European systems and pensions

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Abstract *'Saving is a very fine thing. Especially when your parents have done it for you'.*

Winston Churchill

Like 'globalisation', European pensions systems have been much discussed over the last five or so years. This paper describes the different pensions systems across European and highlights the fundamental macro changes (of which there are too few) that are taking place as well as some of the micro changes. Future papers will consider the main players, the behaviour of corporate pension funds and interaction with financial markets.

Keywords: *European pensions systems; macro changes; micro changes*

Austria

The Austrian pension fund industry has evolved since 1990 when a legal framework was set up to establish segregated pension plans. These plans were a mixture of defined benefit arrangements with guarantees by the employing companies and defined contribution schemes where the guarantees applied to the investment of past contributions only.

Currently, there are serious concerns about the cost of unfunded plans, especially with regard to the social security system which provides a retirement income of 65 to 75 per cent of final earnings (capped by the social security benefit ceiling) for about 85 per cent of the Austrian workforce. An early retirement provision at age 60 with only small discounts (until now early retirement was available for women only at age 55 or over) raises the costs to an extremely high level. Since pension

contributions cover only about two-thirds of the expenses, about one-third falls on to the taxpayer.

The pension liabilities of the large workforce of the State and public services (who account for about 25 per cent of the total national workforce) are covered only by the promise of the taxpayer and are wholly unfunded, thus entailing adjustments each year to the financing of benefits. The costs of such schemes combined with those of the social security scheme will be an increasing burden on the taxpayer because of the effect of the expected increases of 25 to 35 per cent in the numbers of pensioners over the next 15 to 20 years.

The introduction of pension legislation and subsequent frequent amendments give clear pointers towards pre-funding and lower guarantees for beneficiaries. In so-called Defined Contribution Plans, the sponsors provide no guarantee of a fixed

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pension but only the fixed technical interest rate applied to contributions invested, plus any excess investment return over this rate. Actuarial considerations of mortality and other risks govern changes in the level of pensions provided and even those in payment, thus passing on these long-term risks in full for the beneficiaries to bear.

The general effect of the recent legislation on pension funds is the creation of a very precise and detailed set of rules and checks which are highly technical and formal. These rules are based more on a short-term view of the issues rather than on a long-term strategy for coping with them.

Insurance schemes are penalised by taxation and make sense only in combination with specific promises made by the scheme sponsors. This type of arrangement is suitable for managers and executives who are not protected by legislation on pensions and insolvency.

The provisions made for book reserves are fully tax deductible at a fixed technical interest rate of 6 per cent regardless of the type of promise. There is a trend to change from defined benefit final salary plans (which up until now have included social security pensions) to defined contribution plans to reduce costs. The main argument is that this move leads to greater flexibility by increased vesting at lower benefit levels.

Belgium

The Belgian pension fund industry has evolved since the mid-1970s when a legal framework was put in place for the establishment of self-administered and segregated pension plans. The first plans were a mixture of book reserves, pay-as-you-go and pre-funded schemes. However, prompted by concerns over the security of unfunded employee pension assets, all new private schemes

established since 1985 have been required to use the pre-funded method with minimum funding requirements based on current salary and past service.

Legislation such as the Colla Law (this is the current pensions legislation), effective from 1st January, 1996, has served to regulate pensions provision more fully in Belgium. More legislation was expected to become effective in 1999 but has now been delayed until 2001/2002.

Since 1994, the Belgian government has imposed wage restriction legislation in an attempt to improve competitiveness. As a result, few new pension arrangements have been made to date. From 1997/98, wage increases in Belgium have been negotiated in line with its three main competitors, The Netherlands, France and Germany, and are limited to 5.9 per cent per annum for 1999/2000.

Resulting from the recent complete review of Belgian State pension provision, the normal retirement age for women will be increased gradually to 65 over the period to January 2009, in order to equal that for men. Additionally, by January 2005, early retirement will be permitted only after 35 years of service. At present, the State pension is 60 per cent of career average indexed salary after a full career (75 per cent for a married person with a dependent spouse). The ceiling on salary for State benefits was BEF1,404,155 (approximately US\$35,900) in 1999.

About three-quarters of pension schemes are defined benefit arrangements, although most new schemes are defined contribution. The typical target benefit would be equivalent to 66 to 75 per cent of final average salary, inclusive of State benefits, although plans frequently express the target benefit as a lump sum rather than as a pension. Lump sum payments are increasing in popularity due

to the more favourable tax treatment. Several insurance companies have recently introduced flexible benefit plans and these are expected to be very popular over the coming years, although the legal framework in Belgium does not permit the same degree of flexibility as in, for example, US flexible plans.

