of capital in the Single Market. Clearly, prudential supervision is required to ensure that pension funds and life assurance companies can meet their future pension liabilities. This

supervision must not be weakened. One of the objectives of the Green Paper is to consider how the security of benefits can be maintained, removing the current disproportionate restrictions whilst allowing a real Single Market in pension funds to develop for the benefit of pensioners and future pensioners. From the evidence it seems that alternative methods of supervision can provide equivalent security. These alternative methods would have two additional advantages:

- they would be compatible with the free movement of capital and would encourage the expansion of the EU capital market. Such a market would be more liquid than individual national markets; and
- they would allow pension funds to invest a greater proportion of their assets in a variety of long term financial instruments such as equities, in line with the structure of their liabilities. This strategy could increase returns on the investments of pension funds because these instruments have generally carried a higher rate of return than government bonds.

The last point could be significant. It is possible that some EU pension funds could increase their current rate of return by diversifying and taking advantage of a Single Market for investment. Even a relatively modest increase in the rate of return over a typical working life could make a great difference to either the pension payout or the contribution necessary to finance a given pension. The lowering of the cost for companies of financing a given pension would have a positive impact on job creation. The Community is committed to improving employment in the Union. This commitment is borne out by the Commission's Confidence Pact and the employment strategy agreed at the Dublin European Council.

It should be clear that this Green Paper does not seek to endorse the investment by pension funds in equities or any other assets. It believes however that fund managers should be given the freedom to invest in the assets they consider the most appropriate for their particular pension fund and that this freedom should be exercised within a Single Market. This freedom cannot, of course, be absolute, but should be based on prudential rules and subject to supervision. The Commission is committed to ensuring that there is no reduction in the protection of pension funds. Prudential considerations are all the more important for equities given the greater volatility of these assets in the short term. The Commission is looking at alternative methods of supervision that are consistent with the Single Market.

This Green Paper also stresses the need to confirm the right of approved investment fund managers to offer their services in other Member States. This would not only give managers themselves the advantages of a Single Market, but the increased competition could be expected to reduce costs and encourage managers to

improve their performance. The effect would be to increase the returns on investment, for the benefit of members of pension schemes.

Supporting the mobility of workers within the Union is a fundamental Community objective. Yet whilst arrangements relating to statutory pensions exist to facilitate free movement, there is no Community legislation on mobility in the context of supplementary schemes. Supplementary pension arrangements can pose a significant obstacle to labour mobility. This can be the case currently for moves within a Member State; the same is true, to an even greater extent, for moves to other Member States. The issue of migrant workers' supplementary pensions was considered in the report of the High Level Group on the freedom of movement of workers chaired by Mme Simone Veil, which concluded that action was needed to permit migrant workers to be treated on an equal footing with workers who move jobs within a Member State. This Green Paper considers the way forward.

Taxation plays an important role in pension provision and scheme design, providing privileged treatment at the level of contributions, fund income and capital gains, and benefit payments. There are regulations in place to control how these fiscal privileges are used. However, they can be an impediment to a Single Market, both for occupational and life assurance related arrangements, and can hinder the mobility of workers. The Green Paper therefore asks what initiatives are called for to make progress in this area.

The Commission believes the ideas discussed in this Green Paper can make a significant contribution to addressing the question of maintaining income in retirement and to reducing labour costs. Even if action must also be taken in other areas, in particular with regard to reform of state systems mobility of workers and taxation, the Union cannot afford to miss the opportunity that a change in policy towards the investment of pension and life assurance funds offers. This paper does not however attempt to deal with consumer protection issues (such as advice or mis-selling) except in the context of prudential regulation.

The Commission invites comments from the Member States, the European Parliament, the Economic and Social Committee, the Committee of the Regions, the social partners, economic operators, representative organisations, consumers and all other interested parties on the issues raised in this document. Responses to the paper are requested in writing no later than 31 December 1997, to:

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## Chapter I: The demographic and economic context

### A. Current demographic trends

1. The demographic structure of the European Union is changing considerably. The dependency ratio (i.e. the ratio of the elderly to the population of working age) is increasing in most Member States and has already reached historically unprecedented levels. Over the last few decades two major demographic changes have taken place which lie behind the expected increase in the dependency ratio: a decline in the fertility rate and an increase in life expectancy. Although the long term effects of the ageing process on public budgets are rather uncertain and depend on the way the economy and society adapt to the process, there is likely to be significant pressure for an increase in public expenditure in the years ahead. Much of the pressure will fall on public social security pension schemes, which account for by far the most significant proportion of pensions in Europe, since expenditure on them is highly dependent on the age structure of the population. Similar demographic pressure is evident in the US and Japan.
2. The consequences of these changes are considerable. The combination of fewer births and longer life expectancy means that over time the ratio of those who have retired to those working will increase considerably. At present there are four people of working age to support each pensioner through social security contributions. By 2040 it is expected that on average those four people will have to support two pensioners. In some Member States the ratio will be even more unfavourable.

### B. Budgetary implications of demographic changes on state pension arrangements

3. The effects of these developments will be gradual. The Commission has conducted a survey of projections carried out in the Member States of future expenditure on state pensions over the coming decades<sup>3</sup>. The survey focuses on the most recent projections assuming current legislation, i.e. incorporating reforms already announced. The conclusions are as follows<sup>4</sup>.
  - *Over the period 1995-2030 as a whole, the weighted average<sup>5</sup> of pension expenditure to GDP ratios in the 11 Member States for which projections up to the year 2030 are available*

will increase by 3 percentage points (under favourable assumptions) and up to 4 percentage points (under unfavourable assumptions). Expenditure pressures will be relatively strong in several Member States which have not yet substantially reformed their pension systems (Belgium, Denmark, Ireland, Luxembourg, the Netherlands), but also in some Member States which have already introduced substantial reforms (Finland, France, Germany). Expenditure increases are expected to be fairly limited (under favourable economic scenarios) in Italy, Portugal, Spain, Sweden and in the United Kingdom.

- *By the year 2030, in several Member States (Belgium, Finland, France, Germany, Italy, Luxembourg and the Netherlands) the ratio of pension expenditure to GDP may be in the range of 15% to 20%. Expenditure should be lower in Denmark, Spain, Sweden (in the 10% to 15% range), and in Ireland, Portugal and the United Kingdom (below 10%)<sup>6</sup>.*
4. At present, approximately 88% of all pensions paid in the EU are accounted for by state pensions. In turn, these pension costs represent a significant proportion of GDP - approximately 10%<sup>7</sup>. Therefore any increase in total pay-out on pensions by Member States will have an impact on budgets.. Because of reforms already undertaken by most Member States, generally only *demographic trends* now contribute to the increase in pension expenditure as a proportion of GDP.

### C. Current structure of pension provision

5. In line with the principle of subsidiarity, it is for each Member State to decide on a national structure for pension provision that is in keeping with its particular needs. The relative importance of the three pillars in each Member State will therefore vary considerably, and will depend on the legal structure covering pension provision and the extent to which other factors come into play, such as the availability of tax relief. Equally, the nature of these pillars can be widely different. For example, in Finland, pillar 1 consists of the statutory state pension scheme and the statutory occupational pension scheme which is partially funded<sup>8</sup>. In France there is a very significant compulsory pillar 2, which is

administered on a pay as you go basis. In the UK, there is a compulsory earnings related top up pillar 1<sup>9</sup> scheme, whilst pillar 2 arrangements are not compulsory at a national level. In Germany, Austria, Luxembourg and to a lesser extent Sweden, a significant proportion of supplementary pensions is provided through unfunded employers' book reserve schemes. In contrast, the setting up of book reserve schemes is no longer permitted in Spain.

6. Overall, employees in the EU rely for income provision in retirement on a number of sources. In broad economic terms, they can be described as follows.

Pillar 1	flat-rate, social security pensions (pay-as-you-go)
	earnings related, defined benefit (pay-as-you-go/funded)
Pillar 2	occupational pension schemes (pay-as-you-go/funded)
Pillar 3	life insurance based (predominantly) pension savings plans <sup>10</sup> .

The following table shows the extent of the current reliance on pillar 1 schemes. By comparison pillar 2 schemes make up only 7% of total payments.

<i>Type of Scheme</i>	
Pillar 1 PAYG <sup>11</sup> .	88.8%
Pillar 2 Funded, book reserve, insured plans	7%
Pillar 3 Personal pensions	0.9%
Other Means tested, guaranteed income scheme, poor relief programmes	3.3%

*EU wide pay out sources in % of total pay-out (1994 - excluding Austria, Finland and Sweden)*

Source: EUROSTAT

### 7. Pillar 1

This is the basic state scheme, in which participation is generally compulsory. Schemes are financed on a pay as you go basis, where current workers' contributions are used to fund the pension payments of retired people. These pension payments are guar-

anteed by the state, and the scheme is administered by a public institution. Pension benefits are calculated on the basis of a formula fixed in advance and are usually dependent on years of service. Pension income in retirement is usually indexed to inflation or to current wages. The link between contributions made during working life and benefits received after retirement changes substantially from system to system. Basic schemes in some Member States will provide for a pension which bears no relation to income during working life. In such systems there may be an earnings related pillar 1 scheme to top up pensions; contributions will depend on earnings, and benefits will be calculated by reference to those earnings<sup>12</sup>.

#### *Advantages:*

- Near universal coverage.
- Solidarity within and between generations.
- Alleviates poverty in old age and avoids for individuals some of the financial problems associated with longevity.
- Promotes social welfare.
- No discrimination for labour mobility, between jobs both within a Member State and between Member States.
- Insurance against inflation; avoids the consequences of investment risk.
- No selling costs.

#### *Disadvantages:*

- Vulnerable to the risk of population changes which can make current levels of benefit unsustainable.
- As pay as you go schemes have no underlying fund, they are vulnerable to rule changes. Governments may decide to change the basis on which benefits are calculated, thereby creating uncertainty about adequacy of benefits in the future.
- Where funding is through social charges, this can distort the labour market, through a perception of a tax on jobs.
- No scope for individual flexibility in the contribution cycle.

## 8. Pillar 2

Table I shows the current situation of coverage of supplementary pillar 2 schemes. The variety of approaches in the Member States is illustrated by an example: in France the compulsory pillar 2 scheme is pay as you go and coverage is approximately 90% of those in private sector employment, making up 21% of all pension payments, whilst in Italy coverage of supplementary schemes is 5% of private sector workers and constitutes 2% of total pension payout. In the Netherlands, pillar 2 schemes account for almost a third of all pension payments.

