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TOWARDS A SINGLE MARKET FOR SUPPLEMENTARY PENSIONS

Results of the consultations on the Green Paper on supplementary pensions in the single market

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Results of the consultations on the Green Paper on supplementary pensions in the single market

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SUMMARY

The objective of maintaining a high standard of welfare protection is shared by all Member States of the European Union.

Controlling the cost of this protection presents a constant challenge: the protection must continue to underpin social cohesion while making a positive contribution to economic growth.

Pension benefits are a key component of Member States' welfare protection systems. Expenditure by state pension schemes accounts for nearly half of all welfare spending and is equivalent to between 9% and 15% of gross domestic product (GDP) in the Member States.[1] This proportion is likely to rise steeply as a result of the ageing of the EU population: in 1995, 23% of the population was 65 years of age or over; this figure will rise to 40% in 2025.[2]

Coping with these developments is mainly a matter for the Member States, which bear responsibility for the organisation of their retirement systems. Generally speaking, these systems are based on three pillars:

- the first pillar consists of social security schemes ;

- the second occupational schemes ;

-the third personal pension plans.

Schemes coming under pillars 2 and 3 are supplementary schemes in that they are there to supplement public schemes.

It is with such supplementary schemes that this communication is concerned. And of particular concern here are pillar 2 occupational schemes, for which there is as yet no proper Community legal framework. Due regard being had to the application in this area of the subsidiarity principle, the Commission's role is one of proposing reforms that might enable such schemes to benefit from the freedoms of the single market and the new vistas opened up by the euro, thereby increasing their security and efficiency and participating in the development of EU capital market.

This was one of the points made by the Commission communication of 28 October 1998, "Financial services : Building a framework for action".[3] The framework, drawn up in close cooperation with industry and Member States, contains proposals to complete the integration of financial markets in the Union. More open retail financial markets will provide more choice and flexibility for future pensioners. A more efficient capital market will help pension funds by increasing the return on their investments, thus helping to limit the indirect cost of labour and create jobs. The effect of this might be to strengthen the economic foundation to our social welfare.

To this end, it is desirable that supplementary schemes should themselves be adapted in order to take account of the single market and the euro. Investment rules should not unnecessarily restrict the investment strategy of pension funds. For the management of their assets, pension funds should be able to call upon the services of approved asset

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1 European Economy, The Welfare State in Europe, Challenges and Reforms (No 4, 1997).
2 European Economy, Ageing and Pension Expenditure Prospects in the Western World (No 3, 1996).
3 Financial services: Building a framework for action (COM(1998) 625).

managers, wherever these are located in the Union. Service providers of supplementary pension products should be able to operate in all Member States.

At the same time, beneficiary protection must remain the cornerstone of the regulation and control of retirement benefit institutions. All conceivable steps must be taken to guarantee the payment of contractual benefits to future pensioners. However, these steps must not go beyond what is objectively necessary to ensure that scheme members are properly protected.

This view was shared by the vast majority of the Member States and representative bodies that took part in the consultations on the Green Paper on supplementary pensions in the single market,[4] launched by the Commission in June 1997. Although opinions still differ on some points, e.g. investment rules, a broad consensus has been reached on the need to begin introducing a Community framework which might revolve around three main principles: the laying-down of prudential rules for pension funds; the removal of obstacles to the free movement of workers; and coordination of Member States' tax systems.

Prudential rules for pension funds

At present, although the value of assets held by pillar 2 pension funds[5] established in the Member States is equivalent to approximately 23% of the Union's annual GDP,[6] there are still no specific Community rules guaranteeing application of the principles of free movement of capital and freedom to provide services.

This is all the more regrettable since the euro has created for investors a broader capital market that is more liquid and devoid of exchange risk. In some Member States, regulation is sufficiently flexible to allow pension funds to develop and adapt investment policy to the new environment whilst maintaining pension security. Consequently, these funds could better diversify their investment portfolio and achieve, to the benefit of both employers and members, a better balance between risk and investment yield. If we are to facilitate the financing of retirement pensions, it is clearly highly desirable to extend this opportunity to all pension funds established in the European Union.

Experience has shown that over-restrictive investment rules have considerably harmed the yields of pension funds without any gains in security. This has resulted either in reduced benefits or in higher contributions to the detriment of labour costs. Moreover, by especially targeting equity investment, these restrictions limited the capacity to finance the private-sector part of the economy; they also blocked the opening and integration of capital markets in the Union. A more efficient capital market, with liquid and well developed equity and private sector debt instruments, could contribute to strengthening economic growth and job creation in the Union, and thus indirectly to facilitating the financing of social welfare in the decades to come.

The adoption of a directive seems desirable in order to achieve this aim. The directive should, in the opinion of the vast majority of the parties canvassed during the consultations on the Green Paper and the drawing-up of the financial services action framework, seek to attain the following four objectives:

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4 COM(97) 283. The responses to the Green Paper have been summarised in a working document (CAB/62/98) available on DG XV's Internet site (http://europa.eu.int/comm/dg15).

5 Pension fund refers in this context to supplementary pensions linked to employment.

6 Source: European Federation for Retirement Provision (EFRP). The figure is 20% if one subtracts the assets of book reserve and group life assurance arrangements.

(i) to ensure the best possible protection of beneficiaries. This means that investment and management freedom has to be placed in an overall prudential framework.

(ii) to allow pension funds to profit fully from the single market and the euro. Pension funds should only be limited in their investment strategy for prudential reasons. They should also be able to use the services of any asset manager and agent duly approved in the Union.

(iii) to guarantee equal treatment between occupational pension providers. Pension funds have their own characteristics; they justify the development of a specific legal framework. But at the same time, the introduction of competition distortions with other service providers, such as life assurance companies,[7] must be avoided. This involves the establishment of a genuine prudential framework, as undertaken for life assurance companies. It could also involve the definition of similar rules for well defined products.

(iv) to allow the mutual recognition of prudential regimes. At present, a pension fund cannot have members in more than one Member State of the Union. Given the characteristics of supplementary pension schemes and their link to public schemes, only limited forms of membership should be envisaged (for example, inside a single company). Moreover, cross-border membership can only be a long-term aim because numerous conditions need to be met: in particular, better coordination between the tax systems in the Member States is required. Mutual recognition of prudential regimes will also be needed. If a proposal for a directive could allow for such mutual recognition, it would be a first step towards cross-border membership. The latter would have several advantages: for migrant workers, who would no longer run the risk of losing their supplementary pension rights, but also for employers and pension funds, which would be able to achieve economies of scale in terms of administrative and financial management, and hence reduce labour costs.

From the present state of play it can be gathered that a proposal for a directive might comprise three sets of rules:

(i) Fundamental prudential rules. This involves in particular the approval of a pension fund by a competent authority; the need to subordinate approval to strict criteria covering responsibility, competence and the managers' standing; the definition of the intervention powers of the supervisory authority; and the setting-up of mechanisms for periodic declarations to members and the supervisory authorities.

(ii) Rules concerning the investment of contributions. Absolute investment freedom for pension funds is not desirable. Investments have to be adapted to the nature and duration of the liabilities and duly diversified (by currency, geographical area and economic sector). The necessity of having a currency matching requirement needs to be discussed. In any event, te regulatory framework has to be fully compatible with the free movement of capital. It must be stressed that, in general, these aspects will have to form the subject-matter of detailed consultations with the Member States and industry.

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[7] Life assurance companies are also active in the supplementary pensions field, offering group life contracts linked to employment. In some Member States, UCITS are likewise used as a vehicle to provide this type of pension.

(iii) Rules concerning the liabilities of pension funds and the link between assets and liabilities[8] Investments have to be based on a precise evaluation of the fund's liabilities. This evaluation establishes technical provisions calculated according to a prudent and recognised actuarial method. Signature of the accounts of the pension fund by an independent actuary has to be considered for this purpose. A minimum financing level intended to guarantee that acquired rights to benefit are completely covered also appears necessary.

Minimum harmonisation should be the aim for these subjects. Owing to the wide disparity between pension funds active in the Union, the objective can only be to fix a general framework prescribing the principles to be respected in order to guarantee the protection of recipients and economic effectiveness. Cooperation between supervisors of pension funds seems, moreover, essential. A body bringing together the competent authorities may be useful once the directive is adopted.

The removal of obstacles to labour mobility in the Union

A fundamental principle of the single market, labour mobility is all the more important at a time when economic and monetary union (EMU) is being established. At stake is the credibility of EMU among the general public. Europe already has Community rules coordinating effectively, for migrant workers, pillar 1 pension schemes. On the other hand, the lack of such coordination in the case of supplementary pensions is a real barrier to the free movement of workers covered by such schemes. This barrier will affect more and more people and will limit workers' capacity for movement if Member States choose to rely increasingly on supplementary schemes.

Debate here should therefore focus on the following aspects:

(i) conditions for acquiring supplementary pension rights. Conditions that are too complex, or excessively long vesting periods, can constitute a considerable obstacle to the free movement of persons. It is essential that Member States and the social partners give this matter careful consideration.

(ii) the methods for transferring rights. It is a fact that the absence of a common actuarial standard for the calculation of transfer values penalises migrant workers compared with those who remain in the same Member State. On the basis of technical work to be begun with all interested parties, the Commission could envisage the possibility of a legislative proposal on the subject.

(iii) the conditions for cross-border membership of pension funds. Cross-border membership would require mutual recognition of supervisory regimes and better coordination of tax systems. But occupational schemes are also, at the national level, subject to specific social rules, which are connected in particular with benefits payment (treatment of part-time and full-time employees, forms of pension pay-outs, etc.). A technical study seems necessary in order to determine how these rules have to be dealt with in the context of cross-border membership.

(iv) the creation of a pensions forum. A pensions forum might prove to be a useful place in which to discuss the implications of labour mobility in the Union. Such a forum might facilitate the carrying-out of the necessary technical work in this field. Bringing together representatives from the Member States, pension funds

[8] This section is relevant mainly to defined benefit schemes.

and the social partners, it might also monitor existing and future Community legislation.

Coordination of Member States' tax systems

National disparities in the tax treatment of life assurance and pension products, their complexity and specificities, are major obstacles to labour mobility and freedom to provide services in the Union. While ruling out at this stage any harmonisation attempt and taking care to safeguard the tax income of Member States, it is felt that an endeavour should be made to abolish national tax discrimination against products offered by institutions (insurance companies, pension funds) established in other Member States.

