

Brooklyn Law Review

Volume 64

Issue 3

Symposium:

Getting Ready for Individually Managed Pensions:

A Global Perspective

Article 11

3-1-1998

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Recommended Citation

Paolo Clarotti, *Supplementary Pensions in the Single Market: The Commission View*, 64 Brook. L. Rev. 955 (1998).

Available at: <http://brooklynworks.brooklaw.edu/blr/vol64/iss3/11>

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SUPPLEMENTARY PENSIONS IN THE SINGLE MARKET: THE COMMISSION VIEW*

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The provision of pensions is a fundamental aspect of social protection in the European Union. As of today, state pension arrangements are still, by far, the most important pension providers.

However the demographic changes which have already occurred over the last 30 years, and those which are expected in the future (up to 2030), will have dramatic budgetary implications on such arrangements and will make them practically impossible to continue for long. That is why the European Commission is developing a number of ideas relating to certain aspects of supplementary pension provision, in order to cope with this new situation which is emerging relatively rapidly.

Currently, there are four people of working age to support each pensioner in the E.U. By 2030, there will be two. This prediction is the result of greater longevity and the decline in birth rates in Europe. This phenomenon is not confined to the E.U. but is also found to a greater or lesser extent in most developed countries.

Statutory state pensions in the E.U. are mostly paid by the state out of current revenues ("pay as you go"). There are at present no earmarked investment funds for state pensions. If current policies toward pensions are not changed, there will be an inevitable increase in state spending on pensions to pay for the increased number of pensioners.

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Several member states have already initiated reforms to ensure the sustainability of state pension provisions. The need to maintain levels of income in retirement is likely to result in greater reliance being placed on other sources of supplementary retirement income: 1) pension schemes linked to employment (pillar 2) and 2) pension schemes taken out by individuals, usually with life insurance companies (pillar 3).

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

However, given the existence and likely growth of funded supplementary schemes, the Commission has explored in a Green Paper¹ how the "single market" can enable these schemes to operate more efficiently.

The growth in these funds is one of the possible ways of maintaining the level of retirement income. They present an opportunity for the E.U. economy; the Green Paper asks how these benefits can be delivered through the E.U. capital market, particularly in light of the positive impact of the introduction of the Economic and Monetary Union ("EMU"). At present, employment and life assurance linked pension schemes in most member states invest a large proportion of their assets in domestic government bonds. In view of the commitment of member states to financial stability, it is likely that the capacity for growth in government bonds will be limited. This means that the supply of equities and private sector bonds is likely to grow if the increase in available funds is to be taken up by the E.U. capital market.

This forecast is based on the results of many studies which have shown that over the long term, equities have tended to have a higher rate of return than bonds, though this is not inevitable for the future. The investment strategy of a pension fund or life insurance company and the portfolio balance between equities, bonds, real estate and short term placements are principal determinants of the rate of return on overall

¹ Supplementary Pensions in the Single Market: Green Paper from the Commission to the European Council, COM(97)238 final.

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

For example, during the period of 1984 through 1993, there were significant differences in the real rate of return of E.U. pension funds and life insurance funds—with over 6 percentage points difference between the worst and best performers. In a funded scheme, returns need to be sufficient to deal with the effects of salary inflation over the long term. An increase in the annual rate of return of say two or three percentage points can make an enormous difference over a working life and should not be underestimated.

Assume the target is a fixed supplementary pension of 35 percent of an employee's salary on the basis of a 40 year working life. If the real rate of return on assets is 6 percent, the cost is 5 percent of salary: all other things being equal, if the real rate of return is 4 percent, the cost is 10 percent of salary, and if the real rate of return is only 2 percent, the cost is 19 percent of salary. At any rate, the impact of the intervention of pension funds as a supplement to E.U. national state pension schemes (i.e., the increase in the supply of long term capital) may transform the E.U. capital market. This could happen with beneficial effects on E.U. industry and infrastructure.

It should be stressed, however, that the Commission does not advocate any particular investment strategy for pension funds. It is the role of the fund managers to determine the best investment strategy for the ultimate benefit of pensioners, subject only to appropriate prudential supervision. The Green Paper discussed within has merely explored the role the single market can play in the future to maximise the investment possibilities of fund managers whilst maintaining adequate prudential control. It has addressed whether the current rules

of prudential supervision in some member states are disproportionate in that they go beyond what is objectively necessary to ensure the security of funds and at the same time prevent the development of a real single market in pension funds for the benefit of pensioners and future pensioners.