Pension schemes in this category are generally linked to employment or the exercise of a profession (an 'occupational scheme' or 'industry wide scheme'). Membership of these schemes is limited to those working in particular sectors, industries, professions or companies, and will be created as a result of agreement between the social partners or by reference to, for example, standards in a particular industry. Pillar 2 schemes are administered by private institutions, and benefits are not guaranteed by the state. Contributions are set by reference to income, and payment of contributions is generally shared by employers and employees. With notable exceptions<sup>13</sup>, pillar 2 schemes are generally funded, with contributions accumulated and invested in order to provide benefits in the future, rather than to pay benefits to those who have already retired. The analysis in this section focuses on funded schemes. The link between contributions and benefits is closest in defined contribution schemes which provide benefits dependent solely on the return on assets invested. Returns on a member's slice of the fund will depend on investment choice, and ultimate pension benefits will depend on the value of the member's fund at the time of retirement. Funded defined benefit schemes, on the other hand, retain vestigial traces of solidarity, in that they allow for some redistribution of income among the members of the scheme. In defined benefit schemes the employer will effectively guarantee a level of benefits relating to the income of the employee at or near retirement.

### *Advantages*

- Some link between contributions and future benefits in particular for defined contribution schemes, allowing workers to distinguish between contributions levied for pension provision and general taxation levied to pay for other welfare benefits.

- Largely resistant to demographic change.
- Defined contribution schemes: benefits linked directly to investment fund performance.
- Defined benefit schemes: employer's guarantee protects against falls in asset values. Some solidarity is also retained.
- Voluntary arrangements do not distort the labour market.

### *Disadvantages*

- Coverage is not universal in all Member States.
- In some member States vesting periods (during which an employee will not have accumulated sufficient years of service in order to be entitled to a pension) are very long.
- Resistance to complete pooling of risks, so difficult to achieve equal treatment between men and women. (For example, if the pension is paid as a lump sum, this can lead to lower annual payments due to the greater longevity of women.)
- Defined benefit scheme: the approach to valuation of benefits of early leavers can discourage worker mobility between firms both within a Member State and between Member States (see Chapter V below). It can discriminate against those who take a career break. It has also been suggested that there could be a disincentive to employing older workers.
- Defined contribution scheme: investment risk is taken by the scheme member.
- Defined benefit scheme: where the employer provides a guarantee, the insolvency of the employer will remove that guarantee, making the scheme vulnerable to fluctuations in investment values (though the scheme is ring fenced and separate from the employer's own funds).
- Liabilities in salary linked defined benefit schemes depend on external factors such as inflation, and in particular, salary movements.
- Compulsory schemes may distort the labour market.

- No guarantee against the effects of inflation.
- Investment returns may not match expectations.

### 9. Pillar 3

Pillar 3 schemes may be used to supplement the first or second pillars, or both. They have many of the characteristics of defined contribution pillar 2 schemes, although participation is not related to employment or the exercise of a profession, and is arranged individually by contract directly with a product provider, generally a life assurance company. An individual's contributions are accumulated and invested, and the resulting fund is used subsequently to provide pension benefits for the individual.

#### *Advantages*

- If investment performance of the underlying assets is good, this can lead to improved pensions.
- Flexibility regarding contributions. It can accommodate career breaks and periods of part time work.
- Resistant to demographic change.
- Neutral regarding changing jobs.
- If the scheme is a life assurance pension policy, the policyholder will be able in principle to benefit from the freedom of provision of services under the Third Life Assurance Directive, and so select an arrangement from a provider established in any Member State. However, regulatory and tax aspects, which may have an impact, are considered in Chapters IV and V.

#### *Disadvantages*

- Investment returns may not match expectations.
- No guarantee against the effects of inflation.
- No solidarity between and within generations.
- Cost: selling costs are generally high compared with first and pillar 2 schemes.
- Success depends in part on tax breaks.
- Risk of individuals' being sold inappropriate products.

### 10. Group schemes

Life assurance providers play an important role in pension provision. This can be through personal pensions, as described above. Equally, life assurers can provide management of group pension funds on behalf of pension scheme trustees. Such an arrangement falls under the pillar 2. A further option is for the scheme trustees to ask a life assurer to administer the scheme on the basis of a group arrangement. This is a "group scheme", and also comes within the pillar 2. Yet another variation is the group personal pension scheme, which, though organised through an employer, is a collection of individual personal pension policies<sup>14</sup>.

### 11. Recent Member State reforms

Several Member States have in the last decade or so introduced reforms to reduce the impact of demographic change on public pension provision. These reforms have been achieved in a variety of ways. In order to try to maintain the level of benefits, certain Member States have implemented an increase in social security contributions. However, given the already high contribution rates in most Member States, containment of spending is likely to be the primary instrument used to guarantee sustainability. There have already been steps towards decreasing benefits. Such steps include changing benefit indexation formulae, e.g. from a link with earnings to one with prices; increasing the retirement age and thereby the years during which contributions are paid, and reducing the number of years during which a pension will be receivable; reducing the proportion that pension benefits bear to income during working life (the replacement rate); calculating earnings related benefits on earnings over a long period rather than on the final year's earnings; reducing incentives to early retirement.

12. A different approach is for a funded state scheme to be developed to run parallel to the state pay as you go scheme. In Sweden statutory pension contributions are paid currently to the pay as you go scheme; however, once new legislation is implemented 2% will have to be paid into a statutory funded scheme. A more substantial systemic reform in the financing of public pension schemes would be a transformation from pay as you go to funding. Although this has been widely discussed, there are difficulties in implementing it in the case of developed and mature public pension systems such as those prevailing in the EU, not least the crystallis-



ing of future liabilities already 'bought' by non retired workers. This issue is discussed in the Commission's Communication on improving social protection in Europe<sup>15</sup>.

One option that is being considered, and indeed the process has already begun, is that Member States might gradually introduce conditions which are more conducive to the development of private funded supplementary schemes. The level of contributions is nevertheless unlikely to fall dramatically because; not only will it be necessary to pay the pensions of those already in retirement, but the role of state pay as you go systems will remain a fundamental part of the social structure of the Union. Private funded schemes are well established in several Member States including the UK, the Netherlands, Denmark and Ireland. Recent legislation in other states, such as Italy and most recently France, provides an opportunity for further developments in this area.

14. In essence, increased reliance on second and third pillar funded schemes would imply a partial shift in responsibility for retirement income provision from governments towards employers and employees, and towards individuals. Economic considerations point to the desirability of pension systems (the combination of both state and supplementary) which incorporate both pay as you go and funded elements, as these are subject to different risks and returns. However, as the importance of supplemen-

tary pensions increases as a percentage of total retirement income, it will be increasingly important for governments to provide a secure environment for the efficient operation of supplementary funded schemes. The role that the Single Market can play is explored in the next chapter.

## **D. Conclusion**

15. Demographic changes in all Member States have prompted consideration of their effect on the funding of state pension schemes. Continued reductions in benefits and restrictions in pension eligibility to help to ensure the viability of public, pay as you go, schemes is one option many Member States are already implementing, though there are further steps to take.. But this will have a negative impact on total retirement income levels. For this reason the trend towards the development of funded second and third pillar schemes is expected to continue.

It must be clear however that the development of funded schemes in the EU will not of itself provide a solution to the current problems of pay as you go systems. The sustainability of these schemes can only be achieved through further internal reforms. Funded schemes can facilitate the reform of pay as you go systems by offering benefits that compensate for a reduction in benefits from pay as you go schemes.



## Chapter II: Retirement provision and EU Capital Markets

### A. Size of EU pension funds

16. The total assets in the EU of pillar 2 pension funds amount to 1 198bn ECU, of which the UK accounts for the largest share (717bn ECU or 65% of total) (Table II). In fact, the two Member States with the biggest funds, the UK and the Netherlands (261bn ECU), together account for 89% of total assets of EU pension funds. The pension funds of other Member States are relatively small in comparison. This is a reflection of the fact that they are either not funded, pay as you go or based on book reserves, or have a very low coverage (see Table I). The importance of UK and Netherlands funded schemes is reflected again when they are expressed as a percentage of national GDP (79% and 88% respectively), with other Member States falling well below this figure. The EU average is 20 % of GDP. For comparison, US pillar 2 pension funds total 3 546bn ECU (60% of GDP) and Japan 1 800bn ECU (45% of GDP).
17. The total assets of EU life insurance companies are nearly 50% higher than pillar 2 pension funds - 1 600bn ECU (Table III). This figure includes pillar 3 pension policies but is made up principally of all life insurance savings schemes (that are not specifically designed for providing a pension) and life cover without a savings element (e.g. linked to a mortgage). Again the UK has the biggest funds (564bn ECU - 67 % of GDP) followed by Germany (380bn ECU - 21 % of GDP), France (317bn ECU - 30 % of GDP) and the Netherlands (138bn ECU - 46 % of GDP). The tax incentives given by each Member State are a factor in determining the size and growth of these funds.
18. Predictions of the likely growth of pension funds and pension related life assurance funds are difficult. Much will depend on the rules obliging employers to provide cover (pillar 2) and on the encouragement given through tax breaks (pillars 2 and 3). At the moment pillar 2 schemes cover 22% of the EU working population and only account for 7% of total pensions paid to those covered by such schemes. Even if pillar 2 schemes in all Member States only grow to half the coverage of the Netherlands and UK (the Member States with currently the highest coverage but still growing) these funds will increase to 3 000 bn ECU. If they grow to have the same coverage as the Netherlands and UK they will reach 5 000 bn ECU. Similarly, given a favourable tax

environment, the funds of pillar 3 schemes could also grow rapidly as more people decide to increase their reliance on individual pension schemes.

### B. How EU pension and life insurance funds are invested

- 19 Pension funds and life insurance companies make investments in order to meet future obligations. The pattern of investment varies considerably between Member States. The UK and, to a lesser extent, Ireland stand out because of the high percentage of assets in equities (80% and 55% respectively, which compares to the US with 52%) and low percentage of bonds (see Table IV). However, funds in most other Member States rely much more on fixed income securities, mainly government bonds (e.g. 75% in Germany, 67% in France), and much less on equities (11% and 14% respectively). In all Member States real estate investments and short term placements are relatively small. The patterns of foreign to domestic assets also vary considerably. Most Member States' funds invest less than 10% in foreign assets. The UK and the Netherlands stand out, with 30% and 25% of their assets being non-domestic.
- 20 The pattern of actual investment for the assets of life insurance companies is similar to that of pillar 2 pension funds (see Table V). Most assets are in fact held in domestic fixed income securities (mostly government) (e.g. Germany 75% of total, France and Italy 70%). Assets held in equities are much less important (e.g. Germany 5%, France 18% and Netherlands 12%). The UK is an exception with nearly 50% in domestic and over 10% in foreign equities. The reliance on fixed income securities in the UK is much less (25% of total).