Following this flexible and coordinated approach, the Commission and the Member States have started to cooperate in order to examine how to eliminate the main obstacles in this field. According to many migrant workers and employers, an issue which needs to be addressed as a matter of priority is the treatment of contributions and premiums paid to institutions that are established in a Member State other than that in which the member or the policy-holder is established.

The subject is being dealt with within the framework of the Taxation Policy Group, which serves as a high-level forum for discussion between the Commission and the Member States in the tax field. There is a broad consensus on the need to continue the work in hand. Given the diversity and complexity of the problems, a step-by-step approach is generally seen as the appropriate way. On the basis of this work, a legislative initiative which would cover the tax treatment of cross-border contributions paid by migrant workers to supplementary pension funds might be envisaged.

Conclusion

These possible initiatives, which are summarised in Annex 1, would to some extent be separate. They would nevertheless be highly interdependent. Cross-border membership, for example, will require at one and the same time mutual recognition in prudential matters, coordination of tax systems and an adaptation of social legislation.

All also make for a better integration of financial services in the Union. In this, a dual objective must be pursued: to contribute to the integration of financial services for the benefit of growth and employment, and to improve the quality of the benefits provided to future pensioners.

1. INTRODUCTION

1.1 The need for a single market in supplementary pensions

1. Pension schemes are at the heart of Member States' welfare protection. Population ageing and its budgetary implications raise, in all Member States, the question of the financial viability of such schemes. The State is as a rule the leading pension provider through pillar 1 schemes, which are usually financed on a pay-as-you-go basis. There is a risk, therefore, that demographic trends will lead to a significant increase in public spending on pensions. Member States, which are responsible for the structure of pension provision, have actively started reform but many types of continuing action will still be needed to ensure the lasting financial stability of schemes (see box 2). The Commission has stated on a number of occasions that higher employment rates and productivity play a decisive role in this regard. It has also stated that thought must be given to ways of tackling the numerous early retirement departures, which place a heavy burden on schemes.[9] This need to increase the employability of older people who have not yet reached the statutory retirement age has, moreover, recently been confirmed by the Council in the 1999 Employment Guidelines [10]. Part of the solution, in order to alleviate the burden on the public purse, can also be greater reliance on funded supplementary pensions related to employment. It is therefore essential to put in place, from a financial and social point of view, a Community framework that is conducive to their development.

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9 See the communication "Modernising and improving social protection in the European Union" (COM(97) 102 final) and the draft communication "Towards a Europe for all ages", currently being adopted.

10 Council Resolution of 9 February 1999 on the 1999 Employment Guidelines (5530/99).

Box 1:

The various types of pension scheme

Pension schemes are traditionally described using the three pillars model: social security schemes are part of pillar 1 and supplementary schemes belong to pillars 2 and 3.

Pillar 1: this is the basic state scheme, in which participation is generally compulsory. These schemes are usually financed on a pay-as-you-go basis, where current workers' contributions are used to fund the pension payments of retired people. Pension benefits are guaranteed by the State and the scheme is managed by a public body. At Community level, Regulation 1408/71 coordinates these schemes.

Pillar 2: these schemes are characterised by a link to employment, to a professional occupation. They are known as "occupational schemes". They usually operate on a funded basis: employer and employees build up savings which are invested and will be used to finance future pension benefits. Moreover, they frequently provide cover for biometric risks (death, invalidity and longevity). Occupational schemes can be organised in many different ways:

- creation of -or participation in- a pension fund separate from the employer. The fund receives the contributions, invests them and pays out the benefits. Funds are said to be "open" (companies from various industrial sectors can join in) or "closed" (participation is limited to a single company or a group of companies from a given industrial sector). There can be "defined benefits" schemes (the employer guarantees the payment of a given level of benefits) or "defined contribution" schemes (benefits vary according to the returns on the funds invested);
- subscribing a group life assurance contract: contributions are paid to a life assurance company which invests them and pays the benefits. The insurance company generally underwrites the payment of the benefits. Life assurance companies are already regulated at Community level;[11]
- purchasing of securities through an undertaking for collective investment in transferable securities (UCITS): contributions are used to buy securities. Pension benefits vary according to the returns provided by the securities. UCITS are already regulated at Community level;[12]
- "book reserve" mechanisms: the employer undertakes to pay benefits to his employees and makes provision for commitments on the liabilities side of his balance sheet;

Pillar 3: these are contracts subscribed by individuals with service providers, such as life assurance companies or UCITS.

The analysis carried out in this Communication cover the following areas.

Chapter 2 deals with the prudential regulation of pension funds that are separated from the employer and the means to ensure a level playing-field between these funds and other providers of occupational pension schemes.

Chapter 3 examines the obstacles to the free movement of labour stemming from the social regulation governing pension funds and book reserves schemes.

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[11] See Directives 79/267, 90/619 and 92/96.

[12] See Directives 85/611, 85/612 and 88/220.

Chapter 4 covers the taxation of supplementary pensions more generally : occupational schemes and life assurance contracts. It considers the possibility of launching a first legislative initiative on occupational schemes.

2. As a solution for ageing populations, funded supplementary schemes cannot, however, perform miracles. Whatever the system of financing (pay-as-you-go or funded), pensions will always account for part of the domestic product for the period when they are paid. Consequently, people in work always finance the benefits of current pensioners. But supplementary schemes may offer a more global productive investment perspective, both inside and outside the Community, unlike pay-as-you-go schemes, which offer only a national perspective. For this reason, supplementary schemes, especially when there are no cross-border portfolio restrictions, permit greater flexibility than pay-as-you-go schemes in coping with the demographic crisis affecting pension systems.

3. In other words, the advantages of pension savings must not be underestimated. If such savings are invested productively, then they can help to increase national income and hence ease the financing of pensions. The income from investments outside the Union could, in economies which are in need of capital, play an altogether decisive role here.

4. Given the high savings rates in a number of Member States, pension fund growth might only give rise to a switching between forms of saving. But it could also usefully prevent, in some countries, a fall in savings rates. What is more, pension savings have the advantage of being a very long-term form of saving, contributing in a stable fashion to the financing of the economy.

Box 2:

Demographic prospects, their financial implications and possible responses

Resolving the retirement provision problem related to an ageing population is one of the major challenges confronting all Member States of the European Union. The gravity of the situation may vary from one Member State to another depending on their demographic structure. But Member States in general are faced with some major political choices.

There are today four workers to every pensioner. In 2040 the ratio will be two to one. Without reform, the level of expenditure of state pension schemes could in some Member States reach 15-20% of GDP (1997: approximately 10%). The scale of the possible fiscal implications must be underscored: in some Member States, unfunded pension liabilities could rise to 200 % of GDP.

Basic public schemes play an altogether central role in Member States' welfare protection systems and should continue to provide a very significant part of retirement benefits. However, in order to enable such schemes to perform this task without undermining public finances, Member States will have to adapt the financing of their schemes to take account of demographic change. They have the possibility of developing supplementary schemes or of continuing to rely essentially on public schemes and envisaging, for instance, an increase in the period of contributions and/or a decrease in pension pay-outs. An increase in employment rates among, and in the employability of, older people would also constitute an effective response to current trends.

5. The June 1997 Commission Green Paper on supplementary pensions in the single market[13] re-launched the debate in an area in which the EU has failed so far to harness the potential efficiency improvements offered by the single market. Without action, the potential of the euro will also be missed. The lack of an adequate Community framework in the field of supplementary pensions can be regarded as highly unsatisfactory for both future pensioners and the pensions industry. The former are looking for a safe and high pension when retired and the latter already have assets amounting to the equivalent of 23% of EU GDP[14] which they need to invest. Given the reforms launched in Member States and which often aim at developing pension funds, this figure is constantly rising. A reform has been introduced, for instance, in Italy and similar projects are being discussed in France. It is essential that an appropriate Community framework accompanies these trends.

6. The intention of the Green Paper was to foster the widest possible debate on the best ways to tackle the demographic and economic challenges ahead and to determine how the single market and the euro can increase the efficiency of supplementary pensions. The specific role pension funds are to play is for Member States to decide. However, decisions of Member States must take place in a coherent Community framework and respect the following single market freedoms :

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- the freedom to provide services;
- the freedom for labour to move across borders;
- the freedom to invest across borders subject only to appropriate prudential restrictions.

8. Furthermore, the Commission must take account of Article 2 of the EC Treaty, which identifies the maintenance of a high level of employment and social protection as a Community objective. This has to be done while respecting the subsidiarity principle, according to which Member States are responsible for their pension schemes.

1.2 The consultations on the Green paper on supplementary pensions in the single market

9. The Commission received about 100 replies to the Green Paper from Member States, the European Parliament, the Economic and Social Committee of the European Communities, consumer organisations, unions, industry and all financial services. A summary of the replies[15] was prepared and used as a basis for discussion at a hearing held on 21 April 1998 to which all interested parties were invited.

10. The Commission is very pleased with the high level of interest demonstrated by this consultation phase and the overall firm level of support from nearly all parties for Community action in this area.

11. However, the Green Paper was criticised on two important horizontal points. Some respondents felt that the Commission should have put more emphasis on the social aspects of pension funds and that too much stress had been placed on pension funds as a vehicle to create European capital markets. It is clear that capital markets are there to

[13] COM(97) 283 final.
[14] Source: EFRP.
[15] Document CAB/62/98, referred to above.

serve pensioners, not the other way round. Therefore, the policy proposed by the Commission will have as primary concern the protection of beneficiaries' rights and the creation of an environment in which they can enjoy a high level of benefits. However, the role that EU capital market integration can play in favour of growth and employment should not be disregarded: efficient and transparent financial markets can facilitate access to capital and enhance capital productivity.

12. The second issue raised by a number of respondents was the need to address more specifically the security of pensions. Some of them insisted, for instance, on the need to ensure that occupational pension plans are backed by an insurance mechanism safeguarding the accrued rights of beneficiaries in the event of the insolvency of the sponsoring company and of a situation where the assets held by the fund are insufficient to cover liabilities. It is obvious that future pensioners want maximum security for their pensions. Pension security is a critical issue that the Commission should take more into account in its future work, by proposing a genuine prudential framework for pension funds.

13. Notwithstanding these criticisms, the overwhelming majority of contributions fully supported the Commission's analysis in the Green Paper. Other topics raised during the consultations will be examined in the following chapters of this communication.

14. This communication will thus present the policy conclusions to be drawn from the consultations and set out the steps the Commission considers necessary in order to move towards a single market for supplementary pensions.