Pre-funding of retirement benefits is normally achieved through a group insurance scheme or a pension fund (ASBL/VZW), the latter of which usually has a minimum of 200 members. An ASBL/VZW is essentially a non-profit organisation run by a board of directors who are responsible for carrying out the administration of the fund in line with its rules. Both group insurance and pension funds are regulated by the insurance supervisory authorities (OCA/CDV). The OCA/CDV is responsible, *inter alia*, for ensuring compliance with the legislation concerning investment restrictions and minimum funding levels.

Other permitted pre-funding arrangements were introduced in January 1993. These include unit-linked products although this market has been slow to develop due to concerns over the tax deductibility of contributions. Group insurance with an active financing fund (a group insurance plan where the majority of the assets are separately allocated, allowing different investment strategies to be followed) is also permitted and is achieving a moderate degree of success. Proposed legislation, which should become effective in 2001–2002, will introduce the concept of client-tailored funds.

Denmark

The total value of Danish private pension assets, including insured and private pensions, is estimated at around DKK1,190bn (\$187bn). These are

predominantly defined contribution arrangements. Employers do not have to provide pension benefits for their employees but it is common for large and medium-sized companies to have funded pension arrangements which are almost always based on insurance contracts or on mutual funds managed by banks. In contrast, it has been the practice for central and local government employees to have unfunded pay-as-you-go pension arrangements.

All employees are required by law to be a member of the ATP — a public pension fund to which both employers and employees contribute at a flat rate. Additionally, the ATP has administered a compulsory pension contribution of 1 per cent of gross salary since the contribution was introduced by law in 1998. Company pension funds tend to be small, representing in total only about 4 per cent of the Danish pension fund market. At the beginning of the 1990s, a number of industry-wide pension schemes were introduced following collective bargaining in the labour market. About 600,000 wage earners and salaried employees in major unions are included in these schemes. The contribution rates are expected to increase from 4 per cent per annum to 9 per cent per annum over a period of five years.

France

France's very complex three-tier pension system is facing inevitable reforms, as it is likely to lead to uncontrollable deficits if it remains unchanged.

The first tier, provided by Social Security under the repartition (pay-as-you-go) system, generated a small deficit in 1998. In an unchanged environment, this deficit will grow to FF150bn (\$24bn) by 2020.

The second tier is a complementary

one which is provided by ARRCO and AGIRC under a repartition system funded by employee and employer contributions. ARRCO (for blue-collar workers, based on their full salary) will generate a deficit of FF17bn (\$2.7bn) by 2020 in an unchanged environment with an unchanged contribution rate. AGIRC (for white-collar workers only, based on their salary between one to eight times the Social Security ceiling (FF 169,080 or \$27,000 in 1998)) already has a FF6bn (\$1bn) deficit. Without any pension reforms or increased contribution rates, the deficit will balloon to FF32bn (\$5bn) by 2020.

The total assets backing the second-pillar provision funds (including the AGIRC modest provision fund and ARRCO) are estimated at FF176bn (\$28bn) and consist mainly of fairly short-term bonds.

The third tier, offered by large companies, consists mostly of unfunded pension plans which bring retirement benefits to between 70 and 90 per cent of final salary. These can be either book reserves (and contributions are not tax deductible) or funded through insurance contracts (where contributions are tax deductible). However, the increasing financial liabilities have led in some cases to the gradual capping of these benefits for new employees. In other cases, these defined benefit plans have been replaced by defined contribution schemes which have the advantage of giving vested rights.

Some employers provide additional voluntary occupational retirement benefit schemes, which can be financed on a tax-effective basis. These special third-tier benefits are sometimes provided only to certain levels of employees (for example top managers or top- and medium-level managers) by an insurance scheme. The newer funds or schemes tend to be defined contribution schemes (called

Article 39) rather than defined benefit schemes (called Article 83). Very few of these funds are large enough to warrant management on a segregated basis (with the exception of supplementary pension funds). Since August 1994, these funds have a minimum funding level of the accumulated contributions.

Civil servants and public sector employees are part of a separate pay-as-you-go pension system. This system was in equilibrium in 1998, but is expected to produce a deficit of FF130bn (or \$20bn) by 2020.

For civil servants there is a voluntary pension scheme which runs outside of the other schemes. These schemes provide very generous benefits (one-third of SNCF railways and RATP Paris metro retirement funding is supported through employee contributions). The schemes are well funded and managed by Caisse des Dépôts and insurance companies. However, it is expected that the total deficit of these schemes will grow to \$16bn by 2020.

The 1999 Charpin report suggests that if the French pension system remains unchanged and the contribution levels are not increased, its total deficit will grow to FF500bn (\$80bn) by 2020. At present, the French pension deficit represents 11.6 per cent of GDP. It is estimated that by 2040 this figure will grow to around 16 per cent.

Lately, total annual pensions paid out by compulsory plans have been in the order of FF1,000bn (\$160bn). A rough estimate for annual investment in insurance schemes for retirement purposes is FF100 bn (\$16bn).