### C. Returns on pension fund assets

- 21 Many studies show that over the longer term equities have tended to have a higher rate of return than bonds (see Table VI), though this is not inevitable for the future. The investment strategy of a pension fund or life insurance company and the portfolio balance between equities, bonds, real estate and short term placements are principal determinants of the rate of return on overall assets. Because of the greater volatility of equities, any figures on rates of return are sensitive to the period over which these

returns are measured. In the short term, therefore, equities could be outperformed by bonds, or could go down in value. Nevertheless, it is believed by some observers that because of the higher returns associated with equities over a long period, and because pension funds require investment over the long term, there is scope to increase the rate of return on some EU pension and life assurance funds, which currently hold a high proportion of government bonds, by increasing the share of equities in their investment portfolio.

- 22 It is difficult to get unequivocal evidence on this potential for higher equity holdings to increase returns. Any period selected is arbitrary. However over the period 1984-93 (Table VII) pension funds in the UK and Ireland, with important equity holdings, had high real rates of return (10,2% and 10,3% respectively). Member States with around a third of their assets in equities had lower real rates of return (Sweden 8,1%, the Netherlands 7,7%, Belgium 8,8%). The Member States with the lowest proportion of equities in their investment portfolio and a high percentage of government bonds had the lowest returns (Germany 7,1%, Spain 7,0% and Denmark 6,3%, the latter partly as a result of the tax on real interest rate). Other sources over other periods do not however give such clear results.

#### D. Impact of differences in rate of return

- 23 The previous section showed significant differences in the real rate of return of EU pension funds and life insurance funds - with over 6 percentage points difference over the period 1984-1993 between the worst and best performers. In a funded scheme, returns need to be sufficient to deal with the effects of salary inflation over the long term. An increase in the annual rate of return of say 2 or 3 percentage points can make an enormous difference over a working life and should not be underestimated.

Assume the target is a fixed supplementary pension of 35% of salary on the basis of a 40 year working life. If the real rate of return on assets is 6%, the cost is 5% of salary: all other things being equal, if the real rate of return is 4%, the cost is 10% of salary, and if the real state of return is only 2% the cost is 19% of salary. Low rates of return on pension funds and life insurance assets will therefore mean:

- either much higher contributions from employers and employees: this will affect the indirect

costs of labour, and therefore have an adverse impact on the EU's job creation ability;

- or much lower pensions for the same contributions and therefore more pressure on government spending in pillar 1.

It should be stressed that the Commission is not advocating any particular investment strategy for pension funds. It is the role of the fund managers to determine the best investment strategy for the ultimate benefit of pensioners, subject only to appropriate prudential supervision. This Green Paper is exploring the role the Single Market can play in the future to maximise the investment possibilities of fund managers whilst maintaining adequate prudential control. It discusses whether the current rules of prudential supervision in some Member States are disproportionate in that they go beyond what is objectively necessary to ensure the security of funds, and at the same time prevent the development of a real Single Market in pension funds for the benefit of pensioners and future pensioners (see Chapter III). First, however, it examines some of the asset management and supervisory techniques that are consistent with a Single Market in pension funds.

#### E. Can higher returns be achieved without undue risk?

- 24 Because their liabilities are long term, pension and life assurance funds can afford to take advantage of the generally higher returns offered in equities and long term placements. However, it is recognised that equities entail a higher risk than bonds, especially government bonds, and that long term bonds present a greater risk than short term bonds<sup>16</sup>.
25. Clearly, it would be unwise to pursue only high rates of return without any concern for the risk involved. Many of the regulations in the Member States focus on prudential controls designed to reduce risks to which funds are susceptible.
- 26 Advocates of modern risk management techniques suggest that such techniques allow managers to control risk while investing in assets with greater volatility but higher rates of return. These techniques aim to capture the return from the risk premium of equity while avoiding excessively high levels of volatility. In evaluating risk and making asset allocation decisions, it is more appropriate to focus on the relationship between assets and liabilities,

and not solely on assets. For example funds would tend to make assets progressively liquid to match the date the liability is due - this avoids the effects of last minute bear markets or interest rates rises. Thus different pension funds (e.g. young schemes with many contributions relative to pay-out, or old schemes with large pay-outs relative to contributions) should in all likelihood adopt different investment strategies because their asset/liability profiles are different. In this way they can maximise returns at minimum increased risk.

27 In essence, asset/liability management (ALM) seeks to concentrate portfolios on long term assets with the highest returns, compensating for the increase of risk by pooling across assets whose returns are imperfectly correlated (diversification). Thus one asset with a high return but which is risky (i.e. volatile) may be offset by another high return but risky asset, if these risks are not positively correlated.

28 It is argued that diversifying assets is in fact a prudent approach, because over concentration in any one asset can increase risk and reduce rates of return. Even government bonds can fluctuate with changes in interest rates and inflation expectations. Consequently, over concentration of a portfolio on assets such as government bonds, that are regarded as "safe", can actually increase risk in comparison to a diversified portfolio, without obtaining higher returns<sup>17</sup>. Investment in a selection of imperfectly correlated markets will provide managers with a spread of diversified investments, and reduce potentially the risk of over concentration in assets denominated in one currency. One commentator concludes:

"Restrictions imposing arbitrary limits on asset holdings by type of asset, country or currency distribution run contrary to the prudential principle because they severely limit risk diversification. This constraint forces pension funds to assume more risks, while sacrificing return, and to conduct investment policies that are detrimental to their members in the long run<sup>18</sup>".

29 This approach to asset/liability management is the basis of the "prudent man" management and supervisory technique used in some Member States. They judge the financial viability of the pension fund or life insurance company by assessing the match between its financial assets and its liabilities over the expected life of the scheme, taking into account relevant considerations such as the type, size, development and rate of funding of the scheme, and

the volume and nature of the fund's liabilities. When applying such asset/liability management principles, managers will also work within any investment principles imposed by, for example, the trustees or board. It is not a *laissez faire* supervision. On the contrary, it imposes on supervisors the obligation to ensure that the respective roles of manager and trustee/custodian/depositary are fulfilled in such a way as to ensure, in turn, that scheme members' benefits are secure.

30 The role of the supervisory authorities would need to be more dynamic if a qualitative approach to the investment of pension fund assets were to be pursued. Quantitative yardsticks would be much less prominent. When examining the financial health of a fund, supervisors would focus separately on its short and long term liabilities and on its investment horizon, the rate of funding in relation to liabilities and the need for the particular liability structure to be matched with an appropriate asset structure through an acceptable asset/liability management approach.

## **F. How could EU capital markets absorb future increases in EU pension funds and life insurance investments?**

31 The development of funded supplementary schemes in the EU will increase the amount of financial assets available for investment. This growth will be very significant, but gradual. This section explores what advantages the creation of a real Single Market could have in increasing liquidity and reducing costs for pension funds. It also examines the structural changes in EU capital markets likely to come about as a result of increased investment by pension funds.

32 The supply of government bonds is unlikely to match the growth in financial assets of pension funds.

Other vehicles for investment include principally equities and corporate bonds. These can be expected to play a greater role in the EU capital market in the future. In the US market capitalisation is much greater in relation to GDP (US: 68%; EU: 32%) (see Table VIII) and the increase over time in pension fund assets has been successfully taken up by capital markets to provide adequate pensions.

Because EU pension funds will have to find new investment outlets, private sector equity could, gradually, become one of the likely outlets for many funds. However the privatisation of state owned enter-

prises is likely to represent a relatively small proportion of the market as a whole. In addition, EASDAQ and stock markets for small company shares in a number of Member States could supplement conventional issues of equity available for pension and life insurance fund investment. Other new equity might also be issued by EU firms replacing to some extent the traditional sources of corporate finance in Europe.

An additional area for development in the EU, as an alternative in appropriate circumstances to equities, is the corporate bond market. The market for corporate bonds is underdeveloped in the EU by comparison with the US, where the market is more than 7 times larger. If the US experience is mirrored in the EU, it may be expected that the market for corporate bonds will increase markedly in size.

33. Capital markets will adapt to take up these funds. Some of this capital may go outside the EU, though normal asset management practices would result in most of these remaining inside the EU<sup>19</sup>. However if Member States capital markets are kept separate, they will be less liquid and be less able to take up successfully these funds. Therefore barriers to flows of capital which are not objectively justified on prudential grounds, will reduce the efficiency of

this process. The Investment Services Directive<sup>20</sup> has already removed many of the barriers to the functioning of EU capital markets. In addition stage 3 of Economic and Monetary Union will help this process by eliminating exchange risks for investors investing in securities issued in the currencies of participating Member State. Other obstacles, such as transaction costs and delays in implementing investment decisions, will also be reduced by a single currency, and should contribute to increased investment activity. Chapter III examines remaining prudential rules, applied by Member States, that are an impediment to freedom of capital flows and asks whether they are objectively justified.

- 34 Competition between financial institutions and between financial centres in the EU, together with the growth in financial assets available for investment, will lead to improvements in the EU capital market by reducing costs and increasing liquidity. This will be reinforced by EMU, which provides the opportunity for further development of an EU-wide capital market.

**Question:** *The Commission seeks views on the analysis in this chapter.*



## Chapter III: Appropriate prudential rules for a Single Market

### A. Role of supervision of pension and life insurance funds and fund managers

35. It is clear that pension and life insurance funds and the managers of these funds must be subject to prudential supervision. Consumers (i.e. future pensioners) must be protected in an area where they have little knowledge. Supervision must ensure that fund managers execute their fiduciary duties correctly. The regulatory approaches towards pension funds differ widely between Member States. In some states they are covered by regulations specific to pension funds; in others, they are regulated on the same footing as life insurance companies. This means they are subject to the same minimum solvency requirements, rules as to technical provisions and investment restrictions and other provisions as life insurance companies.