Specifically, some of the rules currently imposed by member states as part of their prudential supervision of these funds seem to go beyond what is objectively necessary and prevent freedom of movement of capital in the single market. Clearly, prudential supervision is required to ensure that pension funds and life assurance companies can meet their future pension liabilities. This supervision must not be weakened. One of the objectives of the Green Paper was to consider how the security of benefits can be maintained, removing the current disproportionate restrictions whilst allowing a real single market in pension funds to develop for the benefit of pensioners and future pensioners. From the evidence, it seems that alternative methods of supervision can provide equivalent security.

Advocates of modern risk management techniques suggest that such techniques allow managers to control risk while investing in assets with greater volatility but higher rates of return. These techniques aim to capture the return from the risk premium of equity while avoiding excessively high levels of volatility. In evaluating risk and making asset allocation decisions, it is more appropriate to focus on the relationship between assets and liabilities and not solely on assets.

Thus, different pension funds (e.g. young schemes with many contributions relative to pay-out or old schemes with large pay-outs relative to contributions) should, in all likelihood, adopt different investment strategies because their asset/liability profiles are different. In this way they can maximise returns at minimum increased risk.

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

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

In other words, such distinctly market-oriented management techniques would allow pension funds to invest a greater proportion of their assets in a variety of long term financial instruments such as equities, in line with the structure of their liabilities. This strategy could increase returns on the investments of pension funds because these instruments have generally carried a higher rate of return than government bonds, and at the same time, they would be compatible with the free movement of capital and would encourage the expansion of the E.U. capital market.

However, it must be clear that this freedom to invest in the assets which the fund managers consider the most appropriate for their particular pension fund cannot, of course, be absolute but should be based on prudential rules and subject to supervision. The Commission is committed to ensuring that there is no reduction in the protection of pension funds. Prudential considerations are all the more important for equities given the greater volatility of these assets in the short term. Therefore, the Commission is looking at alternative methods of supervision that are consistent with the single market.

Of course, the Green Paper has also stressed the need to confirm the right of approved investment fund managers to offer their services in other member states. This would not only give managers themselves the advantages of a single market, but the increased competition could be expected to reduce costs and encourage managers to improve their performance. The effect would be to increase the returns on investment, for the benefit of members of pension schemes.

As regards supervision, for the time being, specific E.U. harmonization rules relating to the investment by pension funds of their assets do not exist beyond the principle of, and general rules relating to, the free movement of capital. These

are intended to guarantee to all investors, including pension schemes, the freedom to invest where they wish in the E.U. However, investment restrictions can be imposed if these can be justified on prudential grounds. Member states may not use this exception to the freedom as a means of discriminating against foreign assets, nor as disguised, non-prudential restrictions introduced for other reasons.

Finally, many member states have restrictive rules that generally fix the maximum percentage of a fund that can be held in a particular asset or currency. In this context, the Commission has the following policy objectives:

- freedom for fund managers who are authorised in accordance with the Investment Services Directive², the Second Banking Directive³ or the Third Life Insurance Directive⁴ to offer services all over the E.U.;
- freedom to invest assets of pension funds under the "prudent man" principle; diversification of assets, including diversification into assets denominated in currencies other than that in which the liabilities of the institution are established; removal of any requirements on pension funds to invest in or refrain from investing in particular categories of assets, nor to localise their assets in a particular Member State.

The above ideas and, in general, the whole Green Paper have raised, as expected, many reactions from the various interested fora but not all of them face the same direction. A hearing was also held in April, 1998 in this respect. The main comments have been the following:

- In general, the vast majority of the contributors and, in particular, the financial sector support the Commission's view on retirement provision and the E.U. capital markets. A few member states, trade unions and the representatives of consumer protection associations are more cautious.

² Council Directive 93/22/EEC of 10 May 1993 Investment Services in the Securities Field, 1993 O.J. (L 141) 27.

³ Council Directive 89/646/EEC of 15 December 1989 Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1989 O.J. (L 386) 1 (amending Council Directive 77/780/EEC, 1977 O.J. (L 322)).

⁴ Council Directive 92/96/EEC of 10 November 1992 Coordination of Laws, Regulations and Administrative Provisions Relating to Direct Life Assurance, 1992 O.J. (L 360) 1 (amending Council Directive 79/267/EEC, 1979 O.J. (L 283) and Council Directive 90/619/EEC, 1990 O.J. (L 330)).

- There is widespread agreement that pension funds and pension-related life insurance funds will be a major future growth market. Apart from pension funds and life insurance companies, banks, building societies, friendly societies, mutual funds and investment companies are also operating in the supplementary pension market.

- The financial sector and most of the member states are of the opinion that a conservative asset allocation policy concentrating on a strategy of fixed income securities (e.g. government bonds) is not the optimum. In general, it might be more prudent to invest a substantial part of the asset portfolio in equities because equities can better meet the long term nature of the pension liability. Nevertheless, there can be differences in the investment strategy of fund managers due to differences in the type of pension product they offer (those involving some elements of life insurance or those which are "pure" pension products).

