Pensions internationally

The future of European Supplementary Pensions: Comments on EU Commission Communication COM (99) 134 dd. 11th May, 1999

Received: 17th January, 2000

Rudolf Siebel LL.M

attorney at law, is director at the Association of German Mutual Funds (BVI). After studying law, he started his career in 1990 in BVI as Associate, Securities Funds and International Affairs. After working for five years as Vice President Senior Credit Officer at Moody's Deutschland GmbH, Frankfurt, he returned to BVI in 1998 as Director of Policy and International Affairs. He is a member of UCITS, Legal as well as Pension and Investment Fund Committees of the European Federation of Investment Funds and Companies — FEFSI.

Marcus Mecklenburg

attorney at law, is an Associate, Policy and International Affairs. After studying law, he joined BVI in 1998.

Abstract On 11th May, 1999 the European Commission released a Communication on supplementary pension schemes setting out a series of initiatives designed to enable these schemes to benefit from the single market. The Communication states that this goal might best be achieved by drawing up a European Directive on occupational pension systems. This paper analyses the scope of the Communication, finding that the interests of enterprises and workers in Europe, especially of small- and medium-sized businesses, have not been taken into consideration sufficiently. The authors believe that the particular needs of these groups could be met by including specific rules for supplementary defined contribution systems in the proposed directive.

Keywords: *pension funds; occupational pensions; defined contribution; pension fund directive; pension funds for employees of SMEs*

Introduction

The European Commission has taken the initiative on pension reform at EU level. Most recently it tabled on 11th, May 1999 a Communication entitled 'Towards a single market for supplementary pensions'.¹ The paper presents the results of the consultations on the Green Paper

on supplementary pensions in the single market.² This communication discusses second pillar occupational pension plans in Europe. Of particular concern to the Commission are pillar 2 occupational schemes, for which there is as yet no proper Community legal framework. The Commission sees the need to propose

Rudolf Siebel LL.M
(BVI Bundesverband
Deutscher
Investment-Gesellschaften
e.V., Eschenheimer Anlage
28, 60318 Frankfurt,
Germany.

Tel: (+49) 69 15 40 90 227;
Fax: (+49) 69 597 1406)

reforms that 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 participation in the development of EU capital markets. To this end, the Commission believes that supplementary schemes (pension funds) themselves need to be adapted. In particular the Commission regards the following areas to be in need of reform:

- 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 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, the Commission aims at protecting the beneficiary, and stresses the need to take all necessary steps to guarantee the payment of contractual benefits to future pensioners.

Furthermore, barriers to cross-border membership of pension schemes are to be dismantled and national tax regimes for pensions are to be coordinated.

The Commission has announced its intention to table a proposal for a Directive on supplementary pensions linked to employment (Pension Fund Directive) in the near future.³

The European Commission's approach is moving in the right direction. The recognition of investment funds and companies as suitable pension vehicles particularly has to be regarded as substantial progress in terms of making supplementary pension measures more effective and popular. The

Communication, however, is based more on an assessment of the interests of the traditional pension providers than on the interests of all types of enterprises in Europe, especially of small- and medium-sized businesses. It consequently may fail to reach a large part of future pension beneficiaries. The Communication lacks an analysis of the needs of these kinds of enterprises in the field of pensions. In the past the traditional initiatives in the field of voluntary second pillar pensions have not been able to reach out to small- and medium-sized enterprises (SMEs). This is particularly relevant as SMEs employ the largest workforce within the Union. Smaller enterprises in particular are often deterred by the administrative and other costs, as well as the liability risks associated with traditional initiatives.

The Commission has recognised the need to guarantee equal treatment for different occupational pension providers and has stated the need to establish a genuine prudential framework for pension service providers which could involve the definition of similar rules for well defined products.⁴

However, there is a need to define such specific rules for true supplementary defined contribution (DC) systems. Under such systems, employers only commit themselves to regular contributions of a certain level towards their employees' pension provision, while the more traditional defined benefit systems which exist throughout Europe usually require employers to cover also certain biometric risks of their employees, such as longevity, disability and survivors' pensions.

