Original Article

The EU internal market for occupational pensions: Making further progress

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ABSTRACT Pension funds will play an important role in meeting a number of key challenges common to European Union (EU) Member States: ageing, fiscal sustainability, cost efficient and adequate pensions, flexible labour markets and financial stability. These issues need a much greater coherent policy approach over the next few years. The EU internal market for occupational pension funds, based on the Institutions for Occupational Retirement Provision Directive, can contribute. This would allow employers and employees to reap the benefits of scale and scope economies, risk diversification, lower transaction costs, innovation and more product choice.

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INTRODUCTION

Recently, the *Economist* invited us to “stop thinking for a moment about deep recession, trillion-dollar rescue packages and mounting job losses. Instead contemplate the prospect of slow growth and low productivity, rising public spending and labour shortages”.¹ Demographic ageing remains a serious challenge for the sustainability of public finance and for the economy as a whole, and this challenge has been exacerbated by the financial crisis. Successfully dealing with this challenge may require higher retirement ages, more private savings, or both. Private pensions are likely to remain an essential instrument for securing sustainable and adequate income after retirement.

Pensions policy in the European Union (EU) is a matter decided by the Member States. But the EU can help. The EU can contribute in the development of comprehensive and coherent systems that deliver sustainable, adequate, safe and efficient pensions. Europe has already achieved important milestones, notably with the creation of the EU Internal Market for occupational pension funds in 2003, with the adoption of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (Institutions for Occupational Retirement Provision, IORP, Directive).

The remainder of this article is structured as follows. The next section outlines some of the key common challenges affecting pensions in Europe. Considering that pensions policy is a wide subject, the subsequent section provides an overview of the different services within the European Commission, which are active in this

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field and recalls President Barroso's recent political guidelines concerning European pension systems for the period 2010–2014. The next following section focuses on the IORP Directive and outlines some of the measures that may be needed to make the internal market for pension funds function better. One of these measures is a possible review of the solvency rules for pension funds in the light of the recently adopted Solvency II Directive in the area of insurance regulation. This very specific and important aspect of pension fund regulation is addressed in the penultimate section. The final section concludes the article.

KEY COMMON CHALLENGES AFFECTING PENSIONS IN EUROPE

The financial market crisis and the global economic recession are leaving deep scars in many places. Pensions are no exception. Funded pension arrangements are recovering gradually from the financial crisis. Although the investment losses suffered in 2008 are still far from being fully recouped, investment returns and funding ratios in defined benefit (DB) plans have shown a marked improvement in the first half of 2009.²

The financial crisis has revived the old debate about the 'architecture' of pension systems. Advocates of the welfare state are calling for a U-turn in pension policies and a return to the dominance of the pay-as-you-go state pension.

In their view, the financial market turmoil has shown that fully funded systems, unlike national pension schemes, do not provide a reliable basis for financial provision after retirement.

Income from funded private pension is substantial only in a few countries at present. But funded private pension provision is set to increase. Projections of public pension expenditure, as a percentage of GDP, show an increase of 2.4 percentage points over the period 2007–2060 in the EU.³ Although there is a large diversity across Member States, ranging from a decline of 2.8 percentage points in Poland to an increase of 15.2 percentage points in Luxembourg, the sustainability of public finances requires an increasing role for supplementary pensions. Figure 1 illustrates that the gross replacement rate – income after retirement as a percentage of the last income – from state pension is in most Member States below 70 per cent.

The financial crisis has not called into question the logic of additional private provision, although, increasing unemployment and uncertain employment prospects will make it more difficult to set aside savings each month for retirement. Nonetheless, pension scheme designs may need to be reviewed to ensure adequacy and sustainability of funded schemes.

Europe is heading towards a 'silver society'. Life expectancy at birth in 2008 is 82 years for

Figure 1: Gross replacement rate from state pension (2007, income after retirement as a percentage of last income). Sources: European Commission, OECD and own estimates.

women and 76 years for men. This follows a gain in longevity of 4 years for women and 5 years for men over the past 20 years. By 2060, life expectancy is set to increase to 89 years for women and 84.5 years for men. The old-age dependency ratio, calculated as the ratio of people aged 65 years or above relative to the working-age population aged 15–64 years, is projected to more than double in the EU from 25.4 to 53.5 per cent.