36 Whilst national regulations differ, there are commonalities in approach.

- A requirement for pension funds to be authorised or approved by a competent authority.
- Authorisation or approval could be dependent on fulfilling certain criteria, such as the suitability and approval of managers of pension funds and custodians/depositaries/trustees of the funds' assets; the legal form of the fund.
- A requirement for prudential supervision of the fund, including regular reporting rules and powers of intervention by the supervisory authority.
- Minimum prudential rules on the investment of members' contributions, in particular requiring that they be invested prudently.

**Question:** *Do interested parties agree that these points provide an appropriate basis of regulation?*

### B. The effect of excessive rules on pillar 2 pension fund investments

37. There are no specific EU harmonization rules relating to the investment by pension funds of their assets beyond the principle of, and general rules relating to, the free movement of capital<sup>21</sup>. These are intended to guarantee to all investors, including pension schemes, the freedom to invest where

they wish in the EU. The Treaty permits<sup>22</sup> investment restrictions to be imposed if these can be justified on prudential grounds. Member States may not use this exception to the freedom as a means of discriminating against foreign assets, nor as disguised, non-prudential restrictions introduced for other reasons. Further, the Treaty prohibits<sup>23</sup> any 'privileged access' by central, regional or local government to financial institutions, including pension funds, through the imposition of minimum investment requirements, except on prudential grounds. The Commission is in the process of taking action against Member States that discriminate for non-prudential reasons against foreign assets.

38. Many Member States have restrictive rules that generally fix the maximum percentage of a fund that can be held in a particular asset or currency (see Table IX). Germany is an example of such an approach. It fixes the following maximum asset levels: 30% equity, of which a maximum of 6% may be non EU equities, 25% EU property, 6% non-EU bonds, 20% overall foreign assets and 10% self-investment limit. Pension funds in Member States with such quantitative rules tend to hold a high proportion of assets in government bonds.

39. Member States' rules defining the appropriate supervision can have the effect of frustrating the Single Market and the investment advantages it can bring. The Commission believes that in many cases they go beyond what is objectively necessary to maintain adequate prudential supervision. There are other prudential rules and techniques that are consistent with a Single Market and maintain equivalent prudential security. In particular, Member States' prudential rules relating to investment portfolios can have the effect of obliging pension and life insurance funds to invest a large proportion of their assets in domestic government bonds. Even so the actual investment pattern of investment by pension funds in several Member States has in effect not reached the limits fixed by the rules. For example in Germany pension funds only invest 6% in foreign assets (maximum allowed 20%) and 11% in equities (maximum allowed 30%)<sup>24</sup>.

**Question:** *The Commission would like to know how far quantitative restrictions limit in fact the investment strategy of pension funds, particularly in Member States where the maximum permitted proportion of equities is not reached.*

*Will these restrictions begin to have a greater impact on investment policy if, as is predicted, funds available for investment increase considerably in the future and the opportunity for investment in government bonds is restricted by lack of supply?*

40. In the past the Commission has twice put forward a specific interpretation of the Treaty rules for pension funds: first, in a draft Directive<sup>25</sup> that was withdrawn because the amendments proposed by Member States would have legitimised restrictions on pension funds rather than liberalised them; secondly, in a Communication<sup>26</sup>, which was annulled recently by the European Court of Justice on the basis that the Commission intended to impose new binding obligations on Member States<sup>27</sup>.

The Commission believes the objectives of the withdrawn Directive and the Communication still need to be pursued, in a broader context: in fact all the more so in view of the increasing awareness of the need to reform pension systems with a view to ensuring their sustainability. These policy objectives may be summarised as follows:

- freedom for fund managers who are authorised in accordance with the Investment Services Directive, the Second Banking Directive or the Third Life Insurance Directive<sup>28</sup> to offer services all over the EU;
  - freedom to invest assets of pension funds under the “prudent man” principle; diversification of assets, including diversification into assets denominated in currencies other than that in which the liabilities of the institution are established; removal of any requirements on pension funds to invest in or refrain from investing in particular categories of assets, nor to localise their assets in a particular Member State, otherwise than on justified prudential grounds. Any restrictions imposed on prudential grounds must be proportional to the objectives they may legitimately pursue<sup>29</sup>.
- 41 It is not anticipated that removing restrictions would open the floodgates to an alternative style of fund management. Fund managers would take time to adapt to a new investment strategy; in addition, there is evidence of home country bias as well as the normal prudential policy of keeping the bulk of assets in the same currency as the liabilities. Thus despite the absence of restrictions on foreign equity investment, the proportion of such investment is only around 25%-30% in those Member States

with the most liberal investment regimes. A further observation in this context is that fund managers very often do not currently take advantage of the investment freedom they do have, so a rush towards equities appears unlikely.

**Question:** *Do interested parties agree that the approach to EU supervisory rules described above could provide adequate prudential security at the same time as offering the advantages of the prospect of higher returns within the framework of a real Single Market for pension funds?*

### **C. Rules on pillar 3 life assurance investments**

42. In contrast to pillar 2 schemes, where there is no specific EU harmonisation, the rules for pillar 3 life insurance schemes are harmonised under the Single Market provisions<sup>30</sup>. Once a life insurance company is authorised and supervised in one Member State, it effectively has a European passport and can sell its products in other Member States. A level playing field for competition between insurance companies in different Member States is established and consumers are protected.

43. The relevant EU rules for investment by life insurance companies are given in Table X<sup>31</sup>. Of particular significance are the following:

- investment shall be based on the prudent man principle;
- Member States may not require insurance companies to invest in particular categories of assets, and
- Member States cannot oblige an insurance company to keep more than 80% of its assets in a currency matching its liabilities.

A minority of Member States have a flexible approach to supervision, and insurance companies in such Member States hold a high proportion of assets in equities, including foreign equities. Most Member States however adopt a quantitative approach to supervision, similar to the approach they follow in respect of pillar 2 pension funds (see Table XI). In fact in such Member States most insurance company assets are kept in domestic fixed income securities (Germany 75%, Spain 55%, France 68% and Italy 70%), despite the scope under the rules to invest in equities and foreign assets (equities or bonds, for example) to a greater extent.

**Question:** *The Commission would like to know how far life insurance funds in Member States that impose quantitative limits are in fact restricted or are likely to be restricted in the future in their investment strategy by national rules. It also asks whether the quantitative limits imposed by Member States should be changed along the lines described in section B for pillar 2 schemes.*

#### **D. Should there be similar EU rules for pillar 2 and 3 schemes?**

This Green Paper has examined the prudential rules concerning the investments made by pension and life assurance funds (i.e. the assets side of the balance sheet). The question also arises as to whether pension funds should be subject to rules similar to those that exist for life assurance on the liabilities side of the balance sheet - in particular is there a need to harmonise the technical provisions and the 4% solvency margin of own funds<sup>32</sup>. This is especially the case where they are in direct competition, in particular where employers use life assurance companies to provide employment related pensions (pillar 2) in the form of "group schemes" which are subject to the harmonised rules for pillar 3 schemes<sup>33</sup> (see Table XII).

As regards this point, the organisation representing European insurers (Comité Européen des Assurances - CEA) argues that pillar 2 pension schemes should be subject to equivalent prudential rules whether they are managed or operated by a pension fund or life insurer. The Commission considers there are four options:

- **Option I:** make funds of pillar 2 schemes subject to the rules currently applied to group life schemes
- **Option II:** adapt the current rules on the solvency margin for group life schemes to the framework currently applied to pillar 2;
- **Option III:** define new common EU standards for both pillar 2 schemes and group life assurance. The Commission would be interested to hear any concrete suggestions;
- **Option IV:** accept the differences that currently exist because de facto they do not lead to significant distortions of competition.

**Question:** *Before making up its mind the Commission seeks the view of interested parties.*

#### **E. Fund managers**

45. Authorised fund managers are already entitled to sell investment services throughout the EU on the basis of the Treaty as well as of harmonised criteria<sup>34</sup>. These fund managers are also entitled to offer their services to manage pension funds across borders. Restrictions on this freedom can act as a barrier to improving returns on investments, and infringe Treaty freedoms relating to the free provision of investment management services in the Single Market<sup>35</sup>.
46. Efficient management of a pension portfolio implies an appropriately diversified investment strategy, which can require external specialised advice. Pension schemes need to be able to call on advice and management services from the most appropriate source, which might be from a manager established in another Member State. A fund manager in another Member State might be more aware of non domestic investment opportunities both within the EU and outside it. There should be no impediment to a pension scheme's ability to call on such services. The Commission also considers that increased competition could lead to lower management charges or more efficient management of these funds. Even a one percentage point annual cost advantage or efficiency gain over a working life is an enormous saving.

**Question:** *The Commission seeks views on this point, and asks also whether any current impediments provide actual barriers to the cross border provision of services by pension fund managers.*

#### **F. The way forward**

47. This Green Paper has suggested that changes may be desirable to the rules governing the prudential supervision of pension and life insurance funds. If it is decided to make these changes the question arises as to the most efficient instrument to carry them out. There are several possibilities.

**Option 1. Rely on introduction of euro.** This option would reduce the impact of currency matching requirements for participating Member States. Any assets in a participating Member State would automatically be in a matched currency. Such an approach requires no additional legislative or enforcement effort on the part of the Commission. However this approach would not solve the problem of any unjustified quantitative rules that limit



investment in certain classes of assets (e.g. equities) so de facto obliging investors to buy (government) bonds. It would not help solve the problem for funds located in Member States not participating in the euro with either currency matching or quantitative limits. However, this approach could be combined with the second option.

In parallel to the introduction of the euro Member States might also make unilateral changes to their national regulations in order to facilitate more efficient pension fund management. Such changes would be a matter for Member States, and would depend on their perceptions about what is appropriate for their particular situation.

**Option 2. Apply current Treaty freedoms.** This option would rely simply on the obligations created by the current Treaty freedoms relating to movement of capital and to the provision of services. The Commission could issue guidelines as to how it interpreted these basic freedoms for the investment of pension and life insurance funds and fund managers to offer their services. It would then examine for each Member State both its general rules and decisions in individual cases, to see if they were justified on prudential grounds. Where the rules or decisions were not justified, the Commission would be obliged to start infringement proceedings under the Treaty. The case law would then develop to show the practical interpretation of Treaty rules. Such an approach however has certain disadvantages:

- it would take time for the practical application of the basic legal principles to become clear;
- it could lead to legal uncertainty. This is particularly so because case law could easily identify clearly abusive cases but would have greater difficulty in deciding marginal cases where the border between justified and unjustified prudential restraints is not a simple bright-line test;
- there is a risk that interpretation derived from case law, which is based on an adversarial procedure in individual cases, would become rigid. It might not allow for sufficient change and flexibility in the rapidly evolving and technical area of financial supervision.