- There is widespread agreement with the presentation in the Green Paper of the role of equities on the return of pension funds assets. However, a minority asserts that the Commission's analysis does not deal sufficiently with the uncertainty in the future of continued high yields, in particular from equities, of funded schemes.

- The majority agree with the analysis of differences in rate of return between equities and bonds and on the impact this can have on indirect labour costs and government expenditure. Equity investment is especially regarded as an effective tool to tackle inflation risks of future pension payments. However, there are some skeptical remarks concerning the high volatility of equities.

- Most of the parties are in favor of the use of modern asset/liability management ("ALM") techniques in combination with portfolio diversification. These techniques should be supported by maximum freedom of investment for managers and trustees. There is also a vast majority against the use of quantitative limits. The role of the supervisory bodies should become more dynamic and more flexible in the future; they should support the efficiency of the investment process with a focus on long-term security and capacity of meeting liabilities. Therefore, the quality of supervision needs to be improved in order to fulfill its legal mission in the future.

- All replies stressed that the capital markets within the E.U. could absorb the expected growth in pension funds assets and provide sufficient liquidity. The development of European equity markets will be promoted by the rapid growth of key technologies/industries such as telecommunication, health care, financial services and energy. Most parties also expect a rapid growth of an E.U.-wide corporate bond market, and that EMU will intensify competition and further economic growth in Europe. However, the pace of development in this field depends enormously on the abolition of existing investment restrictions.

- There is very broad agreement that pension funds should be subject to prudential supervision based on the following key requirements: authorisation or approval by a competent authority, criteria for the suitability and approval of managers, regular reporting and powers of intervention by the supervisory authority, and rules on the investment of members' contributions.

- All interested parties agree that if the financial resources available to pension and life assurance funds were to increase, while the supply of government bonds were to decline, existing restrictions would have a greater impact.

- All contributors endorse the right of fund managers to offer their services freely throughout the Union. Existing obstacles to this freedom generally appear to be of a cultural, rather than a legal, nature.

- Views differ sharply, however, as to the interpretation of the "prudent man" concept and the proper way of diversifying investments. For some commentators, it is both safer and more efficient to give managers maximum room for maneuvering so that they can match their investments most appropriately to the nature of their liabilities; any fixed quantitative restriction would, in their view, artificially depress returns. Other interested parties are convinced that only a few fixed rules on the minimum spread of assets would genuinely guarantee a proper diversification of the portfolio, and this would not significantly affect returns. Opinions are rather evenly divided on this question.

- In addition, opinions differ considerably on the question of the (common or different) prudential rules that should be applied to pension funds and group life schemes. Some take the view that the services offered by pension funds and group

policies are sufficiently similar to be covered by identical rules; this is, furthermore, the approach already taken in some member states. Others consider that because pension funds, unlike life assurance companies, do not guarantee the eventual payment of benefits, the risks being assumed by the sponsoring company or by the employees themselves justify the application of different prudential rules.

- Views, at last, differ as to the instruments that could, where necessary, enable the prudential rules on pension and life assurance funds to be adjusted. The difficulty of reaching agreement between the member states on a directive is stressed in many contributions. A directive of this nature, introducing harmonised and sufficiently flexible prudential rules, is nevertheless repeatedly called for by the financial sector and considered feasible by some member states. Although there is near unanimity regarding the beneficial effects which the euro should have on investor freedom, many contributors stress that problems will remain (e.g., “in” and “out” countries, investment outside the euro area, legal certainty, etc.).

- A harmonised prudential system designed, above all, to ensure the financial soundness of schemes must go hand-in-hand with a coherent social framework. This must guarantee workers, throughout their working lives, the continuity of commitments they have been given, without discrimination between workers who stay in their home member state and those who exercise their right to free movement. The responses demonstrate a broad consensus on the approach taken by the Commission in order to remove barriers to free movement. All respondents welcome the directive on safeguarding the supplementary pension rights of employees and self-employed workers who move within the E.U.,⁵ which they regard as a first step in the right direction.

Even if not all the responses have fully endorsed the Commission's suggestions, the fact that a vast majority of the interested fora have reacted in a positive way has prompted

⁵ Council Directive 98/49 of 29 June 1998 Safeguarding the Supplementary Pension Rights of Employees and Self-Employed Workers Who Move Within the Community, 1998 O.J. (L 209) 1.

the Commission to start issuing some regulation in order to achieve the target of a single market for supplementary pensions within a reasonable period of time.

In fact, while there is not yet available a formal proposal for one or more directives, on May 19, 1998 the commissioner responsible for financial institutions, Professor Monti announced at the E.U. Council of Ministers of Finance ("ECOFIN") that the Commission is going to issue a communication at the beginning of 1999, based on the conclusions it has drawn from the above-mentioned consultation.