DC systems are especially suited to reach medium-sized enterprises and the pension needs of a mobile workforce, as demonstrated by US experience. The respective defined contribution system, the '401(k) plan', is the fastest growing

vehicle for occupational pension schemes. During the past two decades, 401(k) plans have been the primary source of growth in the private pension system. From 489,000 in 1980 to 690,000 in 1994, the latest year for which data from the Department of Labour are available, 401(k) plans accounted for approximately 77 per cent of the net increase in all private pension plans.⁵

Because DC systems may take various forms ranging from single funds — such as the German Altersvorsorge-Sondervermögen (AS-Fund)⁶ — to self-directed pension savings plans with a wide range of investment options,⁷ we believe that a European pension fund directive should not prescribe a specific DC system. Instead, the envisaged directive needs to address in general terms the following key areas with respect to DC systems:

- institutional security
- economic efficiency and safety
- transparency
- flexibility
- portability.

These key areas are based on the goal of funded pensions to provide for an adequate level of retirement income with the least effort, while maintaining a high level of security. The proposed directive should specify certain quality criteria with respect to each area, which a DC system would need to fulfil in order to qualify as a recognised second pillar pension scheme under European law (hereinafter, Defined Contribution Pension Fund or DCPF). These quality criteria aim at enabling DCPF to meet the goal of optimal pension provision. This approach would satisfy the Commission's aim to arrive at a minimum harmonisation of supplementary pensions and at the same time respect the principle of subsidiarity

by not prescribing specific types of instruments to member states allowing them to maintain their existing pension schemes.

Hereinafter, we discuss considerations with respect to the integration of true DC instruments into a 'Directive on Harmonisation of Supplementary Pensions Linked to Employment' (Pension Fund Directive). The proposal contains a description and the reasons for the different criteria necessary to achieve a harmonisation of defined contribution schemes at EU level.⁸

The regulation of tax treatment of DC systems could be left to the individual member states according to the split of jurisdiction between the EU Commission and the member states. However, a policy decision at EU level on Europe-wide principles of taxation for these funds would be very helpful.

The following considerations served as the basis for a proposal of the European Federation of Investment Funds and Companies (FEFSI), Brussels, submitted to the European Commission on 13th October, 1999.⁹

The current situation with regard to European occupational pensions

The reasons for the need to introduce harmonised rules for DC systems in Europe become clear when looking at the current state of occupational pension systems in Europe and their weaknesses.

Europe's occupational pension schemes show a very diverse picture. Common to all systems is the dependency of pension benefits on an employment contract or the pursuit of a particular profession. In the majority of cases the contributions are at least in part paid by the employer on a voluntary basis. Although in some cases (eg, France) occupational schemes

are also run as pay-as-you-go systems, most occupational pension schemes are funded. In other words, contributions paid into these schemes are invested for the purpose of funding future benefits rather than current pensions payments.

As funded systems, occupational pension schemes are not vulnerable to demographic changes and are therefore in principle eligible to relieve the State pension systems. However, with respect to their specific design many of the existing occupational pension instruments suffer from a range of shortcomings which considerably hamper their wider coverage and lower their benefits:

- In Europe the coverage of occupational pension schemes among the working population varies between 5 and 90 per cent. A coverage of more than 50 per cent typically exists only in countries where occupational pension benefits are covered by collective agreements.
- Many of the schemes are either tied to a specific employer or a specific industry. This hampers the realisation of the EU goal of mobility of workers both within their countries and at the European level because the transfer of vested pension rights when people change their jobs is either not possible at all or involves a considerable loss.
- The widely spread defined benefit systems (where the employer guarantees the employee a certain level of benefits and also covers his biometric risks) lead to unpredictable liabilities for the employers. In particular, SMEs often are not in a position to expose themselves to such risks without jeopardising their own existence. This is particularly alarming considering that SMEs represent the largest employer in Europe.

- The management of pension monies is often subject to a restrictive investment policy which requires fund managers to invest predominantly in bonds or in the national market. This makes it impossible for the schemes to achieve their goal of earning an adequate pension income for their contributors and thus lowers their attractiveness.
- The taxation of occupational pension schemes varies greatly within Europe. While in most countries pensions are subject to deferred taxation (which means that the pension benefits become liable only during the pay-out phase) there are also various systems with up-front taxation (ie, contributions are paid from taxed income). Up-front taxation lowers the attractiveness of occupational pension schemes, both for employers and for employees.

Therefore, in only a few countries have the existing occupational pension systems been able to relieve substantially the state pension systems.