**Option 3. Adoption of a Directive.** An alternative approach would be harmonisation by a Directive setting out basic principles. It would allow the interpretation of Treaty provisions in this technical financial area to be worked out in cooperation with all partners. A Directive could incorporate mechanisms for cooperation between the Commission and national supervisors to interpret, and update in line with changing circumstances, the practical application of basic Treaty freedoms for the supervision of pension and life insurance funds. The publication of an opinion, arising from such co-operation, on interpretation and application of the Directives could lead to transparency and certainty. This approach has been tried before, unsuccessfully. The difficulties of obtaining a consensus between Member States on Community legislation in this area are clear; it is possible that the heightened interest in the role of funded supplementary schemes might lead to a greater consensus.

**Question:** *The Commission seeks the views of interested parties.*



## Chapter IV: Facilitating the free movement of workers

### A. General considerations

48. Article 51 of the EU Treaty requires Community legislation to be adopted in order to remove all barriers in the sphere of social security which impede a genuinely free movement of workers.

On the basis of this Article<sup>36</sup>, the Community has already adopted legislation (Regulations 1408/71 and 574/72<sup>37</sup>), which removes obstacles to cross-border mobility of workers in the field of statutory pensions. This legislation does not apply to supplementary pension schemes.

More and more qualified and highly qualified people make use of their right to free movement. For this category of people, supplementary pension schemes contribute substantially to their social protection.

### B. Obstacles to free movement of persons relating to supplementary pensions

49. In its Communication of July 1991<sup>38</sup>, the Commission started a discussion at Community level; on the role of supplementary pension schemes and their impact on free movement.

As a follow up to this communication, the Commission services have explored on several occasions, in conjunction with the representatives of Member States, Social Partners and pension funds, how to remove obstacles to cross-border mobility of employed and self-employed persons in the European Union in the field of supplementary pensions.

Given the specific nature of many supplementary pension schemes and their extreme diversity at national level as regards their origin, their occupational and material scope, as well as their legal and technical forms, the current coordination system created for statutory schemes does not seem to be the appropriate instrument to address the problems. A more flexible approach is required.

50. In February 1996 the Commission decided to ask a High Level Panel on Free Movement of Persons chaired by Mme Veil to deliver an opinion *inter alia* on the measures to be taken in order to eliminate the obstacles to freedom of movement of workers which arise in the context of supplementary pensions.

The panel presented its report in November 1996. It came to the conclusion that legislative action at Community level is necessary but that it should be confined, at least initially, to a three-pronged approach, encompassing the following elements:

a) Preservation of acquired rights for members who cease active membership of a supplementary pension scheme as a consequence of moving from one Member State to another at least to the same extent as for members ceasing membership of the scheme but remaining within the Member State in question.

This specific point is inspired by a basic principle of Community law, namely that of "equal treatment". This means that a worker who leaves a supplementary pension scheme in order to work for another employer in another Member State should not lose the rights already acquired in the first scheme which he would have had preserved had he/she changed employer while remaining in the same Member State.

b) Cross border payments: Member States should ensure the application of another fundamental principle of the Treaty (free movement of capital and payments) by taking measures in order to permit payments in other Member States of all benefits due under supplementary schemes.

c) Measures allowing workers temporarily seconded by their employer in another Member State to remain affiliated to the supplementary pension scheme in the country in which they were previously working. To this effect all obstacles to cross border affiliation should be eliminated.

As a first step towards dealing with the obstacles to free movement arising in the area of supplementary pensions, the Commission intends very soon to present a proposal for a Directive concerning the aspects highlighted by the High Level Panel's report. This has already been announced in the Commission's Communication on improving social protection in the European Union.

51. The Commission is also considering the usefulness of establishing a Community Pensions Forum, as

suggested by the High Level Panel. This Forum would be constituted by representatives of the Member States, the Social Partners and pension funds. Its purpose would be to explore the possibilities for solving the outstanding problems for mobility in the context of occupational pensions. For instance, by bringing together the different interest groups, it could serve to find solutions to the problem of non-recognition of pension schemes as between the Member States. In general, its task would be to advise the Commission on the best way to overcome the remaining obstacles to free movement.

52. As has been indicated above, there remain, however, a number of obstacles to free movement, other than those which will be dealt with by the proposal for a Directive. The problems identified can be summarised as follows:

- burdensome qualifying conditions for acquiring supplementary pension rights, including long vesting periods;
- difficulties with transferability of vested pension rights from one Member State to another;
- tax difficulties linked to acquiring pension rights in more than one Member State;
- the specific disadvantage of changing schemes arising in the case of a worker other than a seconded worker who goes to work only temporarily in a Member State other than that in which he/she has been building up pension rights.

### 53. *Qualifying conditions for acquiring rights*

The acquisition of vested rights often takes place after several years of employment in a company (ten years under German law) and sometimes only at the time of retirement. Any job change before the acquisition of a vested right implies that no occupational pension will be paid in respect of this period of employment. Some pension schemes cover however all employees of a given industry (e.g. construction industry). In this case job changes within the industry and within a given country will not be penalised by the loss of pension rights. Cross-border job changes, however, do involve a switch to a new pension scheme. This can therefore be considered as an obstacle to the cross-border mobility of labour.

54. The reason for this is the negative impact on free movement of lengthy vesting periods, either because a worker hesitates to leave his original employer for fear of losing the rights he/she has been building up, or because he/she is reluctant to move to a Member State where lengthy vesting periods are the rule because it will take too long to build up the right to a pension. For example, an Italian or Spanish migrant worker in Germany may have to stay 10 years with the same employer in order to obtain an acquired right under an occupational pension scheme in this country.

55. *Difficulties with transferability of vested pension rights from one Member State to another including the lack of approved mechanisms for recognising pension funds.*

On the question of transferability, there are at present obstacles to transferring acquired rights to a scheme in a Member State other than that in which they have been constituted. These obstacles may take the form of legal regulations or of scheme rules.

If a job leaver has obtained a vested right it will be necessary to decide what to do with this right. Two possibilities exist: rights can be preserved in the pension scheme in which they were acquired, and the job leaver will be able to draw a pension from this scheme once he/she retires. The alternative, if the nature of the scheme allows, is to pay out a capital value representing vested rights. This capital value can then be used to buy a deferred annuity from an insurance company or be paid into the new pension scheme, provided of course the new scheme accepts the transfer.

56. Capital transfer seems to be a straightforward solution in the case of funded pension schemes, but is not normally used in the case of book reserve plans and pay-as-you-go schemes, neither of which set aside financial assets to back up their pension promises. Many job changers therefore have only one option, i.e. that of preserving their rights in the previous pension scheme<sup>39</sup>. In either case – transfer or preservation – future pay rises will not normally be taken into account as they would be after an uninterrupted career with the same employer. Frequently, not even expected price or average earnings rises are taken into account for the calculation of transfer values. As a result, there is a tendency for scheme leavers not to get their fair share out of a pension fund.

Calculation of transfer values which penalise scheme leavers and inadequate preservation of “dormant” rights are severe obstacles to labour mobility.

57. *Tax difficulties linked to acquiring pension rights in more than one Member State.*

Although direct taxation is largely within the competence of the Member States, Member States must exercise their powers consistently with Community law<sup>40</sup>. In this regard, it should be noted that Article 48 implies not only the abolition of any discrimination based on nationality but also the suppression of any national measure likely to impede or render less attractive the exercise, by Community nationals, of the fundamental freedoms guaranteed by the Treaty<sup>41</sup>. Chapter VI below deals more generally with taxation issues.

Workers who wish to exercise their right to free movement within the Union may come up against tax obstacles when trying to transfer accrued benefits (where this is possible) from a funded scheme in the home state to a scheme in the host state. The transfer from the home state scheme may be subject to a tax charge; this can lead to tax disadvantages where the host state does not give tax relief for the incoming transfer, but the benefits are ultimately received subject to income tax. This illustrates the unfavourable position that workers exercising their right of free movement can find themselves in by comparison with those who transfer accrued benefits within a Member State.

58. *The specific disadvantage of changing schemes arising in the case of a worker who goes to work for a short term period in a Member State other than that in which he has been building up pension rights.*

Two situations can be distinguished:

- Workers seconded by their employers to another country in the context of the same company or associated companies: this situation will be dealt with by the proposal for a Directive, which is mentioned above.
- All other workers moving for a limited period to another Member State: These workers, as much as seconded workers, are disadvantaged by changing pension schemes. This constitutes a discouragement of free movement of labour across Member States' boundaries.

## C. Possible approaches

59. One question which has been raised is whether it would be feasible to deal only with the obstacles encountered in the context of compulsory schemes, as opposed to voluntary schemes. It is argued that a regulatory initiative applying to voluntary schemes would act as a disincentive to employers who would otherwise choose to establish such schemes. It seems difficult, however, to treat differently regimes which, so far as the worker is concerned, have the same purpose of completing his or her pension provision. To exclude voluntary systems would have very different effects according to the Member State concerned.

60. From the consultations carried out, it appears that a particular problem arises in relation to any proposal of limitation, imposed by Community legislation, of the length of vesting periods. However, lengthy vesting periods whatever their advantages in other areas may be, constitute obstacles to free movement; so it is necessary to consider how this problem might be overcome. This could be done by legislation at Community level, which would impose a maximum number of years by way of vesting periods. It could also be specified that no Member State could increase the length of existing vesting periods. Another option could be that the Community should not propose anything by way of legislation in this area, and should rather limit itself to promoting the debate at European level by the social partners.

61. On the question of transferability, the approach discussed with Member States and social partners so far is to require that transferability should be allowed where the nature of the scheme permits (typically, funded systems). In other cases, preservation would be the only option. It could also be required that the amount transferred be given a fair actuarial valuation, both by the transferring scheme and the scheme receiving the worker.

In order to resolve technical problems relating to the transferability of pension rights such as the transfer of rights only to approved supplementary pension schemes or the establishment of actuarial standards of transfer values, the creation of a Community Pension Forum, as suggested by the High Level panel, made up of representatives of Member States, the Social Partners and Pension funds, could be useful.