This initiative also follows the E.U. Finance Ministers' discussions at their meeting in York in March 1998 and the identification by the Commission's communication of March 31st on risk capital, where it was stressed that regulatory restrictions on pension fund investments were a severe distortion within the single market.

According to the Commission, pension funds will play an important role in the creation of a Pan-European risk capital market. Smaller and more innovative companies in the fields of key technology industries such as telecommunications, biotechnology, health care, financial services and energy are searching for venture capital. In the U.S., the promotion of investment in venture capital has had very positive effects on labour markets because of the new jobs created. Therefore, the implementation of prudential rules to permit pension funds to invest more easily in risk capital will increase the proportion of Pan-European equity and should have positive consequences for European labour markets.

The communication to the E.U. Council, announced by Commissioner Monti, will provide for an outline of one directive on prudential rules applying to supplementary pension schemes. The Commission plans to present such a proposal for a directive in the second half of 1999.

Obviously, it is difficult today to set forth such an outline, which is still in preparation. However, this Author can try to present the guiding principles for the preparation of not only the above-mentioned communication but also of the directive on harmonized prudential rules in the field of supplementary pensions which will follow it.

As its first objective, the future directive will have to ensure that equal pension products will be subject to the same prudential rules irrespective of whether they are offered by a pension fund, an insurance company or another financial institution such as a bank.

In addition, the focus should be more on safeguarding supplementary pensions rather than on capital markets: in other words, capital markets are to serve pension funds, not vice versa. Security of pensions is a key aim which the Commission has to take into account. The European Parliament has stressed many times the necessity of having a regulation which avoids frauds of the type of Maxwell pension funds.

Another important point is represented by taxation: today pension funds are taxed in a different way in practically every member state. This makes the inter-operability of pension funds, especially for those people who work in different E.U. countries, very difficult and in some cases even impossible. The promotion of uniform tax treatment for a specific type of pension fund is a legitimate objective, but one should be aware of the difficulties reaching it. Many efforts should be made in this direction, even if the results might not be those which one expects. At any rate, one should not forget that the European Court of Justice, in its case-law, has already taken, on the basis of the guiding principles of the treaties which rule the European Union, some positive steps in the direction of single pension funds across Europe. In this context, one of the problems to be solved is that of portability and transferability of pensions.

As stated earlier, the modern asset/liability management techniques are very useful tools in managing the structure of balance-sheet risks of financial institutions. They can be used to control risks and manage the investment portfolio and to ensure that assets are invested in such a way as to reflect the nature and the duration of the corresponding liabilities. However, a properly functioning asset/liability management is most effective when based on maximum freedom of investment in order to fulfill the needs of portfolio diversification according to risk diversification. Therefore, the future proposal should not provide for strict quantitative restrictions on certain assets, especially equities, and currencies like those imposed still today in several member states.

It is, of course, obvious that such freedom of investment has to take into consideration the nature of the pension product, especially when the future pensioner is given a guarantee for a certain minimum amount of its retirement allowance. That is why in the future it will be more appropriate to focus supervisory activities on the products offered rather than on the pension provider (insurance company or pension fund). The Commission will examine ways of establishing prudential rules appropriate to the product so that the same product will be subject to the same prudential rules, regardless of who will provide it.

As of today, prudential rules in E.U. member states—such as fit and proper criteria for managers, solvency requirements and investment rules—depend upon the nature of the service provider and not on the service itself. The E.U. harmonized prudential rules should be more products oriented, even if this would create an important change, especially for supervisory authorities. Quality of supervision would have to be improved in order to play an effective role in ensuring the safety of pension funds.

In this sort of shopping list, some points of the Green Paper have certainly been recognized along with some of the suggestions of the interested bodies. There are more general objectives than specific prudential rules. Before reaching an agreement on such rules, a large number of technical problems need to be solved in order to achieve, at the same time, a level playing field between all competitors in the field of supplementary pensions and an efficient supervisory system. It is likely that some of the existing harmonised prudential rules presently valid for insurance companies will have to be amended in order to provide for special solvency requirements for some pension products, both for insurance companies and pension funds.

As regards the security of pensions and the protection of pensioners, one has to envisage a sort of safety net on the basis of similar devices in force in the whole E.U. territory thanks to particular directives such as the deposits guarantee scheme (directive of 1994) and the investors protection system (directive of 1997).

Finally, this Author must stress that there exist, for the time being, only several good ideas as to what to do to promote supplementary pensions in the E.U. We will have to wait for the official Commission communication in Summer 1999 and, more particularly, for the proposal of directive which will be issued later this year in order to have more detailed information as to the future Commission initiative in the field of supplementary pensions.

The only thing which is certain is that there will be such an initiative in the near future, for the benefit of all the E.U. people.