This brief analysis of the various pension systems in Europe indicates that each country has developed its own system in line with its political, economic and social conditions. In fact, hardly any political arena is the focus of such fierce political struggles as the population's retirement system. This is also the reason why each country has developed its own pension fund system or is in the process of doing so. Against this backdrop, it becomes clear why the EU Commission has not yet been able to devise a single European pension fund system. On the other hand, there are increasing demands from industry and business to introduce a single European pension fund system to keep pace with Europe's integration process and an increasingly mobile

workforce. As a means of overcoming the current problems in the field of occupational retirement provision in Europe, only DC systems that fulfil certain general quality criteria should be recognised as supplementary occupational retirement schemes on a European level.

The following key criteria to reach this aim are:

- *Criteria relating to the economic efficiency of a DCPF* (investment focus on real assets, risk diversification, roll-up of gains, long-term accumulation of the contributions paid for pension provision).
- *Criteria relating to the institutional security of a DCPF* (approval of pension fund by a competent authority with intervention powers, management by asset managers and agents approved in the EU which fulfil strict criteria covering responsibility, competence, and the managers' standing, criteria with respect to the DCPF (free choice of management, custody of assets with a depository bank, separation of powers between management and depository, prudential investment, risk diversification of assets, worldwide investments on the basis of the nature and duration of the liabilities, possibility of currency matching rules, limits on pledging or assigning assets)). Most of these are addressed by the 'fundamental prudential rules' envisaged by the EU Commission.
- *Criteria relating to the transparency of a DCPF* (regular reporting to the supervisory authority and beneficiaries, audited yearly accounts).
- *Criteria relating to the flexibility of a DCPF* (flexibility of payment of contributions and during the pay out/withdrawal phase).
- *Criteria relating to the portability of a*

DCPF (right of unlimited transferability (or ownership) of plan assets at market value for the beneficiary without a loss of retirement income, no waiting periods, market value driven valuation to be carried out based on rules established by the competent authorities).

Criteria for a defined contribution pension fund (DCPF) system

In order to facilitate the discussion, the proposed quality criteria for DCPF are tabled in the order that appears in the EU Commission Communication dd. 11th May, 1999.

Prudential rules for pension funds

The ideas of the Commission relate primarily to the key aspects of institutional safety and transparency of a DCPF. The Commission addresses the following points.

Separation of assets

The Commission proposes to separate the assets of the pension fund and of the sponsoring employer.¹⁰ This proposal takes into account the interests of the beneficiaries of an occupational pension scheme. A pension fund system should never be tied to an employer; in other words, it should be independent of the company. An occupational pension system which is tied to an employer involves a number of potential conflicts of interest between employees and company, or between early retirees and late retirees. In principle, pension provision is nothing more or less than a long-term savings plan which serves the purpose of building up a capital stock which

will buy a pension in retirement. Nobody would seriously consider entrusting his life savings to his employer. Why should employees want to entrust the management of the capital saved in connection with the second pillar system to the employer? There is no objective reason why they should do this.

Authorisation of pension funds by a competent authority and the definition of the supervisory authority's power to intervene and setting up of a system of sanctions

The Commission proposes to require the authorisation of pension funds by a competent authority with well-defined intervention powers as well as the setting up of a system sanctions.¹¹

In order to make it impossible for third parties to access the pension capital it is necessary to provide for a legal framework which involves state supervision. This legal framework should specifically provide that the assets must be managed solely in the interest of the investor's pension provision. The authority would necessarily also need the power to police the sector, ie, to set up and implement a system of sanctions, including but not limited to, a revocation of authorisation.

Authorisation subject to strict criteria regarding the responsibility, competence and integrity of managers

The Commission proposes to require authorisation of pension funds subject to strict criteria regarding the responsibility, competence and integrity of managers.¹² It has to be agreed that it is necessary to provide for a legal framework which involves a check of the quality of the managers similar to article 4 (3) of the UCITS directive.¹³

Setting up a mechanism for periodic statements to members

The direct connection between contributions and accumulation of assets for pension provision should be clear and transparent for the investor. The Commission proposes a mechanism of periodic statements to members.¹⁴ For a DCPF this means publishing regularly the net asset value of the beneficiaries' pension assets, a prospectus and half-yearly and audited annual financial reports. These requirements could be modelled on the time-tested articles 27 to 35 of the UCITS directive. A basis of information for DCPF participants similar to that provided by UCITS will ensure a high level of transparency as required by the Commission, especially in case of DC systems. Members of a pension scheme will be provided with substantial regular information similar to the shareholders of a company who receive information about the company whose equities they own. The information will cover: the status of employer and employee contributions, the investments made by the fund, the income earned by these investments as well as the fees and commissions paid to the plan administrator and the fund manager.