62. In order to remove tax disadvantages, Member States could be encouraged to include specific provisions on the tax treatment to be given to contributions, transfer values and benefits in their bilateral double taxation treaties. Although this would allow individual agreements to be adapted to the specificities of the tax systems concerned, agreeing specific provisions in all the bilateral treaties would be a lengthy and cumbersome process. It would also be less transparent than having common rules at Community level, although such rules might be difficult to negotiate.

63. The proposal for a Directive as referred to above will in principle contain measures allowing workers temporarily seconded by their employer in another Member State to remain affiliated to the supplementary pension scheme in the State in which they were previously working.

This possibility of trans-border affiliation could be extended to all workers moving for a limited period to another Member State. This would require an agreement between the employer in the State of origin, the employer in the Host Member State, the worker, and, where applicable, the supplementary pension scheme in question.

**Questions:**

1. *Is action at Community level required in order to overcome the identified obstacles to free movement (i.e. other than those which will be dealt with in the forthcoming proposal for a directive) in the field of supplementary pensions?*
2. *If so, which action would be the most appropriate for each of the identified remaining obstacles (legislation, agreement between social partners)?*
3. *If not, how could the remaining identified obstacles to free movement be removed?*
4. *Which further initiatives should the Commission take in order to remove the remaining obstacles to free movement?*



## Chapter V: The importance of taxation for supplementary pensions

### A. General considerations

64. The taxation of retirement provision is of particular importance in the design of any funded supplementary scheme, and most, if not all, Member States give some form of tax privilege. The design of pension schemes and the choice between different models of taxation are, however, essentially a matter for Member States. Each national government must decide which tax environment will be most effective for its circumstances, bearing in mind the exchequer costs of giving reliefs. The tax rules which have been developed over many years are extremely complex and specific to each Member State. They contain detailed regulations whose purpose is to ensure that government income that is foregone to encourage saving for retirement is used only for that purpose.
65. This diversity leads to a situation where taxation can be a barrier to free movement of people and the free provision of services. Tax privilege usually depends upon a scheme meeting a number of detailed rules, and, as a consequence, a scheme that is approved in one Member State is very unlikely to meet the tax requirements for schemes in another. This has the practical effect of discouraging contributions to pension funds established in other Member States.
66. Within this framework, the Commission is concerned that any specific tax rules should be consistent with the fundamental Community principles of freedom of movement of persons and of provision of services. This applies both to pillar 2 and pillar 3 pension arrangements. For pillar 3 arrangements the Third Life Directive now provides for the free provision of services in the EU, on the basis of home state supervision. The removal of supervisory barriers to cross-border business by insurance companies has, however, highlighted some tax disadvantages which can occur, particularly in relation to the tax deductibility of life assurance premiums.
67. Tax rules that discriminate against a policyholder who buys a policy from an insurer established in another Member State run contrary to the freedom to provide services. In its decision in the *Bachmann* case<sup>42</sup> however, the European Court of Justice held that such discriminatory provisions might be retained to the extent that they are necessary to preserve the particular coherence of the tax system of a Member State. In this case the ECJ upheld a pro-

vision of Belgian tax law whereby premium relief for life assurance contracts was only permitted in respect of policies issued by companies established in Belgium. The reason was that relief on premiums was linked to taxation of the policy proceeds; if relief were given on premium payments made to foreign insurers, the Belgian tax authorities would not be certain that tax would ultimately be paid on the proceeds.

68. In a later case the Court has made it clear that fiscal coherence could not be invoked as a justification in circumstances where a Member State had voluntarily given up that coherence, for example in the provisions of a double taxation treaty with another Member State. The judgment in the *Wielockx* case<sup>43</sup> shows that a Member State should take into account the effect that double taxation agreements might have on the fiscal coherence that the particular measure creates at a national level. If under the terms of a double taxation treaty a Member State allows benefits paid to non-residents to be taxed only in the country of their residence, the inability to tax these payments should not be a reason for denying tax deductibility only when the contributions are paid to a scheme that is established elsewhere in the Community.

### B. Avoiding double taxation

69. Each Member State has entered into a large number of double taxation agreements with other states, both within the Union and outside. These treaties, which are nearly all bilateral in nature, are designed to promote economic activity by removing the possibility of double taxation, while at the same time ensuring co-operation to combat tax evasion and fraud. Within the Union, 98 of the 105 possible bilateral relations are currently covered by such a double taxation agreement. Where no bilateral treaty exists, some Member States allow relief from double taxation on a unilateral basis.
70. When it comes to the taxation of occupational pensions, existing agreements tend almost exclusively to concentrate on eliminating the double taxation of pensions when they are paid. Most bilateral treaties follow Article 18 of the OECD Model Treaty in giving the country in which the taxpayer resides the exclusive right to tax pension income from a private employment. (On the other hand, pensions for public service are covered by Article 19 of the OECD Model, and are generally taxed in the country in which they originate.) Even though some recent

bilateral tax agreements give taxing rights over pensions from private employment to the source country, the essential principle of preventing double taxation holds good. In this way, the same income will not be taxed twice.

71. A few bilateral agreements between Member States, such as the ones between France and the UK and between Denmark and the UK, specifically cater for pension contributions which a migrant worker may continue to pay to a scheme in one country after moving to the other. These provisions, which go beyond the scope of the OECD Model, essentially provide for a form of mutual recognition of tax-approved pension schemes in the other country. This has the result of allowing the migrating worker to continue to get tax relief in his or her new country of residence on pension contributions paid to the former one. These steps can result in the lifting of barriers to mobility of workers.

### C. The case for a common approach

72. Bilateral double taxation agreements have the considerable advantage that they can be tailored to the specificities of the taxation and the pensions systems of the two countries concerned. Against this, however, must be set the relatively cumbersome nature of the system in that, for relations within the Union, it is clearly time consuming to have to negotiate and renegotiate 105 agreements. This number can be expected to rise sharply with the prospect of future enlargement<sup>44</sup>. Finally, there is no general knowledge of these agreements, and no equality of treatment of equivalent situations under different bilateral agreements.
73. Closer co-ordination of the cross-border tax treatment of pensions could, however, substantially streamline the process of updating, and possibly extending, the scope of bilateral tax agreements. Such co-ordination seems particularly suited to the needs of a developing Single Market, and could be effected in a number of ways. As a first step, it would be necessary to consider whether any specific initiatives or measures are called for by the particular Union context. If Member State governments agreed any rules, there would then be a choice of how to implement them: they might, as now, be incorporated in individual agreements between Member States; or, alternatively, they could be implemented on a multilateral basis. It may on the other hand be appropriate for an agreement on certain aspects of pension taxation to be enacted as Community legislation.
74. In particular, given the need to ensure that the tax benefits that are accorded to pension schemes are not misused, there will also be a continuing need

for rules against tax avoidance. With this in mind, there appears to be particular merit in exploring the concept of mutual recognition of tax-approved schemes in other Member States, as already exists in a few bilateral double taxation treaties. Such an approach, for example in the area of cross-border contributions, could prevent retirement tax reliefs from being misused for other purposes.

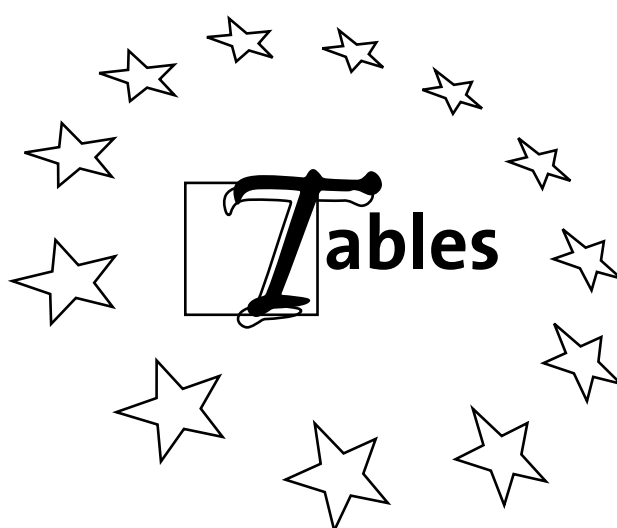
75. The Commission's report of 22 October 1996 on the development of tax systems<sup>45</sup> stresses the need to view taxation policy in the context of the major political challenges that are currently facing the European Union. Chief among these are the themes of promoting enterprise and employment<sup>46</sup>. The Commission's report, which reflects and draws conclusions from the work of the High Level Group on Taxation<sup>47</sup>, underlines its belief that, in order to harvest the full benefits of the Single Market and to stimulate enterprise, tax obstacles and disadvantages to doing business within the Union must be tackled head on.
76. The Commission's report notes the taxation of pensions as a possible area for a future initiative at Community level, and also that, in the High Level Group, many personal representatives called for action to improve the functioning of bilateral double taxation treaties. While fully bearing in mind the principles of subsidiarity and proportionality, the Commission considers that it may prove most useful to explore ways of improving the co-ordination and scope at Community level of tax rules relating to pension provision. Such rules would, of course, be subject to unanimous decision in the Council.
77. The previous chapter discussed the particular concerns associated with workers temporarily employed in a Member State other than their home state, and the legislation which the Commission intends to put forward. This proposal provides an opportunity to take a small but significant step towards co-ordinating certain taxation provisions, at least in the specific area of supplementary pensions.

#### **Questions:**

*To what extent do current tax rules or regulations (for example, related to membership of approved schemes) constitute an actual barrier to the freedom of movement of workers?*

*Is it feasible to rely on bilateral or multilateral tax treaties to take forward closer co-operation between Member States as regards cross border pension arrangements? If so, what should these cover, and how can this co-operation be achieved practically?*

*Is Community legislation an appropriate and feasible alternative?*



### General comment:

Given the growing economic importance of funded pension schemes it is essential for those involved with retirement provision, whether economic operators, public authorities or other interested parties, to have their disposal reliable and harmonised Community statistics on institutions for retirement provision. Such statistics are to be integrated in the competent Community framework regulation, Council Regulation 58/97, concerning structural business statistics.