2. PRUDENTIAL RULES FOR PENSION FUNDS COMPATIBLE WITH THE SINGLE MARKET AND THE EURO

15. **This chapter explains how the euro and the single market can help increase the security and performance of pension funds. It outlines proposals for a directive on the prudential regulation of pension funds that are separate from the company and operate on a funded basis.**

2.1 Pension funds in the euro zone

2.1.1 Increased security of investment portfolios

16. The primary object of any prudential regulation is to protect consumers – or, in this case, members of pension schemes. The euro, by itself, with the elimination of currency risks and currency matching requirements within the euro zone, helps reinforce security. Pension funds, as well as insurance companies, can benefit from a wider capital market in which they can better diversify their assets and their risks. However, this cannot be considered sufficient: in order to really guarantee beneficiaries' protection, diversification of assets has to build on an accurate estimate of the duration and cost of the commitments. Pension funds have always to make sure that they hold enough liquid assets, denominated in the same currency as the commitments, in order to pay the benefits arriving at maturity. Furthermore, pension funds' activities have to be inserted in a overall prudential framework. Pension funds must, *inter alia*, be duly authorised and controlled by a competent authority. Members have to be informed, as well as possible, about how the fund is managed.

2.1.2 Increased efficiency of investment portfolios

17. If Member States opt for increased reliance on schemes to supplement the basic state social security scheme and if these schemes are funded, then an EU-wide capital market and the euro can make the accumulation of these funds more efficient via increased return on investment of pension fund assets. This can lead to higher pensions and thus help to sustain basic state systems, or reduce the social charges for any given pension and so have positive effects on the employment situation. But always, the balance between different pension schemes remains a decision for individual Member States.

18. The euro contributes to increased efficiency in investment portfolio management. Investors are able to make better use of deeper and more liquid capital markets due to the elimination of exchange risks, a reduction of transaction costs and increased competition between market participants. Most respondents to the Green Paper expect that an EU-wide capital market will provide much more capacity than individual national markets to absorb the likely growth in pension funds assets. EU equity and corporate bond markets are still underdeveloped and therefore provide a huge potential for expansion. This is especially true with regard to private bonds, which will offer a broadened spectrum of interest rates at the same time as the spectrum of public bonds is narrowing. Investment in private bonds could thus represent a significant source of revenue for pension funds in the future.

19. Pension funds should also play an important role in the development of pan-European risk capital markets because smaller and more innovative companies in the fields of key technologies and industries such as telecommunications, biotechnology, health care, financial services and energy are constantly searching for equity or corporate bond capital. They could usefully help financing the Trans European Networks projects, which aim at improving mobility across the EU and which can receive venture capital[16]. Given the need to always have a well diversified investment portfolio, pension funds will only invest a limited part of the contributions received in risk capital markets. However, if all European pension funds had 2% of their assets in risk capital shares, the impact on the growth of small and medium-sized companies would undoubtedly be quite significant.[17]

Box 3

The benefits to the economy and employment of a single market for supplementary pensions

A single market for supplementary pensions would be beneficial not only to pensioners and pension providers. More generally, the following benefits might ensue:

- enabling pension funds to invest on a continental scale and increasingly in shares is likely to improve their performance: this might help to reduce the indirect cost of labour, which is often a brake on job creation;

- enabling pension funds to invest more in shares would increase the supply of capital to European businesses. This would bring together investors and borrowers, thereby promoting the process of banking disintermediation. Once free of bank charges, businesses would be able to finance themselves more cheaply;

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[16] Decision 1692/96 of 23 July 1996.

[17] Commission proposals on pension funds have thus to be seen in conjunction with the work undertaken in the field of risk capital. See "Risk capital : a key to job creation in the EU" (SEC(98) 552).

- pension funds have a key role to play in the growth of SMEs, especially those which are innovative in the new technologies. In the Union, between 1991 and 1995 employment increased by 15% in businesses benefiting from risk-capital investment;

- by enabling pension funds to manage plans in more than one Member State of the Union, such funds would achieve economies of scale in terms of administrative and financial management, and this would have a knock-on effect on the indirect cost of labour. In a company or group of companies, a fund covering the whole Union might well replace 15 separate occupational schemes.

2.1.3 A qualitative approach to supervision

20. The euro is creating a huge pool of European capital denominated in a single currency. Market size and liquidity are thus increasing, allowing European companies to reduce their cost of equity capital and to borrow money on better terms. At the same time, the continued efforts of Member States within the Stability and Growth Pact to run smaller budget deficits and reduce the level of government debt will have the effect of "crowding-in" private-sector capital.

21. Hence, double dividends are within reach: for future pensioners and the economy of the Union as a whole. However, there are obstacles to bringing about this "golden scenario", capable as it is of providing a major stimulus to investment with positive consequences for job creation and growth.

22. Some of these obstacles are related to investment rules. Quantitative and rigid asset allocation rules applied in some Member States will hamper pension funds in their attempt to operate on an EU-wide capital market. Stringent limits on the proportion of equities that pension funds can have in their investment portfolio could notably reduce their rate of return (see box 4), without improving the security of the investments. In fact, excessively strict quantitative restrictions can even be a threat to security. Such restrictions might prevent investors from benefiting from the euro zone in order to diversify theirs risks. Moreover, experience shows the lower volatility, and hence the lower risk, of equity investment in comparison with government bond investment over the period of time of a retirement commitment (see Annex 4). Only a qualitative approach to supervision will provide pension funds with the necessary flexibility to achieve the appropriate mix between risk and return in view of the demographic sea-change and the opportunities provided by EU-wide capital markets. At the same time, and as mentioned before, every step needs to be taken to protect as well as possible the rights of members. Therefore, freedom of investment must always be subject to a proper diversification of assets and inserted into a global prudential framework.

23. This flexible approach will also enable pension funds to participate in the development of risk-capital companies. It is recognised that in the United States, at the end of the 1970s, the elimination of investment restrictions imposed on pension funds played a key role in the development of technologically innovative SMEs. Furthermore, these SMEs have provided high levels of returns (see Annex 5). Continued financing of pension provisions relying essentially on public debt, on the contrary, could have the effect of depriving industry, and especially small and medium-sized companies, of the private investment they need in order to play a positive role in the push for growth and employment.

Box 4:

How to improve both the security and performance of pension funds

In those countries in which pension funds are widespread and where they operate successfully, there are no quantitative restrictions on the mix of investments (e.g. listed and unlisted equities, bonds, real estate, loans, etc.). Annex 2 illustrates the better returns of pension funds which are not constrained by investment restrictions. These better returns have been achieved because the share of equities in the asset portfolio can be much higher than in countries which prescribe quantitative limits on the asset mix. They therefore take advantage of the better returns generally provided over the last few decades by equities in comparison with government bonds (see Annex 4).
Some Member States impose strict quantitative limits on certain classes of asset - especially equities - that pension funds can hold. Apart from the fact that this generally *de facto* reduces the rate of return of a portfolio, it is considered more prudent to invest a substantial part of the asset portfolio in equities because they can better meet the long term nature of pension liabilities. It is important to note in this regard that over the long term, as shown in Annex 4, equities are less volatile than government bonds. This is notably due to the constant growth, in the long run, of the real economy and productivity, reflected in the stock-market quoting of companies. Public bonds, while being more stable in the short term, are subject to inflation and interest-rate variations. Furthermore, equity investment can be regarded as an effective tool to tackle the inflation risks inherent in future pension payments.

Reducing quantitative constraints within an appropriate prudential framework would therefore give asset managers enough flexibility to increase equity investment as they see fit, thereby increasing pension fund performance while providing security.

2.2 Prudential rules for pension funds

2.2.1 Appropriateness of a directive

24. The consultations on the Green Paper on supplementary pensions showed that several Member States, several social partners and almost the entire financial sector consider that the lack of a framework for pension funds constitutes a major gap in the European legislation on financial services.[18] This is the view taken by the Economic and Social Committee, which, in its opinion of 10 December 1997,[19] indicated that a directive on fundamental principles would be appropriate. This is also the opinion of the European Parliament, which, in its resolution of 3 December 1998 on the Green Paper, asked the Commission to adopt a proposal for a directive which, in particular, could "enable pension funds to enjoy freedom of investment, lay down the spheres and limits of operation in the individual Member States, and the operating procedures for pension funds to raise capital on Community markets ..." and allows "...advisers to exercise the freedom to provide management services, if they are licensed to do so in any one Member State...".[20]

[18] It is worth recalling that the assets held by pension funds in the 15 Member States total around 23% of the Union's GDP. By way of comparison, assets of insurance companies amount to approximately 35% of GDP, operating in a single market based on nearly 30 legislative or regulatory acts.

[19] ESC 1403/97.

[20] Point 3 of Resolution A4-0400/98.

25. The euro contributes in itself to widening the investment opportunities available to pension funds. Possible restrictions contrary to the Treaty could for their part be eliminated by means of infringement proceedings. It follows, nevertheless, from the consultations that the combination of these two options would not have, for the social and financial operators concerned, the same advantages as a clear legal framework harmonising fundamental prudential principles.

26. A directive, moreover, seems necessary in order to allow the mutual recognition of prudential supervisory regimes, which is necessary for cross-border membership of pension funds. Numerous commentators stressed the need to lay down highly specific membership conditions, especially inside the same company or group of companies, and this despite the fact that there can be no question of opening up completely the supplementary pensions market, as supplementary schemes are closely linked to basic public schemes. But cross-border membership would facilitate the mobility of workers in the Union: the consultations showed without ambiguity that the impossibility of any cross-border membership constituted a major obstacle to such mobility. And it would enable pension funds to achieve economies of scale in terms of administrative and financial management.

27. The lack of mutual recognition of supervisory regimes is obviously not the only obstacle to cross-border membership. Other obstacles include, in particular, tax obstacles which are best treated within the framework of the Taxation Policy Group.[21] Obstacles that are inherent in the specific legal or regulatory provisions in force in some Member States (for example, the obligation to contribute to a national occupational scheme) should also be treated in cooperation with the Member States concerned. The proposal for a directive suggested here would therefore constitute only a first stage in the lifting of the various obstacles which, at this stage, prevent cross-border membership.[22]

2.2.2 Scope and content

28. In order to ensure a homogeneous scope, any directive could concern only those institutions which are genuine entities, are not part of the social security system and operate on a funded basis.[23] The choice of a directive covering pension fund institutions, and not all occupational pension products, would be consistent with existing European legislation on financial services. Products offered by life assurance companies and UCITS would not be affected as they are already covered by Community legislation.

29. In order to ensure that the above-mentioned objectives are met and to afford future pensioners the best possible protection, a future proposal for a directive could cover the following:

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[21] See section 4 below.