The Commission proposes in this context an audit for the annual reports of the pension fund. We believe that the annual reports of DCPF and the financial statements of the pension fund management company (to the extent it is separate from the DCPF) should be audited by the same auditor. The audit should also examine whether the DCPF is managed in conformity with the regulations of the pension law and whether the DCPF rules and terms of contract have been complied with. The result of the audit is to be published in the annual report which should include the full wording of the audit certificate.

Setting up a mechanism for periodic statements to the supervisory authorities

The Commission also proposes a mechanism of periodic statements to supervisors.¹⁵ This could be done by requiring the DCPF to send the prospectus, amendments thereto, half-yearly and audited annual financial reports to the pension regulator. These requirements are modelled on article 32 of the UCITS directive. Additionally, the pension regulator should be able to request from the DCPF at all times all information it needs to avoid any fraud, misuse or embezzlement of pension funds assets. This should be supplemented at regular intervals by an explanation of the overall investment strategy in the light of the commitments entered into. A good basis of information similar to that provided by UCITS will ensure a high level of transparency and security as required by the Commission, especially in the case of DC systems.

Further requirements with respect to the structure of a DCPF

The following criteria which are not discussed by the Commission have to be regarded as essential ingredients of a high quality DCPF.

Segmentation of functions with regular internal checks

The Commission suggests, in the context of discussion of adequate supervision of pension funds using the prudent man approach to management, that a segmentation of front-end and back office with regular internal checks is necessary.¹⁶ It has to be recognised that within a DCPF there are several functions to be carried out, including but not limited to the following:

— Investment Management

— Fund Accounting
— Depositary/Custody
— Pension Administration Management
— Distribution/Marketing.

Any approved DCPF manager should be able to carry out investment management, fund accounting, pension administration (contributions, benefits collection and payments, other registrar communications), management and distribution/marketing functions. However, a DCPF provider providing more than one of the above mentioned functions must strictly separate the function of investment management from fund accounting (Chinese walls). The depositary/custody function may never be carried out by the DCPF manager. Furthermore, the custodian (depositary) should be given certain control functions as outlined in Articles 7 to 11 of the UCITS directive. This arrangement has worked well for the UCITS industry and will considerably strengthen the institutional safety of a pension fund. This has the following implications.

The assets of the DCPF must be kept separate from the DCPF manager by a credit institution which is legally independent of the DCPF and licensed to act as a depositary bank (depositary bank principle). The involvement of the depositary bank makes it impossible for the DCPF management company to access the DCPF's assets. The depositary bank is also responsible for issuing and redeeming the DCPF's units. Another important function of the depositary bank could be to determine the net asset value of the DCPF. Correct unit pricing ensures that the beneficiary's share of the DCPF assets is properly calculated. The DCPFs institutional security is additionally enhanced by the fact that the depositary bank performs a number of legally regulated control and participatory powers. In certain circumstances, the

depository also represents the interests of the investors by asserting claims or by bringing action against endangering the DCPF assets. In performing its functions, the depository must act independently of the DCPF management company and solely in the interests of the beneficiaries. It may carry out the instructions of the pension fund management only if these are not in breach of any law or the rules of the DCPF. The goal of retirement provision furthermore makes it necessary to discuss appropriate capital requirements for the depository of a DCPF system.

The Commission has proposed that pension funds should have adequate internal controls which are verified by external auditors.¹⁷ Indeed, the internal audit function at the level of the DCPF system is very important. The purpose of the internal audit function for the management of a DCPF is to provide the management with information about the orderly conduct of business in all departments and units as well as about any shortcomings and hazards identified. The supervisory authority must specify the requirements concerning the structure, organisation and equipment of the internal audit function in order to ensure that there is an ongoing and effective control of business operations. Each audit should lead to a report which is used by the management to devise counter-measures if any exceptions have been detected. As the Commission points out, internal controls are to be checked by external auditors.