Germany

Demographic changes in Germany, largely as a result of the 1989 unification and a general ageing of the population, have prompted a revision of traditional

pension arrangements and a shift away from a reliance on the fairly generous State system.

The 1992 Social Security Reform Act introduced a gradual equalisation of the State pension age to 65 for both men and women by 2015, a phasing out of early retirement on full pension, increased contributions and reduced benefits. Further legislation, which came into force on 1st January, 1997, adjusts retirement ages in the State scheme effectively reducing the transition period for both men and women. All normal retirement ages will now be equalised by 2004. This new legislation also imposes an actuarial reduction factor of 0.3 per cent on each month's payment before normal retirement age for those who retire early, and modifies the calculation of book reserves, in effect increasing them in an integrated company pension plan. In addition, the setting up of occupational pension schemes is being encouraged.

In December 1997 the German Parliament passed the Pension Reform Act 1999 (*Rentenreformgesetz 1999 — RRG 1999*). The main features of this legislation are:

- the introduction of a demographic factor into the pension calculation formula, to allow for increased life expectancy
- a gradual decrease in benefits from 70 per cent to 64 per cent of average net income
- other changes include revised retirement ages; a new definition of disability and a reduction in death and disability benefits.

Although these changes were clearly necessary, the new government (SPD/the Green Party) has suspended parts of the Pension Reform Act due to their promises made to the electorate while in

opposition. However, since the suspension would lead to a significant increase in contributions for Social Security in the long term and thus to higher labour costs, the new government decided to increase the level of State pensions for the next two years based on the lower cost-of-living index, rather than on the higher average increase in net earnings. The level of benefits may eventually fall below 64 per cent of average net income. Whatever the changes, there are concerns that state pensions will be restructured in order to produce favourable labour market conditions. This would certainly be acceptable if, at the same time, second- and third-pillar retirement income is tax-effectively promoted in order to compensate for the future reduction in State pensions, which has not been the case to date.

Companies which choose to provide occupational schemes must comply with the 1974 Companies Pension Act which demands high limits on vesting periods and requires that pensions in payment be reviewed every three years. Most occupational schemes are defined benefit but there is a trend towards defined contribution (or at least defined benefit arrangements not linked directly to salaries).

Several alternative methods of pension provision are available in Germany. The main approaches are:

- **Book reserving:** This is the dominant form used by companies offering employee pension provision. The employer guarantees the pension liabilities and records the assets as reserves on the balance sheet. In some cases book reserves are backed by separately held assets, through *Spezialfonds* (discussed below); in others the assets are retained for company use. In all cases the

employer must contribute to a mandatory insolvency insurance fund (the *Pensionssicherungsverein*, or the PSV) in respect of the vested members of the plan. Employees cannot generally contribute to book reserve funds, and benefits are taxable. Employer contributions are tax-deductible and the reserves can be offset against the company's taxable assets (except for deferred company plans).

- **Direct insurance:** Group or individual insurance arrangements have the merit of avoiding employer liability. However, employer contributions are taxable at a flat rate of 20 per cent for premiums over DM3,408. Employee lump-sum payments are tax free and only the interest portion of pension payments is taxable. Insurance companies offering these schemes are required to comply with specific regulations designed to ensure the adequate funding of the schemes' liabilities.
- **Pensionskassen:** *Pensionskassen* (pension funds) are separate legal entities overseen by the insurance regulator. They are fully funded schemes with specific solvency and investment restrictions and are required to have employee representation on the board. The taxable status of the contribution to and benefits from *Pensionskassen* is similar to that of direct insurance funds.
- **Support funds:** Support funds are similar to *Pensionskassen* in that they must be established as separate legal entities and have employee representation. However, in other ways support funds are similar to book reserves: any assets backing a support fund may be held in a *Spezialfond* and the employer must contribute to the PSV, whether or not

the support fund is funded, within certain limits. If the support fund is fully reinsured, the insurance premium is tax-deductible (however, most support funds are not fully reinsured); employee contributions are not allowed and benefits are taxed; employer contributions are tax-deductible. A unique aspect of these funds is that the employer, under certain circumstances, may borrow the assets back from the fund.

Ireland

Historically, pension provision in the Republic of Ireland followed the practice adopted in the UK and, consequently, current practice is similar to UK arrangements. Traditionally, pension schemes were of the defined benefit variety but, more recently, there has been a trend towards the defined contribution approach, this being particularly common in the case of new schemes for smaller employers and for subsidiaries of multinationals. Of the 9,607 new schemes registered with the Pensions Board in 1998, 99 per cent of such schemes were defined contribution schemes.

In October 1996 the Pensions Board and the Minister for Social Welfare (now known as the Minister for Social Community and Family Affairs) launched the National Pensions Policy Initiative. The purpose was to facilitate debate on how to achieve a fully developed national pension system and to formulate a strategy and make recommendations for actions needed to achieve this system. Part of this process included examining whether to move towards a compulsory pensions system or to reform the existing voluntary structure. The principal aim of the Initiative is to ensure adequate pensions coverage through a combination of sources.