[22] It is desirable that any political action in this area should, were it to be decided on, be based on statistics reflecting economic reality in the sector. Eurostat has accordingly initiated the establishment of a common framework for the collection, compilation, transmission and evaluation of data on the structure, activities and performance of pension funds in the countries of the Union. This framework, which is annexed to Council Regulation 58/97, might be adopted in 2000.

[23] The need for an homogenous scope of a possible Directive seem to require that pay as you go and book reserves schemes remain outside of this exercise. However, entities managing these schemes should comply with the EC treaty provisions on free movement of capital and free provision of services. Furthermore, a list of social security institutions to be excluded from the scope of the proposal will doubtless have to be drawn up.

- **Basic prudential requirements**

  - separation of the assets of the pension fund and of the sponsoring company;
  - authorisation of pension funds by a competent authority and setting-up of a system of sanctions;
  - need to make authorisation subject to strict criteria regarding the responsibility, competence and integrity of managers;
  - definition of the supervisory authority's powers to intervene;
  - setting-up of a mechanism for periodic statements to members. Transparency is absolutely crucial for the protection of beneficiaries. They must always have the opportunity to be aware of the financial situation of the fund. This is especially true concerning defined contribution schemes in which the worker generally bears the investment risk.
  - setting-up of a mechanism for periodic statements to the supervisory authorities. These might be supplemented at regular intervals by an explanation of the overall investment strategy in the light of the commitments entered into.

- **Investment rules**

30. The principle of "prudent person" management (see box 5) drew wide support during the consultations. It would be the most appropriate regulatory framework with a view to free movement of capital and would allow managers to achieve optimum matching of assets to the nature and duration of their commitments, while taking account of changes in the economic and financial context. It is also suited to the usual profile of pension commitments: the liabilities extend over several decades. It is therefore vital that fund managers be in a position to use a variety of assets with greater or lesser liquidity. Any quantitative restriction of assets by category should be duly justified on exclusively prudential grounds. If Member States so wish, national authorities might be allowed to apply quantitative limits provided they do not unduly restrict freedom of investment (e.g. a 70% ceiling on stock investment). Legal requirements to the effect that funds must invest in specific categories of asset, and a proliferation of quantitative thresholds which in fact significantly restrict freedom of investment must, however, be avoided. Investments in a single issuer and in the sponsoring company should be limited to a prudent level (e.g. 5-10%).

Box 5:

Prudent person investment principle and modern asset-liability management techniques (ALM) - application in practice

The prudent person investment principle

Prudent person rules are general guidelines for those responsible for the conduct of pension funds and investment activities (e.g. fiduciary agents, trustees, asset managers). These rules are of a qualitative nature. The aim is that the responsible persons behave as careful professionals in making investment decisions, but at the same time are aware of the need to earn an adequate return on investments. Prudent person principles require that the fund does not assume unnecessary risk. In fact, it aims at diminishing risk through diversification.

The prudent person investment principle is not just an abstract principle but works in practice. Several Member States have successfully applied it over long periods. It has been shown to give security equivalent to other types of investment rules, but higher yields. If investment strategy is overly timid, this can have the effect of unnecessarily reducing returns. But reckless use of freedom of investment clearly violates the prudent person principle. Both situations lead to sub-optimal results and must be avoided.

Modern asset-liability management (ALM) techniques

Modern ALM is very helpful as a means of managing investment portfolios and ensuring that assets are invested in a way that reflects the nature and duration of the corresponding liabilities. The prudent person investment principle can be regarded as a substantial component of modern ALM techniques and of the financial risk management of financial institutions. These techniques provide information on risks of financial market volatility and their impact on both assets and liabilities.

A properly functioning ALM is most effective when there are no quantitative restrictions for fund managers and trustees in order to fulfil the needs of portfolio diversification as part of risk diversification. Risk diversification aims at improving the return-to-risk ratio of the investment portfolio. During the consultations on the Green Paper, professional respondents gave strong support to the idea that the diversification of investments permitted by an ALM approach would increase the protection of investors by minimising their exposure to problems arising in individual countries or types of investment, rather than increase risks.

For the time being, mathematical ALM techniques are used mainly in big institutions because of their cost. Small and medium-sized institutions use more conventional methods of liquidity planning. However, service provision in the field of risk measurement and risk management is a growing market.

Mature pension funds must always ensure sufficient liquidity. These mature pension funds will have liabilities with a short time horizon and high degree of risk aversion. In contrast, immature pension funds with long-term liabilities and whose cash inflow from contributions is higher than the cash outflow in the form of pension payments will reflect this situation in their investment strategy. Therefore, the share of cash and liquid assets in a portfolio covering short-term liabilities has to be higher than in immature pension schemes. Any given strict quantitative ceiling can thus prove to be appropriate for some pension schemes but not for all of them. Only a qualitative approach to prudential supervision can cater for the various structures of pension scheme liabilities.

Box 6:

Adequate supervision

The experience of those Member States which apply the prudent person investment principle and modern asset-liability management techniques shows that a strict supervisory framework is necessary. The sole application of the prudent person principle is not sufficient. It must be inserted in an overall prudential framework, with both internal and external controls via:

- scheme actuary and fund manager/trustee – internal controls;
- external auditor;
- competent supervisory authority.

Scheme actuary and fund manager/trustee – internal controls

The scheme actuary has to make sure that the pension commitments are calculated in a prudent way. He must ensure that the assets reflect the nature and duration of liabilities. The structure established by the actuary is the primary guarantee of pension security. Therefore the scheme actuary sets the framework for the scheme trustee who must ensure that this policy is efficiently carried out.

Internal control procedures usually comprise

- structural measures (e.g. strict separation of front-office and back-office functions with regular auditing checks);
- measurement and management of investment risks and of the information system.

External auditor

The external auditor has to check whether the internal control system implemented in a pension fund works effectively to guarantee a high level of security for the beneficiaries. He must therefore verify whether the internal control procedures established by the management are rigorous enough and whether the investment managers actually follow the prescribed procedures.

Competent supervisory authority

Pension funds usually report on the structure of their liabilities, and their investment policy plan is part of the annual accounts which may be examined by the competent supervisory authority. This provides the supervisor with the possibility of checking whether the applied risk diversification procedures and internal control structures are adequate. If he considers it necessary, the supervisor can impose remedial measures and sanctions. Given the key role asset management, trustees and actuaries play in the application of the prudent person principle, they are normally subject to special "fit and proper" criteria.

Most responses to the Green Paper considered that increased use of the prudent person investment principle and modern ALM techniques implies an important change and a challenge for those supervisory bodies that are applying strict quantitative limits at the moment. A shift from a quantitative approach to a qualitative supervisory approach may take time. But the benefits of such a change greatly outweigh the costs.

- **Currency matching requirement**

31. The negotiations leading up to the 1991 proposal for a directive failed essentially because of differences of opinion over currency matching. However, the euro considerably limits the scale of these difficulties by making any currency matching requirement within the euro zone unnecessary. With regard to countries not initially participating in EMU, solutions similar to those adopted in the insurance field could be considered, i.e. non-participating Member States could be permitted to consider that assets in euros match commitments in national currency.[24] It remains to be seen whether a matching requirement should be applied to assets in third-country currencies. European legislation imposes an 80% matching rule on insurance companies. The very long-term nature of commitments contracted by pension funds allows them, however, to worry less about exchange rate fluctuations. The view might also be taken that income from investments placed outside the European Union in countries which require capital and in which the proportion of the active population is greater than in the EU might usefully help in the coming decades to finance retirement benefits in EU countries. This question should be the object of further discussions between the Commission and the Member States.

- **Freedom of choice for managers**

32. The right of managers of pension funds to make use of any approved provider of management services (agent, asset manager) anywhere in the EU should be confirmed in any proposal for a directive.

- **Link between assets and liabilities**[25]

33. Protection of beneficiaries demands that freedom of investment be based on an accurate assessment of the commitments entered into by the fund (see box 7). This includes calculating technical reserves according to a prudent and recognised actuarial method. An appropriate calculation of technical reserves is the first guarantee of security for members, and the signing of the fund's accounts by an independent actuary might be considered in order to improve this security. A second guarantee might be to impose a minimum level of finance of pension funds in order to ensure that acquired pension rights are fully covered. Finally, a third guarantee is a prudent evaluation of the assets covering the technical reserves. The holding of assets in excess of technical reserves might also protect members against the risk of a sudden loss of value. However, any requirement in this respect should be moderate (e.g. around 5%) so as to limit the loss of tax revenues.

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[24] See point 5 of Annex 1 to Directive 92/96/EEC (third life assurance Directive). The following asymmetry should be noted: insurance companies established in Member States belonging to the euro zone do not have the possibility of matching their commitments denominated in euros with assets denominated in currencies of non-participating Member States.

[25] These comments apply above all to defined benefit schemes. In defined contribution schemes, the benefit to which the member is entitled is based on the total of contributions paid and income from the investments made with the funds so contributed; he therefore bears the entire investment risk.

Box 7:

Nature of the pension liability

The first line of security for future pensions is the calculation of future liabilities in a sufficiently prudent way. A sufficient provision for liabilities serves as a starting point when applying ALM and this procedure can be regarded as a core matter of security. Assets must then be chosen appropriately to match these liabilities. With respect to the variety of existing pension products offered in the market, general distinctions can be drawn between firm commitment pension plans (usually defined benefit schemes) and best effort commitment pension plans (usually defined contribution schemes).

In defined benefit schemes, the benefit to which the employee is entitled is determined by a formula which typically links the annual pension to the employee's years of service and earnings history. Such schemes can be unfunded (no separate fund), underfunded (fund is worth less than the present value of promised benefits), overfunded (fund is worth more than the present value of promised benefits) or simply funded (fund is worth the present value of promised benefits). The employer usually bears the investment risk and guarantees to make up any shortfall.

In defined contribution schemes the benefit to which the employee is entitled is based on the accumulated contributions made on the employee's behalf, together with the investment income earned on these contributions. A key feature of a defined contribution plan is that the beneficiary bears all the investment risk and by definition the retirement account is always fully funded.

A prudential framework for supplementary pensions must take into account the different implications of defined benefit and defined contribution schemes. The guarantees given to the employee and the question of who bears the investment risk are two key issues in this regard. The existence of so-called hybrid pension plans, which combine features of both defined benefit and defined contribution plans, has also to be taken into account.