**Table I: Coverage Levels - Pillar 2**

<b>Country</b>	<b>Coverage Estimation in % of total private sector employment</b>	<b>Characteristics</b>	<b>Supplementary pensions as % of total pensions (1993)</b>
<b>Belgium</b>	31	Voluntary/funded/pension funds and group insurance	8%
<b>Denmark</b>	80	Company funds/professional funds through collective bargaining/all funded	18%
<b>Germany</b>	46	Voluntary/partially book-reserved (approx. 56%) funded (44%) through Pensionkassen, Support Funds and Collective Insurance	11%
<b>Greece</b>	5	Voluntary/mainly top hat/some (limited) funding	not available
<b>Spain</b>	15	Voluntary/mainly top hat in view of high levels of social security pensions/partially funded/mainly book reserves: will now be phased out	3%
<b>France</b>	90	Quasi mandatory/collective bargaining/PAYG/plus voluntary top hat funded schemes	21%
<b>Ireland</b>	40	Voluntary/funded/pension funds and group insurance	18%
<b>Italy</b>	5	Voluntary/mainly top hat in view of high levels of social security pensions/partially funded	2%
<b>Luxembourg</b>	30	Voluntary/mainly book reserve type plans/a limited amount of funding exists	not available
<b>The Netherlands</b>	85	Company funds/industry-wide funds through collective bargaining/all funded	32%
<b>Portugal</b>	15	Voluntary/pension plans (not funds) executed by recognised management companies and insurance companies/funded/mainly top hat in view of high levels of social security pensions	not available
<b>UK</b>	48	Voluntary/funded	28%

Source: European Federation for Retirement Provision (EFRP) - European Pension Funds 1996 - based on World Bank Report - Tamburi Report

**Table II: Pension fund assets - total and as a percentage of GDP (1993)**

	<i>Assets bn ECU</i>	<i>Assets in % of GDP</i>
Belgium	7	3,4
Denmark	26	20,1
Germany <sup>45</sup>	106	5,8
Spain	10	2,2
France	41	3,4
Ireland	18	40,1
Italy	12	1,2
The Netherlands	261	88,5
UK	717	79,4
<b>EU<sup>46</sup></b>	<b>1198</b>	<b>20,3</b>
US	3546	59,1
Japan	1800	44,7

Source: EFRP - op. cit.

**Table III: Assets of life assurance companies - total and as a percentage of GDP (1995)**

<i>Country</i>	<i>Life assurance enterprises assets bn ECU)</i>	<i>Assets as % of GDP</i>
Belgium	6	2,9
Denmark	65	49
Germany	379	20,5
Greece	n.a.	
Spain	18	4,2
France	317	30,0
Ireland	n.a.	
Italy	31	3,7
Luxembourg	5	37,6
Netherlands	138	45,6
Austria	5	1,7
Portugal	3	3,9
Finland	6	6,3
Sweden	65	36,9
UK	565	67,1
EUR 15	1604	24,9

N.B. Figures not completely comparable, owing to different national valuation rules (investments can be valued at purchase price, as in Germany, or at current price, as in the UK).

EU total included only Member States listed.

Source: Eurostat 1997

**Table IV: Distribution of pension funds (pillar 2) assets, as % of total assets (1994)**

	<i>Equity</i>	<i>Fixed income</i>	<i>Real estate</i>	<i>Short term placements</i>	<i>% of Foreign assets</i>
Belgium	36	47	7	10	n.a.
Denmark	22	65	9	4	7
Germany	11	75	11	3	6
Spain	4	82	1	13	5
France	14	39	7	40	5
Ireland	55	35	6	4	n.a.
Italy	14	72	10	5	5
Netherlands	30	58	10	2	25
Portugal	(18)	(57)	5	19	n.a.
Sweden	32	47	8	13	12
UK	80	11	6	3	30
US	(52)	(36)	4	8	10
Japan	(29)	(63)	3	5	n.a.

Source: Royal Institute of International Affairs, UBS and EFRP (Figures between brackets are estimates).

**Table V: Distribution of life assurance assets (pillar 3) as % of total assets (1994)**

<i>Country</i>	<i>Equities</i>		<i>Fixed income</i>		<i>Real estate</i>	<i>Other</i>
	<i>Domestic</i>	<i>Foreign</i>	<i>Domestic</i>	<i>Foreign</i>		
Denmark	20	5	66	-	3	6
Germany*	5	n.a.	76 <sup>2</sup>	n.a.	5	14
Spain*	2	n.a.	55	n.a.	10	33
France	19	-	69	-	8	4
Italy	7	5	70	5	12	2
Netherlands	12	2	71 <sup>1</sup>	4	6	6
Sweden*	23	n.a.	61	n.a.	7	9
UK	49	12	24	3	9	3

\* denotes countries where split between domestic and foreign assets was unavailable

<sup>1</sup> includes loans (50%)

<sup>2</sup> includes loans (61%)

Sources: Comité Européen des Assurances, OECD Insurance Statistics Yearbook 1987-1994

## Table VI: Differences in rates of return of equities compared to bonds

The period over which the differences in rates of return of equities compared to bonds is calculated is important. The premium normally associated with the returns on equities over bonds depends very much on the level of the stock market and the beginning and end of the period over which comparisons are made. Several different sources are given below. Whilst the difference varies, all sources show consistently the higher return on equities.

### Table VIa: Real rates of return (% pa) (1967-1990) in domestic currency

<i>Country</i>	<i>Equities</i>	<i>Bonds</i>
Denmark	7,0	3,4
Germany	9,5	2,7
France	9,4	1,0
Italy	4,0	-0,2
Netherlands	7,9	1,0
Sweden	8,4	-0,9
UK	8,1	-0,5
US	4,7	-0,5
Japan	10,9	0,2

Source: E.P. Davis: 1995

### Table VIb: Excess returns of equities over bonds markets (% pa) (1981-1995) in domestic currency

Belgium	11,5
Germany	7,1
France	4,5
Italy	1,5
Netherlands	6,9
Sweden	15,5
UK	2,9
Japan	2,9
US	1,5

Source: JP Morgan - FT/S+P Actions World Indices - Pragma Consulting

**Table VIc**

<b><i>Real returns (% p.a.) from US markets (1926-1984)</i></b>	
Small company stocks	9,1
Large company stocks	7,1
Long term govt. bonds	1,7

Source: Ibbotson Associates Inc.

<b><i>Real returns (% p.a.) from UK market (1919-1993)</i></b>	
Equities	7,9
Gilts (long)	2,0

Source: BZW 1994

<b><i>Real return (% p.a.) from Belgian market (1959-1994)</i></b>	
Equities	4,6
Fixed income	2,3

Source: Banque Degroof

**Table VII: Pension funds 1984-1993. Average Rates of Return, Volatility and Relationship of Return to Risk**

	<i>Average nominal Pension Fund Return (real returns in brackets)</i>	<i>Average Standard Deviation of nominal returns</i>	<i>Return/risk ratio<sup>47</sup> on nominal returns (Col 1 ÷ Col 2)</i>
Belgium	11,8 - (8,8)	8,9	1,3
Denmark	10,0 - (6,3)	9,4	1,1
Germany	9,4 - (7,1)	7,2	1,3
Spain	13,8 - (7,0)	19,9	0,7
Ireland	14,0 - (10,3)	13,7	1,1
Netherlands	9,5 - (7,7)	7,2	1,3
Sweden	14,5 - (8,1)	8,5	1,7
UK	15,5 - (10,2)	11,4	1,4
US	13,5 - (9,7)	9,4	1,4
Switzerland	7,6 - (4,4)	6,7	1,1
Japan	8,2 - (6,5)	8,3	1,0

Source: EFRP

Note: Similar figures on the returns on life insurance investments will shortly be available through EUROSTAT within the framework of Insurance Service Statistics.

**Table VIII: Stock markets' size (domestic equity) (1996)**

<i>Country</i>	<i>market capitalization in % of GDP</i>
Belgium	45.9
Denmark	41.8
Germany	29.6
Greece	19.7
Spain	42.3
France	38.9
Ireland	49.7
Italy	21.7
Luxembourg	193.4
Netherlands	97.8
Austria	14.3
Portugal	23.7
Finland	50.7
Sweden	97.2
UK	149.9
EU	32
US	68
Japan	65

Source: Federation of European Stock Exchanges and European Commission.



**Table IX: Summary of National Regulations on Pension Fund Portfolios (pillar 2)**

<b>Country</b>	<b>Restrictions</b>
<b>Denmark</b>	A maximum of 40% may be invested in "high risk assets" - these include domestic equities, foreign equities and unlisted securities. Also 80% currency matching requirement. In case of EU currency, up to 50% of liabilities can be covered by assets denominated in ECU. No self-investment.
<b>Germany</b>	Maximum 30% EU equity, 25% EU property, 6% non-EU shares, 6% non-EU bonds, 20% overall foreign assets, 10% self-investment limit <sup>48</sup>
<b>Spain</b>	5% limit in securities issued by any one enterprises. 90% of assets must be invested in quoted securities, bank deposits, property or mortgages. 1% must be in current accounts or money market.
<b>France</b>	At least 50% to be invested in EU government bonds, less than 33% in loans to sponsors
<b>Italy</b>	No pension law for self-administered schemes but investment policy determined by the board of directors and usually restricted to government bonds, bank deposits, insurance policies and property.
<b>Netherlands</b>	5% self-investment limit; prudent man rule
<b>Sweden</b>	Majority to be held in bonds, debentures and loans
<b>UK</b>	5% self-investment limit; prudent man rule
<b>USA</b>	Prudent man rule.
<b>Japan</b>	Minimum 50% in bonds, maximum 30% equity, 20% property, 30% foreign, 10% in one.

Source: European Commission "Supplementary Pensions in the European Union" (1994)

**Table X: EU rules on investment by life insurance companies (pillar 3)**

The EU rules on investments by life insurance companies may be summarised as follows (Articles 20 ff and Annex I of 3rd Life Directive):

- investment must take account of the type of business carried on by an undertaking in such a way as to secure the safety, yield and marketability of its investments, which the undertaking shall ensure are diversified and adequately spread (“prudent man”);
- the types of assets that can be used to cover technical provisions (basically future claims/pension payouts) are specified (equities, bonds, etc.);
- the method of valuing these assets is specified;
- Member States may not require insurance companies to invest in particular categories of assets;
  - in addition Member States shall require every assurance undertaking to invest, with respect to its technical provisions, no more than:
    - 10% in any one piece of land or building;
    - 5% in shares or bonds of the same undertaking except those to a State, regional or local authority;
    - 5% in unsecured loans including 1% for any single unsecured loan
    - 3% cash in hand
    - 10% in shares not dealt in on a regulated market, and
    - finally Member States cannot oblige an insurance undertaking to keep more than 80% of its assets in a currency matching its liabilities<sup>52</sup>.