The Pensions Board published its report on the Initiative entitled 'Securing Retirement Income' on 7th May, 1998. The report followed widespread consultation and a national conference. The ultimate target recommended by the Board is that 70 per cent of those over age 30 should have supplementary pensions cover. The recommendations include a package of interdependent innovations, including the introduction of a new pension vehicle — the Personal Retirement Savings Account (PRSA). A form of mandatory access is proposed in that employers not operating an occupational pension scheme or contributing to a PRSA will be required to facilitate access by employees to PRSAs, although the employer will not be obliged to contribute to that vehicle. The proposals include enhancing supplementary pension coverage by introducing greater flexibility for money purchase vehicles. This greater flexibility should allow fair competition between vehicles. Legislation giving effect to PRSAs is expected in 2000/2001.

In addition to this prospective change to the pensions framework, the Finance Act 1999 introduced major changes in the options for the self-employed and for proprietary directors of occupational pension schemes. The legislation has introduced greater flexibility into the self-employed regime and has removed the requirement to purchase an annuity at retirement provided that individuals have either a guaranteed income of IR£10,000 p.a. or IR£50,000 (or residue of individual's fund if less) which is applied to purchase an annuity or in an Approved Minimum Retirement Fund (AMRF). Once these conditions are met, the individual may apply his/her fund to an Approved Retirement Fund (ARF) which gives significant control to the individual over his/her investment choices.

In relation to the State pension, an Interdepartmental Working Group has been set up to consider the Board's proposals on pre-funding, the social security pensions and the major reforms recommended in the 1998 report ('Securing Retirement Income'). This report is pending, but in the meantime, the Minister for Finance announced on 23rd July, 1999 that the Government has decided to begin providing resources on a planned basis to secure the pensions in retirement for an ageing population by allotting 1 per cent of the GNP to pre-funding the prospective costs. The implementing legislation is awaited and this base figure of 1 per cent may be revised when the Interdepartmental Working Group report is published and considered.

Currently (and there is no immediate proposal to alter the status quo), occupational pension provision is not compulsory, but it is estimated that about 50 to 55 per cent of people in employment will receive occupational retirement benefits in addition to their flat State pension entitlements. Many of those not included in this estimate are engaged in atypical work arrangements (ie, part-time, self employed, etc.). There is no income-related pension under the State social security system. Most public sector employees are covered by an unfunded pay-as-you-go scheme but employees of the commercial semi-State companies generally receive benefits from funded schemes which rank among the largest schemes in the country.

The total value of the Irish pension fund market is estimated at IR£31bn (\$45.9bn). A feature of the market is that there is a relatively small number of large funds — those in excess of IR£100m (\$131m). Typically these large funds are invested directly in a range of Irish and non-Irish securities. Medium-sized funds adopt a similar investment philosophy

but may obtain exposure to the property and non-Irish equity sectors through the medium of pooled investment vehicles. Smaller funds may be entirely invested through pooled investment funds. Insurance contracts — such as deferred annuity and deposit administration policies — although once popular, are now rarely used for pension fund investment purposes.

Italy

Italy has a generous three-tier pension system traditionally financed through pay-as-you-go contributions. Contributions to the first pillar (INPS for private sector employees, INPDAl covering industrial executives and INPDAP covering State, regional and local authorities employees) are compulsory. Additionally, there are roughly ten other compulsory funds for specific professional categories (eg, journalists). Total contributions paid in 1998 were Lit209,000bn (\$126.8bn) (of which Lit111,000bn (\$67.3bn) was for private workers). Total pensions paid during the same period were Lit238,000bn (\$144.3bn) (of which Lit118,000bn (\$71.6bn) was for private workers). The system is gradually moving away from a final pay system towards one with a direct link between contributions and the amount of pension payment. As a result, there are different methods of calculating benefits depending on an individual's contribution history during the transition period. There is also a progressive reduction in the role of the seniority pension.

In 1993, the government passed Decree 124 which was Italy's first legislation covering the second and smallest tier, private pension funds (estimated total assets as at the end of 1996 were Lit22,000bn (\$13.3bn), with 600,000 participants and total annual

contributions of Lit2,100bn (\$1.3bn)). Although Decree 124 encouraged the creation of 'Fondi Pensioni' (pension funds), insufficient tax incentives meant that it was only moderately successful. However, in early 1995, Law 335, which further reduced INPS coverage, made significant progress towards putting acceptable incentives into place. By law, all new schemes must be on a defined contribution basis. The latest data available from the COVIP indicate that:

- the number of pension funds registered with the COVIP (as at March 1999) were 607 pre-existing pension funds, 75 open pension funds sponsored by banks, insurance companies or investment managers (SIMs) and 21 closed pension funds set up by specific categories (metal-working industry, chemical industry, etc.);
- the number of participants (as at December 1998) was 635,000 in pre-existing funds, 377,000 in closed pension funds and 15,000 in open pension funds. COVIP's expectation is that the number of participants in the closed pension funds will double by the end of 1999.