2.2.3 Insurance against system failures (see box 8)

34. One additional safety measure might be to insure against the risks of the scheme being interrupted. In a defined benefit scheme, this type of insurance, which can take various forms (guarantee given by a third party, guarantee fund, state guarantee, etc.) is meant to remedy a situation in which the fund's sponsoring company becomes insolvent and the assets held by the fund are not sufficient to meet the commitments entered into. It might also be useful in the case of both defined benefit and defined contribution schemes as a means of remedying any fraudulent activities on the part of managers. However, a system of this kind needs to avoid the pitfall of the moral hazard. Knowing that acquired rights will in any case be honoured, some managers might be drawn into a risky investment strategy. It may be possible to avoid this altogether by limiting cover to cases of illegal transactions (e.g. fraud, embezzlement or theft).

35. Member States should consider whether this might be appropriate, in particular when it comes to responding to the problems which result from fraudulent transactions. It is essential that potential members, notably when cross-border membership becomes possible, be duly informed of the existence or otherwise of such insurance.

Box 8:

National experiences with regard to plan termination systems

- **Germany**: in 1996, about 57% of occupational pensions in Germany were established as book reserves. Under the book reserve method, firms must form a book reserve to offset the pension benefits earned by employees as these benefits accrue. There is no legal separation of assets that cover the pension liabilities from other assets of the company. To protect the promised pension benefits in the event of employer insolvency, the book reserve system is accompanied by mandatory insolvency insurance. Insolvency insurance is provided by the Pensions-Sicherungs-Verein auf Gegenseitigkeit (PSVaG), a mutual insurance corporation. Apart from investment returns on PSVaG assets, employers are required by law to make contributions sufficient to finance the insolvency insurance on a pay-as-you-go basis.

- **United Kingdom**: the minimum funding requirement (MFR) sets out a statutory funding level most private-sector defined benefit occupational pension schemes must meet. The MFR is a discontinuance test aimed at ensuring that the scheme has sufficient funds to meet members' benefits at any time, thus providing protection if the employer becomes insolvent. Apart from the MFR, all UK pension schemes are generally part of the Pensions Compensation Scheme, which provides compensation to members in certain limited circumstances where the assets of the scheme are insufficient to pay benefits (there should be at the same time insolvency of the employer, underfunding of liabilities by more than 10% and reduction of assets caused by theft or fraud). The compensation is financed by a levy payable by all schemes.

- **United States**: the Pension Benefit Guaranty Corporation (PBGC) guarantees pensions provided by defined benefit schemes. In general, US defined benefit schemes are required to purchase PBGC insurance, whereas PBGC is required to provide coverage to protect participants in these plans. PBGC is financed by premiums from insured pension plans, investment returns on PBGC assets, assets held by plans at termination and amounts recovered from employers who terminate underfunded plans.

2.2.4 Means of ensuring equal treatment of operators

- **General comments**

36. The consultations showed support for the idea that similar pension products should be subject to equivalent prudential treatment, irrespective of the institutions offering them (life insurers, pension funds, combined banks and insurance companies, UCITS). The main service providers currently operating under pillar 2 are pension funds, both open and closed (see box 9), and life assurance companies. Annex 3 indicates some of the differences between these institutions and the products they offer.

37. In general, the Commission considers that a specific prudential framework should be defined for pension funds. Applying rules identical to those applicable to life assurance would not seem appropriate given the existence of several institutional and functional differences between the two. It is, however, absolutely essential that everything should be done to offer pension fund members the highest possible standards of security. This means that account should be taken of the diversity of existing pension funds and that precise and strict rules should be laid down which take account of both the assets and liabilities on pension funds' balance sheets, as has already been done for insurance companies.

- **Equality of treatment at the level of the institution**

38. At the level of the institution, the insolvency of a life assurance company and the interruption of a pension fund scheme have very different consequences for beneficiaries. Where the operation of a pension fund is interrupted, members are generally deemed to own the assets held by it. By contrast, when a life assurance company becomes insolvent, policy-holders will often form a group of creditors which has a lower claim than other creditors (the liquidator, the company's employees, the tax authorities, social security institutions). The need to protect beneficiaries might therefore justify stricter prudential rules.

39. Still at the level of the institution, it should be remembered that most pension funds operating in the Union are closed funds which offer their services on a non-profit-making basis to a single firm or a single group of firms within the same branch of the economy.[26] Such institutions predominate in the United Kingdom and the Netherlands, the two Member States in which pension funds are most common. These institutions do not seek to offer their products to other employers and this distinguishes them from insurance companies. A competition problem can arise, however, prior to the setting-up of an occupational pension arrangement. At this moment, the employer and/or social partners have the choice between the services of a life assurance company, the creation of a closed fund, participation in an open fund or other arrangements.

[26] See Box 6 and Annex 2.

Equality of treatment at the level of the product

40. At the level of the product, it must be stressed that, in the bulk of cases, pension funds do not themselves guarantee payment of the pension. In the case of defined benefit schemes, payment is usually guaranteed by the employer, while in defined contribution schemes, the member usually bears the investment risk. Life assurance companies, on the other hand, usually commit themselves to a guaranteed fixed rate of interest. Life assurance companies offering products where the investment risk is borne by the investor are an exception. In such cases, there is a lower solvency margin requirement (1% of mathematical provisions instead of 4% when the insurance company bears the investment risk).[27] This fact also seems to militate in favour of different prudential treatment.

41. Competition might, however, be distorted if, in the same way as an insurance company, a pension fund itself guaranteed to pay benefits. In this case, application of a solvency margin of 4% of the mathematical reserves should be contemplated. This is, incidentally, how things are regulated for pension funds in several EU Member States, including Germany and Spain.

- **Equality of treatment and investment rules**

42. Inequality of treatment might also occur at the level of investment rules. This would be the case, for example, if the investment rules proposed in a future directive were more flexible than the national provisions adopted by some Member States in transposing the investment rules of the third life assurance Directive. This problem might be dealt with in two ways: either unilaterally by the Member States concerned, which, while remaining within the framework established by the third Directive, might make their investment rules more flexible, or multilaterally, by considering the possibility of drawing up ad hoc investment rules for covering the technical reserves linked to group policies taken out with life assurance companies.

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[27] See Article 19(e) of the first life assurance Directive (79/267/EEC).

Box 9:

Issues to be considered in order to ensure a level playing-field between occupational pension providers

The problem of the level playing field can only be solved through a comprehensive analysis of pension business managed by the various types of pension providers. The following elements have to be considered.

- The type of benefits offered: a distinction must be made between firm commitment pension business (usually defined benefit plans) and best effort commitment pension business (usually defined contribution plans). The plan/scheme can be financed through a diversity of vehicles, e.g. pension funds, insurance programmes, etc.;
- The type of guarantees offered: a distinction must be made between company-sponsored pension funds (where the employer usually bears responsibility for the final delivery of pension benefits) and open or autonomous pension funds (institutions that themselves bear responsibility for the payment of the benefit or where all the risks are borne by the employee);
- The types of risk: a distinction must be made between technical risks (risks relating to pension liabilities, notably actuarial calculations and underlying projections) and financial risks (risks relating to assets covering pension liabilities, notably investments, interest rates and inflation);
- The type of pension asset administration: a distinction must be made between self-administration (where the institution manages the pension business assets and pension business liabilities itself), simple financial management[28] and financial management with guarantee;[29]
- The rights of pensioners in case of insolvency: a distinction needs to be made between pension funds where future pensioners are the sole creditors and life assurance companies where future pensioners are only one in a list of creditors whose preference is ranked according to national law.

[28] Business line run by life assurance companies pursuant to Article 1(2)(c) of Directive 79/267/EEC.
[29] Business line run by life assurance companies pursuant to Article 1(2)(d) of Directive 79/267/EEC.

2.2.5 *A new context*

43. The withdrawal of the proposal for a directive presented by the Commission in 1991 and amended in 1993[30] and the problems linked to the 1994 communication[31] have highlighted the difficulty of reaching agreement between the Member States on how the prudential supervision of pension funds should be brought into line with the principles of the single market. However, in the light of the reactions to the Green Paper and the consultations which have taken place in the context of the framework for action on financial services, the Commission considers it should take this matter up again.

44. While remaining true to the central objectives of freedom of investment and management, this new initiative should differ from earlier proposals on a number of points. Drawing the lessons from the consultations, the new proposal should place greater emphasis on fund security and compliance with basic prudential requirements. It would thus not focus solely on asset allocation, but would take better account of constraints linked to the liabilities on a pension fund's balance sheet and the need to avoid creating any distortion of competition between the main operators in the area of supplementary pillar 2 pensions. Finally, the proposal should be more ambitious and strive to take a first step towards creating the conditions necessary for cross-border membership. The probable emergence in the long term of transnational products calls for the development in the Union of cooperation between national pension fund supervisors. The specifics of such cooperation should be considered in the near future.

45. A proposal for a directive would be put forward in a very different context to that prevailing in 1991. Apart from the single currency, which offers pension funds greater security and wider investment possibilities, there is nowadays much greater consensus on the need to reform pension schemes in order to face up to the budgetary and demographic prospects summarised in the first chapter of the Green Paper. These prospects require all public authorities to do their utmost within their respective areas of competence to ensure the long-term financial sustainability of pension schemes. Enabling supplementary schemes to take advantage of the single market and the euro should be seen in this context.

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[30] 91/C 312/04.

[31] 94/C 360/08.

3. FACILITATING THE FREE MOVEMENT OF WORKERS

46. **This chapter examines the problems generated by occupational pension schemes for the free movement of workers in the Union.**

47. A fundamental principle of the single Market, labour mobility is, potentially, all the more important now that Economic and Monetary Union has been established. Europe already has effective community rules which co-ordinate first-tier pensions for migrant workers. These have allowed millions of EU workers to migrate within the Union for all or part of their working lives, secure in the knowledge that they can receive a retirement pension based on the aggregation of their years of work throughout the Union. By contrast, the absence of such a co-ordinating system for supplementary pensions constitutes a real barrier to free movement on the part of those European citizens who are covered by such systems. This barrier will, if Member States choose to rely increasingly on supplementary pensions, affect more and more people and will, in the process, damage the capacity for mobility within the European labour force.

48. Successive European Councils have stressed the paramount importance of creating conditions in the Member States that would promote a skilled and adaptable workforce and flexible labour markets responsive to economic change. The remaining problems relating to supplementary pensions constitute real obstacles to free movement and adaptability. In order to meet the objectives of the European Employment strategy, these challenges require active intervention by the member States and the European Union.