Sufficient capital

The management of pension funds should only be allowed if the manager of a pension fund is sufficiently capitalised to compensate the fund for losses incurred because of mismanagement, negligence, malfeasance or fraud. Adequate capital requirements — also for

the depository of a DCPF — need to be addressed in the directive.

Portability of the pension

As a rule, contributors should receive fund units for their contributions. Employees wishing to switch from one DCPF arrangement to another should have the possibility of doing so by 'selling' the units of their system and 'buying' units of another. This solves the problem of transfer value; purchase and sale should be effected at the current market value based on an objective valuation system. This feature of an ideal pension is becoming increasingly important in view of the fact that people are changing their jobs much more frequently than in the past. For instance, in the United Kingdom employees on average change their jobs every 6.4 years. At the same time the number of part-time workers is increasing, especially among the female population. If an employee's share of a pension fund is portable, adequate pension income can be achieved even in an environment of high mobility. This would also improve cross-border mobility of workers, a goal which the EU Commission has been propagating for many years:

- *Ownership status of employees.* A DCPF system which is based on securities ownership is favourable. This strengthens the legal position of the individual employee. He/she not only has claims on a pension scheme but as owner of securities he/she also has an ownership title to the assets destined for retirement provision. This will facilitate transferability and portability of pensions. Furthermore, there is no need for specific solvency rules for DCPF.
- *No waiting periods.* A DCPF system that is based on ownership of securities has the additional advantage

that it does not need any waiting periods for pension entitlements. This means that all employees can be included in the system from the first day of their employment (including part-time and short-time workers). This would also improve mobility of workers, a goal which the EU Commission has been propagating for many years.

- *Neutrality.* Switching of jobs should not be an acceptable argument to reduce the transfer value of a pension in favour of the employees which remain in the fund. This, however, is the case in a number of member states with traditional pension instruments. DCPF are ideally suited to maintain neutrality in case of job changes as those that are based on ownership of securities or otherwise secure the transferability of the individual's pension assets at market value.

No pledge or assignment

The Commission did not discuss the need to protect the assets of a pension fund against pledge or assignment. The management of a pension fund should not be allowed to pledge or assign assets of the fund or make guarantees running against the fund in order to avoid any losses to pensioners.

Freedom of choice

Every employee should have the right to choose DCPF and/or DCPF management companies and/or DCPF investments on his/her own judgment. In the same way as savers can deposit their savings with several competing institutions, employees should be free to invest the contributions for their occupational pension scheme with several DCPFs or have at least several investment options inside their DCPF. Depending on his/her personal risk

attitude or age, the investor should be free to choose between high-risk or low-risk strategies or a combination of both. During their working life, employees should not be tied to a particular pension institution.

Flexibility

Payment streams into and out of a DCPF should not be tied by a rigid formula. Instead, each employee should be free to fix his own contribution/withdrawal rate and his own payments into and out of the system, even if they no longer enjoy a tax privilege beyond a certain level. It should be possible for the employee to increase, reduce and temporarily suspend the agreed regular payments/withdrawals.¹⁸ In this context also, ways of achieving more flexibility of employers contributions need to be discussed.

Investment rules

Prudent man rule/quantitative investment limits

A regulation of investment rules not only relates to the institutional safety of a pension fund but, more importantly, predetermines to a large extent the economic efficiency of the fund. The legal framework should specifically provide that the assets must be managed solely in the interest of the investor's pension provision. For instance, the law should make it absolutely clear that these funds may not be used for speculative purposes, eg, by constraining borrowing powers.

The Commission favours a qualitative regulation of investment rules based primarily on the so-called 'prudent man approach' and only if a member state so wishes, national authorities might be allowed to apply quantitative limits provided they do not unduly restrict

freedom of investment.¹⁹ However, besides the 'prudent man rule' an option of regulating investment policy on the basis of quantitative limits in order to increase the acceptance of the directive, especially among Continental European member states, should also be provided for. Quantitative limits may be set in a way to allow the goal of funded pensions to be met, ie, to provide for an adequate level of retirement income with the least effort while maintaining a high level of institutional security during the capital accumulation phase. As a result, this debate is only of secondary importance to the need to find an optimum retirement vehicle.