Most of Italy's pension provision is made through the third constituent, life coverage, which collected premiums of Lit51,750bn (\$31.4bn) in 1998, an increase of 40 per cent more since 1997. Since Italy has one of the highest savings rates in the world, it is not surprising that insurance coverage has traditionally been the vehicle of choice for pension provision.

Netherlands

The Netherlands has the second-largest pension fund industry in Europe, after the UK. Also, pension assets are more

important to the Dutch economy than to any other European country. Total pension assets are estimated at €564.1bn (\$582bn) which includes industry-wide schemes, company pensions and insurance contracts.

The General Old Age Act or *Algemene Ouderdomswet* (AOW) (in place since 1957) is the primary basis of the State pensions system and provides a flat-rate State pension for residents from age 65 irrespective of past earnings or wealth. This is then supplemented by industry-wide funds, company pensions and pensions for professionals.

There are currently 84 industry-wide schemes, 938 funded single employer pension funds (which are integrated with/provide additional social security and cover about 2m employees) and over 20,000 insured schemes. The biggest funds are in the public sector and there are a number of very large industry-wide and company pension funds.

Private pension arrangements are typically defined benefit in structure. There is currently some debate in the industry on the relative attractions of defined contribution arrangements, but to date there has not been a discernible move in that direction. The development of private pensions has been encouraged in recent years by State legislation through the Pensions and Savings Fund Act (PSA) which requires all pension liabilities to be funded through an industry-wide or company pension fund, or an insurance policy.

Employer and employee contributions are tax deductible for schemes offering pension payments but taxable for lump-sum schemes. (Consequently, lump-sum schemes are rare.) Pension payments from both State and private schemes are subject to income tax.

As stated above, some sort of funding is compulsory for all Dutch pension plans. Many employers still use deferred

annuity insurance contracts although the larger funds more usually have direct investments. The three main ways of funding for pension obligations are:

- **Industry-wide schemes:** These play an important part in providing integrated pension provision in conjunction with the State retirement pension. Eighty-four such funds have been created through negotiation between employer and employee representatives of a particular sector. Membership in 66 of these funds is compulsory. In addition there are 11 pension funds for professions and each has compulsory membership.
- **Company schemes:** A company scheme must be established by Deed of Foundation and operate as a separate legal entity from the employing company. The Foundation Board must have at least 50 per cent representation by employees. Separate sub-committees may be set up to handle specific issues such as investment policy providing they report to the Foundation Board. These sub-committees do not require employee representation.
- **Insurance contracts:** Group insurance arrangements are subject to consultation with the Dutch Works Council, which oversees the formation of, and any subsequent amendment to, collective pension arrangements for non-industry schemes. Group life insurance is not generally included in pension provision for tax reasons. Individual pension insurance arrangements are not regulated.

Combinations of these arrangements are possible within one fund: for example, an industry-wide or company scheme might also use an insurance contract for top-up benefits.

As mentioned above, regulations regarding disclosure, valuation of funds and funding requirements are increasing the pressure on investment professionals. Additionally, the expertise of pension professionals will be investigated to ensure that pension fund managers and board members have sufficient knowledge of complex investment matters. As these regulations become stricter and private pension provision becomes a necessity, there will be increased pressure on fund managers to achieve better performance thus encouraging them to expand into riskier investments.

Norway

The statutory social security retirement pension consists of a flat rate pension and an earnings-related pension. Even though the social security pension can reach up to 40 per cent of salary for certain income levels, it is common for companies to set up collective pension schemes for their employees. All collective pension schemes are based on the defined benefit principle and are usually funded arrangements invested in insurance contracts. Defined contribution schemes are at an early stage of development and new legislation allowing this type of scheme is expected within the next couple of years also for the social security retirement pensions which currently are funded on a pay-as-you-go basis.

In the public sector, the State generally operates on a pay-as-you-go basis, while local authorities usually use funded arrangements. Approximately 900,000 Norwegians are covered by collective pension schemes. This figure excludes the number of unfunded pensions in the public sector.

Pensions can also be set up on an individual basis but the tax-reduction

restrictions limit the annual premium to NOK40,000 (\$5,080). It is estimated that 850,000 Norwegians have individual pension arrangements funded by a bank or an insurance company. Pension arrangements have traditionally been funded through insurance companies but banks have made their way into the personal pensions market over the last five years, mostly through acquisitions of life insurance companies. Since 1997, unit-linked contracts have also entered the market successfully. Indeed, at 30th June, 1999, approximately NOK777m (\$99m) of pension fund assets were invested in unit-linked funds.