3.1 General considerations

49. Article 42of the EC Treaty specifies that the Council shall, acting unanimously on a proposal from the Commission, adopt such measures in the field of social security as are necessary to provide freedom of movement for workers.

50. On this basis, the Community adopted legislation (Regulations (EEC) No 1408/71 and No 574/72)[32] which aims to remove obstacles to cross-border mobility of workers in the field of statutory pensions. The legislation does not interfere with the freedom of Member States to determine the organisation of their own statutory pension schemes; it seeks to ensure that the potential mobility of a worker is not impeded by being penalised in terms of pension (and other social protection entitlements) on moving from one Member State to another.

51. These Community Regulations, however, do not apply to supplementary pension schemes.

52. In this connection as far back as its Communication to the Council of July 1991, the Commission addressed these questions and mapped out the future action to be taken in this area. While stressing the positive role played by_supplementary pension schemes in providing workers with social protection, it highlighted a number of obstacles to the free movement of workers and thus to the completion of the Single Market.

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[32] The updated version of these Regulations is published in OJ L 28 of 30.1.1997. Since the extension of the personal scope of the Regulations to self-employed persons, the additional legal basis of Article 308 of the Treaty has been required.

53. The treaty requires the elimination of any national measure likely to impede or render less attractive the exercise by workers of the fundamental freedoms guaranteed by the Treaty as interpreted in successive judgements by the Court of Justice[33]. Action is, therefore, needed to remove such obstacles in order to facilitate cross-border mobility of workers while taking account of the specific features of supplementary pension schemes.

54. In the Green Paper on Supplementary Pensions in the Single Market, the Commission posed a number of questions to all interested parties (including governments, social partners, and supplementary pension scheme representatives) which are intended to deepen the analysis of the remaining problems which constitute obstacles to free movement. They concerned in particular long vesting periods, difficulties with transferability of vested pension rights and tax difficulties linked to acquiring pension rights in more than one Member State.

3.2 Results of the consultation on the Green Paper

55. In the field of social security, regulation 1408/71 has permitted the co-ordination of the schemes of employed, self-employed people as well as their families. The diversity of national schemes could only lead to co-ordination and not harmonisation. An approach based on co-ordination and not harmonisation would also be appropriate for supplementary schemes.

56. The responses to the Green Paper demonstrated that there is a large consensus on the Commission's approach to the elimination of obstacles to free movement related to supplementary pensions. This elimination should be progressive and, therefore, Directive 98/49/ECadopted on 29 June 1998 should form the basis of further action. This Directive represents a first step towards removing obstacles to the free movement of workers. Under the Directive, posted workers now have the possibility to continue to make contributions to the pension scheme in the Member State of origin.

57. A majority of Member States think that further new legislative action is at this stage premature. Nevertheless, a majority of other actors (social partners, pension funds) recognise that the problems identified in the Commission's Communication of 1991 and in its Green Paper on Supplementary Pensions are real, and that they impede free movement of persons within the European Union. The European Parliament and the Economic and Social Committee also consider that the problems encountered by workers moving within the European Union are significant, and that the Community should take further action to eliminate these obstacles since they are incompatible with the concept of the Single Market.

58. There is also a view that before taking any further action, the Commission should have a closer look at how questions such as transferability of pension rights, long vesting periods and problems related to double taxation, should be tackled.

59. Cross-border membership, at least for some categories of migrant workers moving for a short period to another member State, could be useful in order to avoid changes from one scheme to another and losses of pension rights. However, cross-border membership of workers will be very difficult to realise in practice. Apart from the harmonisation of prudential rules presented in the previous chapter, it will require mutual recognition of

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[33] See Case C-279/93, *Finanzamt Köln-Altstadt v. Schumacher,* judgment of 14 February 1995, ECR p. I-225; Case C-19/92, *Kraus*, judgment of 31 March 1993, ECR p.I-1663; Case C-80/94, *Wielockx*, judgment of 11 August 1995, ECR p. I-2493; Case C-107/94, *Asscher*, judgment of 27 June 1996, ECR pI-3089.

the relevant fiscal provisions in Member States and a series of amendments to existing national regulations governing labour conditions. However, cross-border membership would strongly facilitate labour mobility in the Union and is asked for by representatives of the industry. It should thus be seen as a medium to long-term objective for the European Union.

60. The idea of a Pensions Forum, as suggested by the High Level Panel on Free Movement, was generally welcomed by the social partners but not by government representatives who preferred that the Commission use the existing bodies organised at Community level such as the Advisory Committee for Social Security of Migrant Workers. This is also the proposal of the Economic and Social Committee. The European Parliament welcomes, however, the idea of such a Forum.

3.3 Possible actions

61. The responses to the Green Paper would suggest that there are a number of areas in which future action might be taken.

- **Qualifying conditions for acquiring supplementary pension rights**

62. It is evident from the reactions to the Green Paper that this is an issue where there is no consensus amongst Member States. At this stage, a legislative framework seems to be premature. However, it cannot be denied that qualifying conditions in broad terms can constitute an obstacle to labour mobility.

63. The creation of a skilled and adaptable European workforce for the next century is a central element of the European Employment Strategy and, as such, is a key policy objective for the Union. Long vesting periods for supplementary pension schemes tend to hamper the ability of workers to move in response to labour market developments: something which is likely to be of greater importance than ever in the future world of work.

64. In addition, it could be argued that long vesting periods are a source of indirect discrimination affecting female workers, since they are most likely to change jobs or interrupt their careers. This aspect has been emphasised on several occasions by the social partners and the European Parliament.

65. The Commission would feel that it would be appropriate to open a debate at European level with the social partners in order to examine how this obstacle to free movement can be overcome.

66. The Commission will also take particular care to ensure that discriminations based on sex are eliminated in the area of supplementary pensions.

- **Cross-border affiliation for workers, other than posted, moving from one Member State to another for a short period**

67. Directive 98/49/EC of 29 June 1998 allows workers who are posted by their employer to another Member State, to remain affiliated to the supplementary pension scheme in the Member State where they were previously working. All other workers moving for a limited period to another Member State do not have this option. Like posted workers, these people expect to return to their Member State of origin and would normally wish to do so without a break in the accrual of their pension rights. Consequently, they would

benefit from being able to continue to make contributions to the supplementary pensions scheme in the Member Sate of origin.

68. All the comments received by the Commission indicate that cross-border affiliation, as described above, would be an important step in terms of removing obstacles to free movement of labour across Member States' boundaries, but that it would be difficult to put into practice. It requires the lifting of a number of obstacles to the continued affiliation of the worker to his/her former pension scheme. An agreement between the old employer in the Member State of origin, the new employer in the host Member State, the worker, and where applicable, the supplementary pension scheme in question is not always easy to achieve.

69. The Commission will launch a study to examine in detail how the difficulties for cross-border affiliation of this category of workers could be overcome. In the light of the results of this study, the Commission will take the appropriate action in order to tackle this problem.

- **Transferability of pension rights**

70. The need for action in this area was, in particular, emphasised by trade unions and representatives from pension funds. It is undeniable that the calculation of transfer values which penalise scheme leavers and inadequate preservation of "dormant" rights are severe obstacles to labour mobility.

71. The wide variation in the method of financing supplementary pensions in the actuarial calculation of transfer values and in taxation treatment, makes transferability from one Member State to another difficult. Technically it is possible in all countries to accept transfers from another Member State but this ability is theoretical or impossible in practice for certain schemes such as the book-reserve and pay-as-you-go schemes both of which do not set aside financial assets to back up their pensions commitments. Transferability would be possible only in the case of funded schemes where the nature of the scheme permits it.

72. In a general way, within one Member State there are common actuarial standards to calculate the values of capital transfers from one scheme to another, provided that the schemes are of a similar nature . However, in the absence of a standard approach to the treatment of capital transfers in the supplementary schemes between Member States, a worker moving to another Member State is disadvantaged more than if transferring capital values to another company within his or her home country.

73. A lowest common denominator for the calculation of the amount of capital transfers and the conversion of such transfers into future pension provision could help to overcome part of the problem.

74. In cases where capital transfers are not possible, preservation of vested rights would be the only option. In these cases, a guarantee should be created that the "beneficiaries" of so-called dormant rights will get a fair share out of their supplementary pension scheme. It is clear that all of these goals will take some considerable time to achieve.

75. The Commission will intensify its efforts with the assistance of all parties involved (representatives from governments, social partners and supplementary pension funds) to resolve the 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.

76. This would serve as a basis for further exploration of the necessity for a legal framework on transferability of vested rights.

77. The Commission will also continue its research in the area of supplementary pensions with the publication of a biennial report on the situation in the different Member States. This will be prepared in collaboration with a network of high-level national experts on supplementary pensions.

- **Pensions Forum**

78. The establishment of a Pensions Forum has been suggested by the High Level Panel on Free Movement. Such a Forum would serve as a vehicle to bring together representatives of all involved parties (governments, social partners and pension funds) to consider how barriers to cross-border labour mobility related to supplementary pensions can be addressed. The Forum could assist the Commission to find appropriate solutions for the remaining problems identified, as well as in relation to the follow-up of existing Community legislation. .

79. The Commission supports this idea and has, accordingly, decided to convene a Pensions Forum which will meet twice a year, to be composed of representatives of government, social partners, pension funds and, if appropriate, other institutions active in this field.

4. TOWARDS A BETTER COORDINATION OF NATIONAL TAX SYSTEMS

80. **The Green Paper dealt with both 2nd pillar and 3rd pillar arrangements, and the basic tax problems are indeed identical. For practical reasons, however, the first step of staged Community action could tackle the tax treatment of cross-border contributions by migrant workers to supplementary pension institutions within the 2nd pillar alone.**

4.1 Results of the Green Paper consultations

81. The diversity, complexity and specificity of national tax rules that have developed over the years have been identified as major barriers to the free movement of persons and the freedom to provide services in the field of supplementary pensions and life assurance. Basically, the problems are the general question of how to treat cross-border payments to supplementary pension funds or life assurance companies and the fact that migrant workers are confronted with two or more pension and taxation systems which are not necessarily compatible.