Investment policy focus on real assets

Investment limits, however, whether quantitative or 'prudent man', should be designed not only with the view of not unduly limiting the freedom of investment of a DCPF system. In order to enhance the economic efficiency of a DCPF system, the investment rules should assure that the DCPF pursues an investment policy that is based on investment of real assets (equity and real estate). Scientific research²⁰ and the findings of the Commission²¹ suggest that pension funds should pursue a real assets oriented investment policy in order to achieve a high long-term performance similar to the very successful Anglo-American pension funds which invest a large portion of their assets in equities and — to a much lesser degree — in real estate. In order to overcome the bond-oriented investment policy, especially that of traditional pension providers in Continental Europe, it will not be sufficient just to change their investment rules. It will also be necessary to include other institutions which think in risk/return categories into the second pillar, such as investment fund management companies.

As a result, member states should be asked to require DCPF to follow an investment policy that focuses on investments in real assets. Member states which do not follow the prudent man approach to investment should be free to implement state specific limits for an investment policy that is based on predominant investment in real assets to be able to take into account differences in markets and investor perception.²²

Looking at the record of Anglo-American pension funds, it becomes clear that for the purposes of optimum retirement provision it will be sufficient if not all of a pension fund's assets are invested in equities. For example, even in the UK, a country with a strong equity culture according to research by William M. Mercer,²³ pension funds invested not more than 72 per cent of their assets in equities in 1998. Investment limits (which allow high equity holdings, eg, the 70 per cent limit on equity holdings as suggested by the Commission) may ensure that DCPF are less volatile than equity funds. This would accommodate the safety concerns of large groups of the European population who regard the volatility of the equity market more as a risk than an opportunity. Although the DCPF system should remain predominantly invested in real assets at all times, the investment rules should, however, not prevent DCPF systems or their participants from responding properly to any exceptional situations on the equity markets and to react to liquidity requirements. By allowing DCPF to deviate from the principle of investing predominately in real assets, the DC system may implement investment policies which require a different asset mix — but only if the need can be proven, eg, a DCPF with a large

number of elderly contributors close to retirement and pensioners may require a higher investment in regular income instruments such as bonds. This aims at satisfying liquidity constraints and also aims to allow for switching between different investment options and for so-called life cycle investment. Pure 'conservatism' on the part of the contributor should not constitute a sufficient reason for not investing predominately in real assets.

Risk diversification

The Commission suggests in its discussion of asset liability management (ALM) techniques, that ALM will consider portfolio diversification as a part of risk diversification.²⁴ In order to ensure a level playing field among all DCPF — whether they use ALM techniques or not — there should be an express requirement for DC systems to follow the principle of 'risk diversification'. As suggested by the Commission, in case of DCPF using quantitative investment limits, member states may limit investments in a single issuer/investment and in the sponsoring company to a prudent level (eg, 5–10 per cent). Member states should also limit speculation, eg, limit the use of derivative instruments in DCPF to hedging purposes only.

Currency matching requirement

The Commission is opening up the discussion on the necessity of a currency matching requirement.²⁵ This discussion being necessary, however, in any case a currency matching requirement needs to take into account the actual investment needs of European pension funds. Research by InterSec shows that most pension funds in Europe do not invest or do not plan to invest more than 30 to 40 per cent of total assets outside their home country.²⁶

Freedom of choice of managers

In the directive, it needs to be recognised that an approved DCPF manager may carry out several functions, including the following:

- Investment Management
- Fund Accounting
- Pension Administration Management
- Distribution/Marketing.

As the Commission states, pension funds should be able to use any provider of management services anywhere in the EU.²⁷ The proposal should specifically allow credit institutions (second banking directive), life insurance companies (third life directive), securities firms (ISD) and UCITS managers to act as DCPF managers.²⁸ A DCPF organised as a single UCITS, however, may only be managed by a UCITS manager in accordance with directive 85/611/EEC.

The directive should expressly recognise that an approved DCPF manager may carry out several functions, including investment management, fund accounting, pension administration management and distribution/marketing.

Added performance through reinvestment

The Commission does not discuss further requirements for the investment of DCPF. However, DCPF should be required by law to reinvest the income earned. This ensures that the compound interest effect is fully utilised to increase the value of the pension assets. Its impact on long investment periods are generally underestimated, even by experts, although it is in fact almost impossible to overestimate it. The following example illustrates this point using an amount of EURO 10,000.00 invested at 8 per cent over a period of 30 years with annual distribution. Over this period of 30 years, the investment yields a total

interest income of EURO 24,000.00. If, however, the income is reinvested and therefore the compound interest effect is used, the net income — all other things being equal — is more than EURO 90,000.00. A similar effect can be achieved by a continuous accumulation of savings.