In the future, for the generations that have recently entered the labour market, a marked decline in pensions can be expected if the number of years worked and contribution rates remain the same.

Long-term adequacy and sustainability of pension systems depend on continued efforts to reach the Lisbon target of a 50 per cent employment rate of older workers, notwithstanding the downturn. We see, in several countries, a relatively high proportion of early retirement. This phenomenon is barely correlated with health. Unused labour capacity is especially large in some Member States in which many healthy individuals are not in the labour force.

DB schemes may distort retirement incentives and contribute to spurring early retirement. Defined contribution (DC) schemes – which tend to be disincentive free, that is the value of the pension rises broadly in line with the contributions made to it – show that without the (dis)incentives created by the DB system, individuals are far more likely to carry on working beyond the official retirement age. The significant disadvantage of the DC schemes is, however, that they expose retirees heavily to market volatility.

Although mobility in the EU labour market is of growing importance, progress could be made by removing obstacles for mobility resulting from pensions such as the lack of portability and the restrictions from national social and labour law. Although the IORP Directive and the Solvency II Directive are helpful, many obstacles remain for schemes to operate across borders and for individuals wishing to move jobs or countries. The Internal Market needs to propose more

efficient solutions for European-wide pensions to meet the needs of mobile workers.

The pension fund sector has not been the source of financial instability. The business model of pension funds – despite of the painful losses – is a time proven and resilient one. However, private pensions are part of the financial services field and the IORPs are large investors in many markets. Thus, any reforms of the framework under which financial services are conducted will unavoidably affect the sector. It is quite understandable that a crisis of the magnitude of the current one will lead to sweeping changes.

There are three perils to be avoided in regulatory reforms and it is important to get the balance right. First, overly lax regulation results in huge direct cost through bankruptcies, other economic and social damage and possible financial instability. Second, overly restrictive regulation results in huge indirect costs through increased expenses, decreased efficiency and underdeveloped market potential. Third, overly complex regulation is costly and less effective, as it is harder to monitor and enforce and carries a higher risk of ‘malfunction’.

ONGOING AND PLANNED EU ACTION IN THE FIELD OF PENSIONS

In recognition of these European and indeed global challenges, the World Economic Forum and the OECD⁴ have recently called for multi-stakeholder collaboration and innovative approaches to the sustainable financing of pensions and health care. It tries to change the mindset and considers ageing to be an opportunity rather than a risk. It is suggested that a larger pie can be attained through cooperation before distributing parts in the value-claiming process.

What is Europe doing about this? Dealing with pensions in Europe is a complex issue. Pensions are subject to the subsidiarity principle, which is a fundamental principle underpinning EU policy making. It ensures that decisions are taken as closely as possible to the citizen. Member States are therefore responsible for the overall organisation of the pension system in general

terms. At the same time, there are some specific areas in which Member States have recognised that pooling action would be more effective than acting alone. The European Commission is therefore active in several areas that are directly or indirectly related to pensions. Several Directorate-Generals (DGs) of the European Commission are involved.

DG MARKT (Internal Market and Services) aims to promote the Internal Market for occupational retirement provision based on the IORP Directive. The basic idea is to facilitate cross-border activity and this is flanked by a minimum set of common prudential rules. In addition, retirement income is often secured through life assurance or banking products. Reverse mortgages could, if accompanied with the proper safeguards, become an efficient additional individual source of pension. Moreover, the financial crisis has underlined that financial products have to be sold and bought in markets with good communication, disclosed information and financially astute participants.

DG EMPL (Employment and Social Affairs) plays a key role in exchanging best practices within the Open Method of Coordination for pensions. The EU has also adopted a Regulation to coordinate social security systems⁵ and a Directive to protect workers' pensions when the employer becomes insolvent.⁶ The European Commission also remains committed to the portability of pension rights, even if the current Directive proposal has not been successful so far.