Box 11:

Summary of the problems resulting from heterogeneous tax regimes

- In many Member States the tax treatment of supplementary pension contracts and life assurance policies which have been concluded with non-resident institutions is less favourable than the treatment of policies with resident institutions. Generally, there is no principle of mutual recognition, so it is unlikely that a pension scheme approved in one Member State will meet the requirements for tax relief which is granted to schemes in another Member State. Consequently, persons interested in supplementing their pensions can, in practice, only buy national products if they wish to benefit from tax relief. Pension and life assurance institutions from other Member States are thus forced to set up an establishment in each Member State in order to secure the same tax conditions for their product. This negates freedom of services and freedom of choice for the consumer.
- A worker migrating from one Member State to another is often prevented from continuing with a policy held in his Member State of origin because the host Member State does not allow the deduction of premiums paid, or else taxes the contributions paid by the employer in circumstances in which contributions to an institution in the host Member State would not be taxed.
- The most serious problems have been identified with persons migrating from a Member State which operates the so-called EET system (contributions are exempt, growth of the policy is exempt, benefits are taxed) to a Member State with the so-called TEE system (contributions are taxed, growth of the policy is exempt, benefits are exempt) or vice versa. This basic mismatch of systems can lead to situations of double non-taxation (contributions can be deducted and proceeds are not taxed) or double taxation (both contributions and proceeds are subject to taxation).
- During the consultations, many expressed the view that the EET system is the most appropriate approach and should, in the long run, be generally applied. Its main advantage is that no tax is levied on an unsure future benefit when a pension is not inherited and the beneficiary may die before retirement (in which case, under a TEE system, he would have paid taxes via his contributions on pension payments he never received).
- Pension and life assurance institutions can also face tax obstacles, notably when investing across borders. Some of these obstacles are linked to the fact that pension institutions are often not subject to tax. An example mentioned in the reaction to the Green Paper was the capital gains tax imposed by a Member State on non-resident institutions which invest in assets located or traded in that Member State, compared with resident pension institutions which are exempt. This biases decisions on asset allocation within the single market. As to the accumulation of pension fund benefits, tax rebates are sometimes only given in respect of investment within the Member State concerned.
- Clearly, the above problems are exacerbated when more than two counties are involved. This is the case, for instance, where a migrant person is working in one Member State for a multinational company based in another and contributing to a supplementary pension fund in a third Member State. Therefore, some contributors stressed the need to find European solutions, in particular a definition of a pension plan that would be recognised for tax purposes in all Member States. In their view, this could then lead to the establishment of tax-efficient, genuine pan-European pension funds that can operate throughout Europe and thus benefit from the resulting economies of scale.

82. The consultations also touched on the question of how these problems could be overcome. Some contributors expressed the view that the Commission should draw up guideline standards, based on principles and practices that are common to a number of existing bilateral agreements. In the discussions it was stressed that non-binding measures might be easier to achieve, but that their practical use might also be limited. An advantage of bilateral tax treaties is that they can be tailored to the pension systems of the countries concerned. On the other hand, it would be extremely cumbersome and time-consuming for Member States to negotiate and renegotiate 105 agreements[34] and this would still not guarantee equal treatment and non-discrimination. The immediate practical value of guideline standards could therefore be limited, as it would take decades to integrate them into the bilateral tax treaties.

83. Others contributors were of the opinion that Community legislation would be the most reasonable solution. The mutual recognition of pension schemes, criteria for the general recognition of genuine old-age schemes for tax purposes, rules allocating the right to tax in a way which prevents double taxation, but also rules to ensure an appropriate level of taxation, an effective system for the exchange of information, and efficient rules on mutual assistance in collection were mentioned as possible features of a Community initiative. Mention was made of a multilateral convention or a directive as examples of legally binding measures, providing legal certainty and creating a level playing field.

4.2 Possible actions

84. This is particularly important for workers moving from one Member State to an another who risk losing benefit rights already acquired under the scheme in the Member State where a pension has already been taken out. At present, there is no Community legislation governing the allocation of the right to tax pension income, or the tax treatment of transfer values representing pension rights acquired under a previous pension scheme. Nevertheless Member States should ensure that workers exercising their right to free movement should not be subject to any form of undue restriction or discrimination, in accordance with Articles 39 and 43 and Regulation 1612/68.[35]

85. Whilst there should be safeguards to ensure that tax cannot be avoided by a migrant worker or a pensioner, Member States should ensure that migrant persons are not subject to any form of double taxation. Most bilateral taxation treaties currently include such provisions, often drafted along the lines of Article 18 of the OECD Model Tax Convention on Income and on Capital, which attributes the right to tax to the country of residence. If no bilateral treaty exists, the way in which double taxation is avoided depends on the national legislation of the relevant Member States.

86. In a statement in the ECOFIN Council minutes of 1 December 1997, the Commission undertook to consider the problems of the taxation of life assurance and pensions with the assistance of the Taxation Policy Group and with a view to possibly drawing up a proposal for a directive. The ultimate objective of this work is to ensure in practice the free movement of workers and self-employed persons (Articles 39 and 43of the EC Treaty) and the freedom to provide services (Article 49 of the EC Treaty), as provided for in the 3rd life assurance Directive 94/96/EC. This work has already begun.

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[34] Within the Union, there are 105 possible bilateral relations, of which 98 are currently covered by a bilateral or multilateral tax treaty. Only a few of them already contain comprehensive arrangements in this area. In a Union with 20 Member States there will be as many as 190 bilateral relations.

[35] Regulation (EEC) No 1612/68 of the Council of 15 October 1968 on freedom of movement for workers within the Community, OJ L 257, 19.10.1968, p. 2.

- **Principles for a coordinated approach**

87. In the Commission's opinion, the Green Paper on supplementary pensions, the written reactions and the hearing which followed show that there is a general consensus on the need for coordinated action on the basis of a step-by-step approach. After reviewing the results of the consultations, the Commission draws the conclusion that such a coordinated approach should build on the following principles:

 - The purpose is not to seek harmonisation of Member States' pension and life assurance taxation systems. A coordinated approach would be adapted to the diversity of rules within Member States. This approach has been successfully followed in the social security field, namely in Regulation 1408/71.

 - The freedom to provide services and the free movement of persons cannot be hampered by unduly restrictive or discriminatory tax treatment of cross-border pensions and life assurance.

 - Any common approach should allow and help Member States to safeguard the tax revenues which they are entitled to collect according to their tax legislation. It should provide for a system which is enforceable and which stimulates compliance with tax legislation by convincing taxpayers that they cannot escape their obligations, wherever they go or invest within the Union.

- **The influence of the case-law of the European Court of Justice**

88. According to the case-law of the European Court of Justice, restrictions resulting from unjustified differences in the tax treatment of cross-border pension and life assurance are contrary to the EC Treaty, in particular Articles 39, 43, 49,et 56. In the *Safir* case,[36] the Court held that rules entailing differences in the tax treatment of foreign insurance policies which were likely to dissuade individuals from concluding insurance policies with insurers established in other Member States were in principle contrary to Article 49 of the Treaty. The Court robustly rejected all the arguments put forward to justify the restriction, in particular that of fiscal coherence. It should be noted that on no occasion since the *Bachmann* case [37] has the Court entertained this specific justification for tax policies.

- **State of play in the Taxation Policy Group**

89. At the meeting of the Taxation Policy Group on 3 July 1998, members were invited to express their views on the main issues relating to a coordinated approach for the taxation of supplementary pensions and life assurance. There was unanimous agreement on the need to do further work on the issue, with most members agreeing to a coordinated approach. The above-mentioned principles - no harmonisation, no discrimination, no revenue shortfall - were very broadly endorsed. There seemed to be support for tackling

[36] Case C-118/96 [1998] ECR I-1897.

[37] Case C-204/90 [1992] ECR I-249. The Court held that Belgium's refusal to allow deduction of pension and life assurance premiums constituted discrimination contrary to Article 39 and 49 However, it also held that, according to the characteristics of the Belgian pension tax system, such discrimination was justified by the need to preserve fiscal coherence. It is worth recalling that the Belgian tax system consisted in a delayed tax payment and not in an exemption given to pensions taken out in Belgium. In those circumstances, the refusal to grant an exemption for the premiums of non-Belgian insurance was balanced by the fact that no taxation would have been imposed on the proceeds of such an insurance policy, in contrast to a policy subscribed in Belgium. The Court's reasoning relating to fiscal coherence was set out more precisely in Case C-80/94 *Wielockx* [1995] ECR 2493.

as a matter of urgency the problems of migrant workers and there was also some support for exploring ways of improving the exchange of information. Some members favoured legally binding measures - a multilateral convention was a frequently mentioned option - but others clearly opposed any legally binding solution, and could only support guidelines. Some members also stressed the need to take account of social and legal problems, instead of simply focusing on tax aspects.

90. At the meeting of the Taxation Policy Group on 8 March 1998 there was agreement that a staged step-by-step approach would be advisable for addressing the differing and complex problems. Members also agreed that the first step should ideally tackle the tax treatment of migrant workers' cross-border contributions to second pillar institutions. Bookreserves schemes would nevertheless not be covered, since there are no contributions paid by the employees but only a commitment of the employer.*

Future work to be envisaged

91. The Commission believes that the Taxation Policy Group is the most suitable forum for consultation with Member States on how to take the issue further. Given the complexity of the topic, it has been decided to create a technical sub-group which will assist the Taxation Policy Group.

92. The Commission hopes that, on the basis of the work in the Taxation Policy Group and the technical group, it will be possible to formulate an appropriate legislative initiative in 1999 or 2000. It follows from the foregoing that such initiative would be only the first step in the direction of broader action in this field. This first step could usefully cover the tax treatment of cross-border contributions by migrant workers to supplementary pension institutions.

ANNEX 1

Measures to be considered following the consultation on the Green Paper on supplementary pensions in the single market

Measure	Objectives	Institutions/bodies concerned	Possible timeframe
Proposal for a directive on the prudential regulation of pension funds	To protect members' rights, ensure freedom of investment and management, and facilitate cross-border membership.	Commission, interested parties, then Council, Parliament and Economic and Social Committee.	Adoption by the Commission at end of 1999/early 2000. Negotiations with Council and Parliament from 2000.
Coordination of Member States' tax arrangements in the field of pensions and life assurance	To facilitate labour mobility and ensure freedom to provide supplementary pension and life assurance services.	Member States, Commission (in context of Taxation Policy Group). Council, Parliament and Economic and Social Committee (if proposal for a directive is presented).	Consultations to be continued in 1999. Possibility that a proposal for a directive will be presented by the end of 1999 or early 2000.
Consultations on the conditions for acquiring supplementary pension rights	To identify means of facilitating labour mobility.	Commission and employer/employee organisations.	During 1999/2000.
Feasibility study on cross-border membership	To examine in detail the obstacles to cross-border membership, and identify ways of eliminating them.	Commission	During 1999/2000
Creation of a pensions forum	To create a forum for specific dialogue on pensions and labour mobility.	Commission	During 1999 or 2000
Technical work on transferability of supplementary pension rights	To examine the conditions for introducing a legislative proposal.	Commission in conjunction with Member States, the pension fund industry and employer/employee organisations.	During 1999/2000. Possibility that a proposal for a directive will be presented during 2000.