The value of the pension market at 1st January, 1999 was approximately NOK380bn (\$49.9bn).

Portugal

The Portuguese pensions market has changed significantly over the past ten years. Funded pension arrangements only really began in the late 1980s when companies were given strong tax incentives to establish pension funds for their employees. Under legislation introduced in 1986/87, sponsors received double tax deductibility on pension fund contributions, which spanned 1987 and 1988. The initial incentives allowed the market to grow rapidly at first and while subsequent years showed little increase in the number of new funds, the actual assets grew strongly from the need to fund existing pension plan liabilities. This large increase in assets is shown clearly by the statistics: total market assets were Esc2,300bn at 30th June, 1999 (\$11.8bn) compared with less than Esc1,000bn at 31st December, 1994 (\$6.3bn).

By the 1974 revolution, State pension benefits had become very generous; indeed, part of the motivation for promoting private sector pensions resulted from the strains on the social

security system. Now, with increasing budgetary pressure to reduce State pension benefits, private sector pensions (including new funds) are gaining more prominence and activity in the market.

Since 1987 many companies have set up their own pension funds, most of which are supplementary to the State system. The other main methods of pension benefits provision are:

- insurance contracts
- book reserving
- pay-as-you-go
- individual retirement savings funds.

There are onerous funding requirements for all pension plans established by banks operating in Portugal. Originally these plans had to be fully funded by the end of 1999; however the deadline has been extended into 2000.

Spain

Following the introduction of a new pensions law in November 1995, the Spanish pension fund market is currently undergoing a period of substantial change. Primarily, this concerns the ways in which pension plans are being financed.

Before the introduction of this new law, pension plans could be funded through life insurance, mutual societies, qualified company plans and non-qualified company plans. Many company plans are financed by book reserves or deposit administration contracts and these are classified as non-qualified plans. Such plans have more limited tax benefits but fewer restrictions are placed on the employer with regard to the fund structure and plan arrangements. However, under the new law, all non-qualified plans must either move over to a qualified plan basis and comply with the restrictions it

implies, or use a group insurance contract. The only exceptions are the financial entities (banks, insurance companies and brokers).

Qualified company plans are tax-efficient vehicles but operate under more stringent conditions which include restrictions on their investments and having a number of employee representatives on the Commissions of Control which oversee the management of pension plans. The number of employees appointed ensures that they, and not company representatives, are in the majority. These plans do, however, impose limits on the tax benefits available on employee contributions.

In comparison, group insurance contracts have less of a tax advantage, and have fewer investment restrictions. Furthermore, the employer-sponsor keeps control, and there are not any contribution limits.

The implication of the move to qualified company plans is that the funds under management of pension fund providers will increase greatly as assets are moved from book reserves and deposit administration contracts. The law initially stipulated that all non-qualified plans must have arrangements in place for transferring their assets by May 1999, but due to the delay in issuing the regulations that cover it, this period has been extended to 1st January, 2001. Companies will have a transitional period of 10 to 15 years to gradually make the change to external funding.

Companies are obliged to put together formalised plans before their book reserves systems are replaced by the new qualified plans. The transitional period should last no more than ten years, during which both sets of financing will exist in parallel. However, in a case where the fund is in deficit when the arrangements are being approved, the sponsor will have up to 15 years to

make good the deficit, instead of the ten-year transition period.

Current forecasts suggest that pension fund assets will increase from Pta4,701bn (\$29bn) at 30th June, 1999 to Pta6,500bn (\$40bn) by the year 2001. Some analysts estimate that the value of the book reserves and deposit administration contracts which will be transferred through this externalisation process is approximately Pta3,000bn (\$18.6bn).

Until recently, by law, Spanish pension funds could be managed by only one fund manager, and this manager had to be Spanish. However, in June 1998 these restrictions were eased. More specifically, 80 per cent of each pension scheme must still be managed by a single Spanish fund manager, but the remaining 20 per cent may now be managed by any number of fund managers, provided they are all Euroland managers and as long as they are selected to manage only Euroland assets for the scheme in question.

The growth of the Spanish pension fund market has not kept pace with international levels and compared with other developed countries the market remains small. Contributing factors to this low growth are the generous State pension system, the reluctance of employers to adopt qualified plans, and the delays in issuing the regulations which will help develop the externalisation process. However, with the new law's prohibition of book reserves and the likelihood that State pension cover will have to be reduced, the situation looks set for change.

Sweden

Pension benefits in Sweden are mainly provided via a State-based system. The total value of pension assets is estimated to be SEK2,300bn (US\$271bn) including

both life and institutional pension assets. It is estimated that this figure will rise to SEK3,000bn (\$353bn) by the year 2005. A large portion of Sweden's pension liabilities are unfunded and financed via a pay-as-you-go system or book reserves.