DG ECFIN (Economic and Financial Affairs) plays a key role in the generation of the EU's ageing projections, in the monitoring of fiscal sustainability and, together with DG EMPL, in the assessment of labour markets.

DG TAXUD (Taxation and Custom Union) addresses cross-border taxation issues in which they affect pension funds. EU action against discriminatory taxation of foreign EU-based pension funds by both the Commission and the European Court of Justice is producing tangible results.⁷

In September 2009, European Commission President Barroso set out his political guidelines for the mandate of the European Commission

2010–2014 to the European Parliament.⁸ In these guidelines, he describes the rationale that could drive the Commission's work on pensions looking forward. President Barroso emphasises that 'the crisis has shown the importance of the European approach to pension systems. It has demonstrated the interdependence of the various pension pillars within each Member State and the importance of common EU approaches on solvency and social adequacy. It has also underlined that pension funds are an important part of the financial system. We need to ensure that pensions do the job intended of providing the maximum support to current and future pensioners, including for vulnerable groups'.

Today, it is too early to say exactly how these political guidelines will be implemented over the next 5 years. One possibility is to organise a structured dialogue at the EU level in order to learn from each other, share experiences, identify best practices and possibly point out whether regulatory changes might be useful. But, this will of course depend on the new European Commission that has taken office on 10 February 2010.

THE IORP DIRECTIVE

The adoption of the IORP Directive in 2003 has been difficult to achieve and it has turned out to be, mainly, an 'enabling' Directive. Its objective is to allow pension funds to benefit from the Internal Market principles of free movement of capital and free provision of services. The directive allows pension funds to manage occupational pension schemes for companies established in another Member State. This enables pan-European companies to operate only one pension fund for all the subsidiaries. At the same time, the IORP Directive establishes rigorous prudential standards ensuring that pension fund members and beneficiaries are properly protected. However, it is important to bear in mind that these prudential standards are based on minimum harmonisation and mutual recognition, which means that Member States can go (and have gone) beyond the common EU requirements. The IORP Directive does not follow the more recent 'Lamfalussy approach' to financial market

Figure 2: Pension fund assets (2007, as a percentage of GDP).
Sources: European Commission, OECD and own estimates.

regulation, which facilitates harmonisation and makes EU regulation more flexible.⁹

The importance of pension funds varies, however, considerably from one country to another (see Figure 2). This reflects that there are considerable differences in the way in which occupational pensions are delivered. In some Member States, pension liabilities remain mostly on the balance sheet of the employer (book reserves). In others, pension liabilities are generally outsourced to a separate pension fund, although there are differences across countries in the degree to which the sponsoring employer remains involved in the pension fund. In some Member States, occupational pensions are delivered mostly by insurance undertakings. The IORP Directive covers only a very small part of the pensions policy area. The Directive only concerns occupational pensions and not all occupational pension schemes are covered. The Directive covers only those pension funds operating on a funded basis and established separately from the sponsoring undertaking.

First, results have been achieved since the adoption of the IORP Directive but the level of cross-border activity within the EU remains low. Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) reports¹⁰ that there were 76 cross-border cases as

Figure 3: Number of cross-border IORP cases in the European Economic Area (EEA).
Source: CEIOPS⁷.

of September 2009 (see Figure 3). The question is why there is not much cross-border activity and whether this is caused by a lack of demand or a lack of supply. Anecdotal evidence suggests that many experts in the pension fund industry are far from convinced that there is a need for EU-wide cross-border pension funds. The national preference seemingly still predominates strongly. Sponsoring undertakings are developing separate local pension solutions for each country. This does, however, not necessarily mean that there is no potential to realise scale and scope economies, lower transaction costs, risk diversification or innovation. Indeed, many stakeholders seem to acknowledge that there are

potential efficiency gains in the internal market for IORPs. There would also be benefits in stepping up cooperation across pension funds to pool specific tasks such as the administration of payouts. The issue is, rather, that reaping these gains is still too complex.