**Table XI: Summary of national regulation of life assurance companies (pillar 3)**

<b>Country</b>	<b>Restrictions</b>
<b>Denmark</b>	40% combined limit on domestic equity and foreign equity, 10% limit on unlisted securities, 10% combined limit on mortgages and loans
<b>Germany</b>	Maximum 30% domestic equity, 25% property, 6% foreign equity, 5% foreign bonds, 10% unlisted securities, 50% combined limit for mortgages and loans
<b>Spain</b>	No specific limits.
<b>France</b>	65% combined limit on domestic equity, unlisted securities and foreign equity. 40% limit on property, 10% combined limit on mortgages and loans
<b>Italy</b>	Maximum: 20% domestic equity, 20% unlisted securities, 20% foreign equity, 50% foreign bonds, 50% property, 50% mortgages, 0% loans
<b>Netherlands</b>	10% combined limit on unlisted securities and mortgages, 8% limit on loans
<b>Sweden</b>	25% combined limit on domestic equity, unlisted securities and foreign equity. 25% combined limit on property and mortgages, 10% limit on loans
<b>UK</b>	10% combined limit on unlisted securities, mortgages and loans

Source: Policy Issues in Insurance, OECD, 1996

**Table XII: Assets of group life schemes as a percentage of pillar 2 pensions assets (1994)**

<i>Country</i>	<i>%</i>
Belgium	73
Germany <sup>50</sup>	12
Spain	52
France <sup>51</sup>	6
Netherlands	25
Finland	56
Sweden	81
UK	5
EU <sup>52</sup>	65

Source: CEA

**Table XIII: Pension funds v Life Insurance**

Similarities exist between pension funds and certain life insurance products: both aim at provision of a sum at a future date and are often granted tax inducements to encourage such provision. In some states this outward similarity is reflected by the application to pension funds of the regulations similar to those that apply to life insurance under the Third Life Directive. The principal similarities and differences are listed below.

*Similarities:*

- Both are long term investments
- Both involve professional management of assets through authorised persons
- The interests of consumers are crucial in both 'products'
- Both therefore entail standards to avoid unnecessary risk to the funds entrusted by the consumer to the manager/company.

*Differences:*

- Pension scheme liabilities are longer term than life insurance liabilities. The average for life assurance contracts is around 8-12 years. For pensions, liabilities are very often in the region of 20 - 25 years; more, if the pension benefits are paid from the same source. This suggests that pension funds need to match their longer term liabilities with longer term assets. This tends to lead towards a higher proportion of equity or property investment than is the case for life assurance.
- Life policies are subject to the risk of early surrender. This requires appropriate provisioning in the form of readily liquidable assets, or cash, in order to meet expected, and unexpected, levels of early encashment. By contrast, regulations generally prevent early surrender of pension funds benefits, except in very limited cir-

cumstances. In addition, transfers to other schemes may be permitted only in certain circumstances, for example on a change of job, and this will generally result in a penalty. The level of short term liquidity requirement is therefore much lower for pensions.

- Similar points can be made in connection with loans. Life insurance companies generally offer loans on the security of life policies. They need to ensure short term liquid assets exist to provide these loans. Pension schemes cannot usually offer such a facility; therefore short term liquidity for this purpose is not necessary.
- Life insurance liabilities are generally expressed in nominal terms: there is a given sum assured, fixed at the outset of the policy. In contrast, pension liabilities are linked to salaries - in which case what is important is real growth. Purchasing shorter term assets in respect of long term pension liabilities could be dangerous, as there is a strong risk that those assets will not achieve a level of growth sufficient to maintain the pension expectations of scheme members.
- In defined benefit schemes an important factor is the 'guarantee' provided by the employer that the pension promise will be honoured whatever the investment return on the fund. No such guarantee exists in the context of life insurance. This guarantee can obviously affect the attitude to investment of the fund manager.

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## Footnotes

<sup>1</sup> Com (97) 102

<sup>2</sup> There are some exceptions for certain occupational schemes, for example in France where occupational schemes are pay as you go, and in Germany where pension provisions are backed by book reserves.

See D. Franco and T. Munzi, "Public Pension Expenditure Prospects in the European Union: A Survey of National Projections", *European Economy*, 1996, No. 3.

<sup>4</sup> National projections are not homogeneous in the coverage of pension expenditure. Comparable estimates of the impact of the pension expenditure on general government accounts have been produced on the basis of national expenditure trends and 1995 ratios of total public pension expenditure to GDP.

<sup>5</sup> Weighted by 1995 GDP in units of Purchasing Power Standard

<sup>6</sup> The figures for Luxembourg and Portugal are based on projections to the period 2015-2020 only.

<sup>7</sup> Eurostat, 1995 estimate.

<sup>8</sup> Assets in 1996, 120% of the wage bill, 39.5% of GDP

<sup>9</sup> Subject to the possibility of opting out in favour of a private arrangement.

<sup>10</sup> This category is often seen as comprising any form of saving that might be used to provide retirement income, such as individual precautionary savings, residential property ownership, share ownership, family support, etc.

<sup>11</sup> Also includes the French second pillar, which is a pay as you go system with many of the characteristics of a state scheme.

<sup>12</sup> For example Finland, see paragraph 5 above

<sup>13</sup> For example in France, the compulsory ARRCO and AGIRC schemes; in Germany, the approach of many companies of backing pension promises with balance sheet reserves ('book reserves').

<sup>14</sup> The issue of group arrangements is discussed in Chapter IV.

<sup>15</sup> COM(97) 102

<sup>16</sup> For our purpose we can identify two types of risk:

- credit risk: the risk that the creditor will not pay because the company goes bankrupt or the government defaults. Over the long term these are reflected in the average rate of return of the different assets. Although of course in any one year they can be important and be reflected in the volatility of the asset.
- market risk: the risk that the price of an asset will fall such that the investor may not be able to meet his liabilities in that year without liquidating a higher proportion of his assets than expected. This market risk is reflected in the volatility of an asset.

<sup>17</sup> See also Table VII where some of the real returns on government bonds were negative over quite long periods.

<sup>18</sup> Prof. B. Solnik, "Fundamental considerations in cross-border investment: the European view". The research foundation of the Institute of Chartered Financial Analysts, April 1994.

<sup>19</sup> In the United States pension fund managers are not subject to quantitative investment restrictions. Because they have continent inside opportunities to buy dollar assets, only 10% of their investments are in fact outside the USA.

<sup>20</sup> Investment Services Directive 93/22/EEC.

<sup>21</sup> Art. 73b of the Treaty.

<sup>22</sup> Art 73d 1(b).

<sup>23</sup> Art 104a.

<sup>24</sup> Of course individual pension funds may be constrained by the maximum rules even if on average for all funds the limits are not reached. Some funds may be very "conservative" in their investment strategy and wish to keep a high proportion of government bonds. Other funds with a profile of young members may wish to take a higher proportion of equities.

<sup>25</sup> OJ 93/C 171/11

<sup>26</sup> OJ 94/C 360/08

<sup>27</sup> Case no. C-57/95 France v Commission.

<sup>28</sup> Investment Services Directive 93/22/EEC; Second Banking Directive 89/646/EEC; Third Life Insurance Directive 92/96/EEC.

<sup>29</sup> The Commission suggested in its draft Directive and Communication as a first step that currency matching requirements should not exceed 60%. In any case the introduction of the EURO will reduce the constraining effect of any currency matching requirements.

<sup>30</sup> Third Life Directive, 92/96/EEC.

<sup>31</sup> These provisions concern the EU prudential rules for investments made by life assurance companies, i.e. the assets side of the balance sheet. On the liabilities side of the balance sheet there are also harmonised EU rules. These are based on the calculation of "technical provisions" which are the expected liabilities, and the assets that must back these provisions to ensure the liabilities can be covered. In addition insurance companies are obliged to keep a "solvency margin" of 4% own capital to cover unexpected circumstances and give added assurance that liabilities can be met.

<sup>32</sup> See footnote 30.

<sup>33</sup> See Third Life Directive 92/96/EEC, and also Ch. II para 28 above.

<sup>34</sup> Second Banking Directive 89/646/EEC; Third Life Insurance Directive 92/96/EEC; Investment Services Directive 93/22/EEC.

<sup>35</sup> Article 59

<sup>36</sup> Since the extension in 1982 of its personal scope to self-employed persons, Regulation 1408/71 is based on Articles 51 and 235.

<sup>37</sup> Lastly amended and updated by Regulation (EC/118/97; O.J. of L28 of 30 January 1997)

<sup>38</sup> Communication of the Commission to the Council, "Supplementary social security schemes: the place of supplementary pension schemes in the social protection of workers and their effect on the free movement" SEC(91)1332.

<sup>39</sup> This would also be the case if the new employment relationship did not provide for membership in an occupational pension scheme.

<sup>40</sup> See *Finanzamt Köln-Altstadt v. Schumacker*, Case C-279/93, judgment of 14 February 1995.

<sup>41</sup> See *Kraus*, Case C-19/92, ECR [1993] I-1663, judgment of 31 March 1993.

<sup>42</sup> *Bachmann v. Belgium*, *Commission v. Belgium* (C204/90 and C300/90, judgment of 28 January 1992),

<sup>43</sup> Case C-80/94, judgment of 11 August 1995..

<sup>44</sup> It would, for example, require 190 agreements to cover all bilateral relations within a Union of 20 Member States.

<sup>45</sup> Com (96) 546.Final.

<sup>46</sup> Florence European Council 21-22 June 1996. Presidency Conclusions (SN300/96) pages 2-3.

<sup>47</sup> This High Level Group, under the chairmanship of Commissioner Monti, brought together personal representatives of EU finance ministers on four occasions between June and October 1996, following the informal ECOFIN meeting on 13 April 1996

<sup>48</sup> Book reserves in Germany: 124 bn ECU (1992) source CEA

<sup>49</sup> EU total includes only Member States listed

<sup>50</sup> The higher the better

<sup>51</sup> This does not apply to book reserve schemes

<sup>52</sup> Assets denominated in ECU are deemed to be matched

<sup>53</sup> Bulk (56%) of assets of pension funds are book reserves

<sup>54</sup> Group life premia as a percentage of total pension premia. Assets could not be calculated in view of fact that main pension schemes (AGIRC/ARRCO) are on a PAYG basis

<sup>55</sup> Includes only listed Member States and excludes France