Conclusion

We believe that if a harmonisation of true defined contribution schemes at EU level can be achieved there will be a bright future for European supplementary pensions. Europe will obtain the most modern and efficient second pillar system in the world which meets the needs of employers and employees, especially of small- and medium-sized businesses.

References

- 1 COM (99) 134.
- 2 COM (97) 283.
- 3 The Commission has recently tabled more detailed proposals for the contents of such a directive, cf. Commission of the European Communities: 'Supervision of institutions for occupational retirement provision — A working document of the services' (MARKT/2067/99. compl.).
- 4 COM (99) 134, p. 4.
- 5 Cf. ICI, Perspective newsletter Vol. 5 No. 1: '401(k) Plan Asset Allocation, Account Balances, and Loan Activity' p. 3, available at www.ici.org/pdf/per05-01.pdf.
- 6 Cf. Manfred Laux/Rudolf Siebel, 'The AS-Fund — a modern pension fund for everyone', Frankfurt: Fritz Knapp Verlag, 1999; Manfred Laux, 'Germany: The personal pension fund for the second and third pillar', *Journal of Pensions Management* 1999, Vol. 4, No. 4, pp. 339.
- 7 FEFSI, Adam Lessing (ed.): 'Mutual Funds in European Old-Age Provision', Wien: Braumüller, 1997.
- 8 The Commission apparently believes that DC schemes may also cover biometric risks (cf. Commission's working document Markt/2076/99 compl. EN Art. 2 subsec. 10: defined contribution scheme'). The authors would like to stress that the considerations in this paper apply solely to 'pure' defined contribution schemes which do not cover biometric risks. However, it should not be read that biometric risks could not be covered within such DC-schemes on an optional basis through buying additional insurance.
- 9 The FEFSI proposal can be obtained from the homepage of the Pensions Institute, Birkbeck College, University of London, <http://www.bbk.ac.uk/res/piwp/wp2002.html>.
- 10 COM (99) 134 para. 29.
- 11 COM (99) 134 para. 29, box 6.
- 12 COM (99) 134 para. 29.
- 13 Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).
- 14 COM (99) 134 para. 29.
- 15 COM (99) 134 para. 29.
- 16 COM (99) 134, box 6.
- 17 COM (99) 134, box 6.
- 18 The EU Commission is planning to exclude investment funds allowing for the redemption of assets for other purposes than the financing of retirement benefits from the scope of application of the planned directive, cf. working document MARKT/2067/99 compl. at p. 2. We believe it is sufficient if member states' tax laws effectively discourage the redemption of assets for other purposes than the financing of retirement benefits.
- 19 COM (99) 134 para. 30.
- 20 Dornau, Robert, Szczesny, Andrea, '250 Analysten, 1 Portfolio?', Discussion paper No. 99-17 of ZEW Zentrum für Europäische Wirtschaftsforschung (Centre for European Economic Research) available at [ftp://ftp.zew.de/pub/zew-docs/dp/dp1799.pdf](http://ftp.zew.de/pub/zew-docs/dp/dp1799.pdf).
- 21 COM (99) 134 appendix 4.
- 22 Currently, Article 14 para. 2 of the envisaged pension fund directive, as proposed in the working document of the EU Commission (MARKT/2067/99 compl.) does not allow member states to require pension institutions to invest in particular categories of assets, such as equities or real estate.
- 23 William M. Mercer, 'European Pension Fund Managers Guide 1998' Vol. I, p. 53.
- 24 COM (99) 134, box 5.
- 25 COM (99) 134, para. 31.
- 25 InterSec, FT Mandate, 24 May, 1999 p. 18.
- 26 COM (99) 134, para. 32.
- 28 Currently, Article 15 para. 1 of the envisaged pension fund directive, as proposed in the working document of the EU Commission (MARKT/2067/99 compl.) does not allow for UCITS management companies as investment managers of the assets of pension institutions. However, draft Article 5 para. 3 of the UCITS-Directive 85/611/EEC as amended by EU Commission proposal COM (98) 449 dd. 27th July, 1998 provides for the management of assets of pension funds by UCITS management companies.