In January 1998, Sweden finally reached a five-party agreement on the reform of the Social Security pension system which has been under review since 1994. A draft law was submitted to Parliament in April 1998 and became effective in 1999. The reformed system is the result of switching from a supplementary pensions system to a defined contribution basis.

The components of the Swedish pension system are described below.

Social Security pensions

Social Security provision currently consists of a mandatory State pension and an elective corporate pension. Benefits from the State pension are linked to a minimum base rate, 'B'. The pension has two components: the AFP, a basic flat-rate pension of 0.96 B (SEK35,136 or \$4,134) for 2000 for a single person and 1.57 B (SEK57,462 or \$6,760) for 2000 for a couple, plus a supplementary earnings-related pension (ATP) of 60 per cent of earnings between B and 7.5 B after 30 years of employment. Earnings are the average earnings over the 15 best years in covered employment, automatically adjusted for cost-of-living increases. Together, the ATP and AFP will provide a pension level of 60 to 70 per cent of final salary.

The total pension contribution will be 18.5 per cent of gross salary shared between the employer and the employee. The pension system will be financed through a combination of pay-as-you-go and premium reserves. Of the total contribution, 16 per cent will be allocated to the pay-as-you-go system

and 2.5 per cent to the premium reserve system. It should be noted that while employer contributions are payable on total salary, pension entitlements accrue only in respect of earnings up to 7.5 times B, as in the current system.

The pension will be payable from age 61 for all persons and there will be no upper limit for late retirement. There will be a guaranteed minimum pension for persons who have not worked long enough to accrue an adequate pension. The minimum pension will be at least 1.90 times B for a single person and 2.13 times B for married couples.

There will be a transition period whereby persons born before 1938 will be covered entirely by the current system, persons born between 1938 and 1954 will be covered partly by the current system and partly by the new system, and persons born after 1954 will be covered entirely by the new system.

Pay-as-you-go pension

An individual account will be set up for each employee to record contributions credited to the pay-as-you-go system. Each year, the balance of contributions will be adjusted according to an index. The index will reflect increases in average earnings rather than consumer prices. At retirement a divisor will be applied to the balance of the individual's account to determine the pension entitlement. The two principal factors which will determine the divisor are life expectancy at retirement age and assumed future growth in wages. A typical rate of 1.6 per cent per annum will apply for the latter.

Premium reserve

The remaining 2.5 per cent contribution will be deposited in an individual premium reserve account and earn

interest. Employees will have the option to select an investment manager for their premium reserve account. At retirement, the value of the account will be converted to a life-time annuity and paid out as the proceeds of a pension policy.

Private sector pensions

There are two contractual plans in private industry, one for salaried employees (the ITP plan) and one for wage earners (the SAF-LO plan). Affiliation with these plans is compulsory for all members of the Swedish Employers' Confederation (SAF) if they employ one or more employees who are members of the Confederation of Salaried Employees (PTK). As over 95 per cent of Swedish employees are covered by contractual plans and all residents are covered by Social Security, a very large majority of employees is covered by mandatory plans.

Salaried employees

These employees are covered by the ITP plan, which is a defined benefit scheme based on final salary. The ITP plan can either be insured through the SPP life insurance company or financed through a book reserve method, which requires credit insurance to be taken out with the insurance company, FPG. This plan was under negotiation, but failed in the summer of 1999. People are hoping that these negotiations will soon resume. There is also a defined contribution part, ITPK (for most employees) which is a company contribution amounting to 2 per cent of salary. The accrued reserve may be used for a temporary pension for five years (or possibly a lifetime pension). Plan members may place these contributions with carriers other than SPP. Since the summer of 1996, the collective agreement has allowed companies to set up separate corporate

pension funds (*Pensionsstiftelse*) to finance white-collar pension liabilities.

Wage earners

About 2m employees are covered under the SAF-LO agreement, the scheme for blue-collar employees in the private sector. The accrued reserves may be used for a temporary pension for five years (or possibly a lifetime pension). Plan members may place these contributions with carriers other than SPP. The new SAF-LO plan allows 2 per cent of salary to be invested in a defined contribution plan.

Public sector pensions

Individuals working in the public sector are all covered under different defined benefit schemes. Defined contribution plans also exist.

Switzerland

Pension funds have been mandatory since 1985 when legislation was passed requiring employers to provide a second tier of pension benefit to employees to supplement the State scheme. Since then the Swiss private pensions market has grown significantly. However, the mandatory legislation (known as the BVG/LPP law) provides only for a minimum level of benefit (maximum old age at CHF9,700 (\$6,240), maximum disability pension at CHF18,000 (\$11,580) and maximum widow's pension at CHF10,800 (\$6,950) annually, compared with an average salary of CHF70,000 (\$45,030)) so additional benefits are often funded under expanded or supplementary plans.