ANNEX 2

Returns on pension fund portfolios 1984–96
(mean of real total return in local currency)

Percent domestic currency	**1984–93**	**1984–96**
Belgium	8.8	9.0
Denmark	6.3	6.0
Germany	7.2	7.0
Ireland	10.3	11.0
Japan	6.5	0.0
Netherlands	7.7	8.0
Spain	7.0	–
Sweden	8.1	–
Switzerland	4.4	4.0
United Kingdom	10.2	10.0
United States	9.7	9.0
No asset limits	**9.5**	**9.5**
Asset limits	**6.9**	**5.2**

Sources: EFRP report, June 1996; Pragma Consulting; and OECD staff calculations

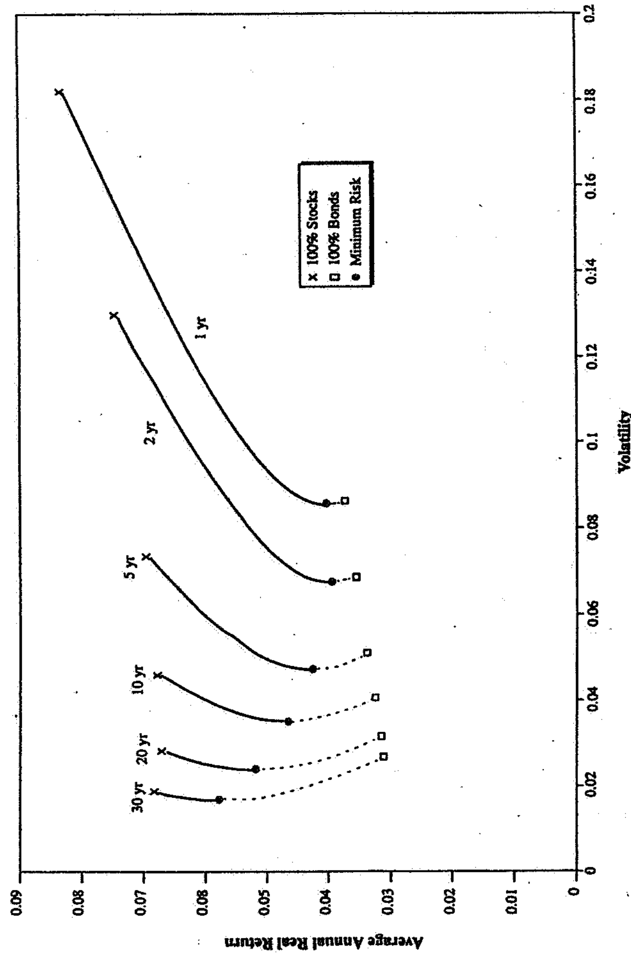
Annex 3

Indicative comparison between life assurance companies, open pension funds and closed pension funds

	Life assurance companies (via group policies)	**Open pension funds**	**Closed pension funds**
Nature of activity	Commercial activity based on a variety of products	Commercial activity generally based on a single product	Generally non-commercial activity based on a single service
Relationship to other financial operators	Service provider	Both service provider and consumer	Both service provider and consumer
Situation in the event of an occupational scheme being interrupted	Policyholders are generally one of several groups of creditors.[38] Each group has its claim met in a specific order.	Members are generally deemed to own the assets held by the fund	Members are generally deemed to own the assets held by the fund.
Guarantee of payment of supplementary occupational benefits	Provided by the insurer except in the case of policies linked to an investment fund where it is stipulated that the insurer does not assume any investment risk	Generally provided by the pension fund in the case of defined benefit schemes; investment risk borne by the employee in defined contribution schemes.	Generally provided by the employer in the case of defined benefit schemes; investment risk borne by the employee in defined contribution schemes.
Relationship to members of occupational pension schemes	Indirect, via the employer.	Indirect, via the employer.	Members frequently participate in the management of the scheme

[38] See the proposal for a Commission directive on the winding-up of direct insurance undertakings (89/C253/04, OJ C 253, 6.10.1989).

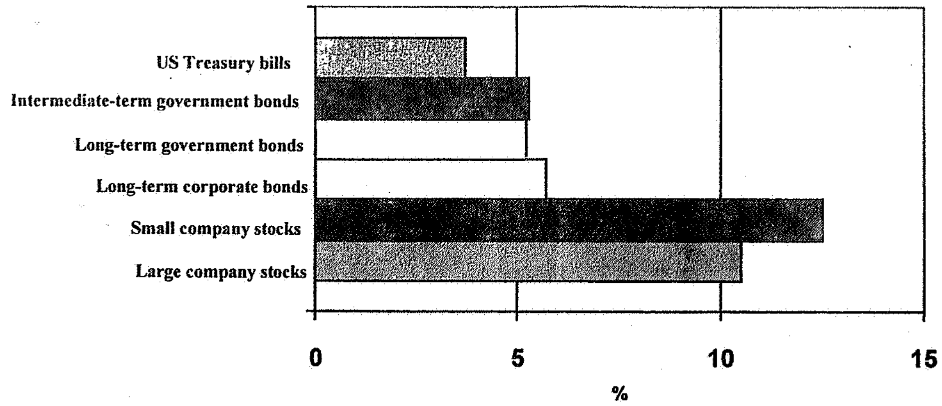
Risk/Return Trade-offs for Various Holding Periods (1802 – 1995)



Source: Professor Jeremy Siegel, "Stocks for the Long Run," (Irwin Professional Publishing, 1994)

Morgan Stanley Equities Analytical Research

This annex shows that for periods longer than 10 years, a portfolio consisting of 100% stocks was equally volatile (in other words, equally safe) as one consisting of 100% bonds but that shares had returns of approximately 7% and bonds of only 3-4%. Over a working life, a difference of 3% every year is enormous. Minimum risk shows lowest possible volatility that could have been obtained with the best mix of bonds and stocks.



Source: Morgan Stanley Dean Witter

<u>ANNEX 6</u>

Equity versus Bond Markets
Excess Return Equities
Local Currencies

Annualised figures	15 year period 1984–1998	10 year period 1989–1998
Belgium	9.09 %	1.98 %
France	3.12 %	0.17 %
Germany	4.36 %	3.71 %
Italy	0.95 %	-3.47 %
Netherlands	7.18 %	7.95 %
Sweden	4.32 %	2.94 %
Switzerland	9.88 %	12.08 %
UK	3.67 %	1.40 %
USA	5.29 %	7.08 %

Source: Pragma Consulting NV/SA

ANNEX 7

Asset allocation

Country	Domestic equities %	Domestic bonds %	Foreign equities %	Foreign bonds %	Real estate %	Cash/ Other %
Belgium	18	31	24	12	5	10
Denmark	17	65	7	1	8	2
Finland	9	69	1	1	7	13 [1]
France	8	75	5	10	–	2
Germany	6	71	3	4	13	3
Ireland	24	26	33	4	6	7
Italy	2	56	–	–	40	2
Netherlands	15	47	19	10	7	2
Norway	13	60	6	6	7	8
Portugal	14	72 [2]	4	1	2	7
Spain	9	65	2	1	–	23
Sweden	20	64	8	–	8	–
Switzerland	10	25	5	7	16	37 [3]
UK	53	9	22	6	2	8

1) money market instruments
2) 50/50 % fixed and floating issues
3) includes loans to employer, mortgages and other short term loans

Source : European Pension Fund Managers Guide, Volume I – The Marketplace, 1998 ; William M. Mercer

ANNEX 8

Population and pension assets

Country	Population in millions	Dependency ratio[1]	Value of pension assets $bn	Pension assets as a % of GDP	Pension assets per capita ($000's)
Belgium	10.2	24.2	25	11	2.5
Denmark	5.3	22.4	148	84	27.9
Finland	5.1	20.9	40	35	7.9
France	58.6	22.7	95	7	1.6
Germany	82.0	21.7	310	14	3.8
Ireland	3.6	19.0	29	42	8.0
Italy	57.4	23.2	91	7	1.6
Netherlands	15.6	18.8	502	127	32.2
Norway	4.4	25.0	35	23	7.9
Portugal	9.9	22.4	10	9	1.0
Spain	39.3	23.5	22	4	0.6
Sweden	8.9	28.6	142	66	16.0
Switzerland	7.1	22.4	288	117	40.6
UK	59.0	24.6	1015	77	17.2

1) Population aged 65+ as a proportion of population aged 15–64.

Source: Population Concern 30 June 1997, European Pension Fund Managers Guide, Volume I – The Marketplace, 1998 ; William M. Mercer

Glossary of terms relating to pension funds management

Actuarial calculation : calculation made by an actuary to establish whether a pension scheme has enough assets to cover its liabilities/commitments. The actuary must ensure that the liabilities are calculated in an adequate manner.

Asset allocation : the spread of assets of a fund by type of asset and/or geographical area

Asset Liability Management : method which aims to minimise risks by managing and controlling the matching of liabilities, assets, liquidity and investment policy

Asset Manager : person engaged by the pension fund to manage the assets of the fund. It can be a credit institution, an insurance company or a collective investment company (UCITS). Some funds manage their own assets.

Currency matching : requirement that assets used to cover liabilities are denominated in the same currency as these liabilities

Custodian : institution (usually a credit institution) which holds the assets and the of the pension fund

Defined Benefits Scheme : scheme where the benefits are fixed in advance (e.g. as a percentage of salary). In general the employer bears the risk with respect to the payment of the pension.

Defined Contribution Scheme : pension scheme in which the contributions are fixed.The payment depends on the level of these contributions and on performance of the assets purchased. The employee usually bears the investment risk.

Fund Manager : persons responsible for the overall policy of the fund (its financial, particularly asset allocation, and administrative aspects). Managers are in general representatives of the affiliates and the employer. The management can also be delegated to trustees, who make the commitment to manage the fund to the bast of their capacities.

Funding requirement : requirement that the assets of a fund that are used to cover liabilities must never be less than these liabilities.

Sponsoring company : company or group of companies which use the services of a fund in order to provide a pension to employees

Technical provisions : item on liability side of balance sheet of a pension fund which represents the commitments undertaken by the fund. These technical provisions must be covered by assets whose liquidity, security (diversification) and rate of return are adapted to the commitments made.