In order to protect the interests of employees, the administration of a pension scheme cannot be conducted by the sponsoring company/organisation. A separate foundation must therefore be set

up for this purpose and administered by a Foundation Board on which the employer and employees are equally represented. However, decisions on investment issues may be delegated to a separate sub-committee. Alternatively, a company can employ the Common Foundation of an insurance company or bank for this purpose.

Tax is assessed on pension benefits but not on the contributions. Different cantonal regulations apply to the tax treatment of lump-sum payments. Many of the largest schemes are public pension funds.

The main vehicles used for funding pension schemes in Switzerland are:

- fully autonomous funds, currently accounting for more than two-thirds of pension assets
- self-managed funds with partial reinsurance of risk
- collective insurance contracts provided by insurance companies.

The management of the assets for the two first categories is done mainly internally. Based on best estimates by professionals, the proportion of internal asset management appears to be growing with the sizes of the funds. The external money managers currently represent between 10 and 20 per cent of total assets. Domestic bonds and equities are often managed internally and external money managers are used primarily for foreign currency bonds and international equities.

The amendment to the ordinance on pension plans (OPP2) obliges a foundation committee to set objectives and principles for investing assets and to have in place controls and procedures for monitoring the investment process.

Large funds have already defined their investment strategies in writing. However, the extension of these

requirements to the smaller pension funds has been relatively slow to take effect.

A new requirement to be met by Swiss fund managers is the implementation of the Swiss Performance Presentation Standards (SwiPPS) which have been in place since 1st January, 1997. These standards are very similar to AIMR standards.

The pressures of the competition between fund managers have meant that the performance of 'composites' of either balanced portfolios or specialised mandates are readily available. However, it is still difficult to get hold of pre-January 1997 performance numbers based on SwiPPS.

This requirement is viewed very positively for selecting money managers as well as for the monitoring of pension funds.

United Kingdom

The UK has the largest pensions market in Europe with estimated total assets of £744.6bn (\$1,241bn). Pension provision has not been compulsory for UK employers but about half the employed workforce is estimated to be covered by corporate sponsored plans. These arrangements are still predominantly of a defined benefit nature, although there is a discernible trend towards defined contribution plans.

Historically, public sector employees have been well provided for with generous pension benefits. Within this, local government authorities operate funded arrangements, but Central Government commitments are generally unfunded pay-as-you-go arrangements which are generous and are therefore becoming increasingly onerous.

A typical corporate plan would aim to provide a pension of between 50 and 67 per cent of final salary after 40 years' service (usually averaged in some way).

For approved (ie, tax-exempt) plans the Inland Revenue has placed some restrictions on the amount of remuneration and service allowable for pension purposes. Almost all plans provide for part of the benefits to be taken as a tax-free lump sum; the remainder of the benefits have to be taken as an annuity which is taxed as income in the hands of the recipient.

Both employees' and employers' contributions to approved pension plans are tax-deductible as are employers' costs towards the provision of risk benefits (death, disability, etc.).

Most employers use direct investment or mutual funds as their investment medium, although death and disability benefits are usually insured. This represents an evolution from the position 25 years ago when many funds were in deferred annuity insurance contracts. Industry-wide schemes do exist but are relatively uncommon. The largest funds tend to be:

- local government funds
- large corporate funds
- public and ex-public sector funds (eg, Post Office, etc.).

In the wake of the Maxwell-related pension fund scandal, followed by a number of lesser scandals, the Government commissioned a thorough review of the framework within which occupational pension schemes operate. The review resulted in the Pensions Act 1995, the main provisions of which came into effect in April 1997. The Act represented a significant increase in responsibilities for trustees and sponsoring employers alike; particular issues addressed include guaranteed pension increases, member-nominated trustees, fuller disclosure, a formal statement of investment policy and the requirement to meet a Minimum Funding level.

More recently, at the end of 1998, the UK Government announced plans for a reform of pensions provision. As part of this, employers who do not offer employees access to a corporate pension plan must offer access to 'stakeholder pensions'. These are money purchase arrangements which must meet minimum standards in terms of cost, access and terms. The details are yet to be determined.

Finally, the Government has announced regulations concerning Socially Responsible Investment (SRI) and voting by UK pension funds. From mid-2000, this will require pension funds to disclose what their policy is, if any, on these issues.

Concerns about loss of control on costs and other burdens arising from the Pensions Act 1995 requirements have also fuelled the trend towards defined

contribution plans. Typically, sponsors are setting up such plans for new employees where the investment vehicles are usually pooled or mutual funds. Linked to this, many of the major providers have launched products providing a range of pooled funds designed to cater for the degree of choice offered to members in a typical defined contribution plan.

Within defined contribution plans, a 'lifestyle' approach has found favour with many trustee groups and plan members. This approach tends to involve investment in an equity-orientated growth fund during a member's working lifetime, with automatic switching into less volatile bond and cash funds as the member approaches retirement. These bond and cash funds aim to protect the buying power of a member's fund with regard to purchasing an annuity and a cash lump sum at retirement.