In going forward, it may become necessary to remove perceived obstacles to cross-border activity, using a wide range of policy instruments. One possibility would be to review the IORP Directive. The recent consultation conducted by CEIOPS on the Budapest Protocol¹¹ has confirmed that there are many issues in the definition of « cross-border activities » itself. There is probably too much room for different interpretations by the Member States. Other important aspects of the IORP Directive that may need to be examined further in the light of international best practices include governance, risk management and internal controls.

Moreover, the crisis has vigorously exposed the risks of the gradual shift of moving towards DC schemes. Many people have lost considerable part of their savings and wealth because of the dramatic falls in asset prices. Similarly, a lot of pension funds assets have lost big chunks in value. These losses are irreversible for those who are close to retirement and some people even had to postpone their retirement decision. Market developments demonstrated that individuals are exposed to the risk of not receiving an adequate level of benefits from DC schemes. Guarantees and lifestyle portfolio compositions can reduce short-term volatility, but these come at a cost. DC schemes are much more prevalent in the EU today than, say, one decade ago. The question is whether our policies and regulation can cope with this shift. As the trend away from DB schemes towards DC schemes continues and accelerates, new policy challenges may arise, such as adequate communication with members and beneficiaries.

A recent Commission consultation¹² has confirmed that the creation of an Internal Market also requires the removal of fiscal barriers and a clarification concerning the link between EU prudential legislation and national Social & Labour Law (SLL). The EU has little competence in the areas of taxation and social policy, but

some progress has been achieved over recent years. Progress is being made with discriminatory taxation of foreign EU-based pension funds. CEIOPS has recently launched an Internet site containing information about national SLL relevant to the field of occupational pensions.¹³ Transparency can be a powerful instrument in disclosing national differences and simplifying the cross-border business environment.

Moreover, pension funds, like insurance undertakings, are major institutional investors and this has several important implications. Clearly, pension funds are part of the transmission mechanism for systemic risk and hence they play a crucial role in contributing to financial stability. It is therefore important that pension funds are suitably represented in the future European Systemic Risk Board. The collection of high quality and timely statistics on the pension funds sector should be stepped up. Moreover, pension funds rely on strong investment performance to meet their pension promises. Lower GDP growth, and thus lower real interest rate, may lead to accumulated capital flowing out to emerging countries in search of yield. This may have implications for macroeconomic imbalances. Finally, in the face of Europe's lead on climate change, responsible investment and factoring in environmental risk may become more of an issue going forward. It will be important to align the incentives to promote Environmental, Social & Governance investment policies for prudent investors with a long-term perspective.

SOLVENCY RULES FOR PENSION FUNDS

The recently adopted Solvency II Directive is an immense step forward for the EU insurance industry. It is without doubt a far-reaching reform with global impact. It is an important step in the right direction, but it will see modifications – especially as the global financial regulatory and supervisory landscape is being greatly remodelled following the financial crisis. There must be careful planning and detailed discussion with the industry and other key stakeholders on the likely impact of specific requirements. The field testing of many aspects

of the solvency reform (before the directive was adopted) was very productive and appreciated by all parties, especially since they uncovered a series of potential problems early in the process.

The adoption of the Solvency II Directive has raised a debate in Europe about the solvency rules for pension funds. This is because the solvency rules for pension funds are those currently applying to insurance undertakings (that is, Solvency I until 2012). The application of Solvency II to IORPs has been fiercely debated. Those who are in favour of applying Solvency II to pension funds argue that pension risks should be subject to the same regulation irrespective of whether that risk is borne by an insurance undertaking or a pension fund. This argument is based on concerns relating to level playing field issues across financial sectors and regulatory arbitrage across Member States ('race-to-the-bottom'). Those who are against the application of Solvency II for pension funds argue that IORPs are usually underfunded and it is conjectured that the application of Solvency II would lead to a substantial increase in capital charges, possibly implying higher contributions from employers and/or employees or a reduction in the supply of occupational pension products altogether. Moreover, in some Member States, pension funds are backed by sponsor covenants and do not carry the liability directly.

Owing to this controversy, the European Commission carried out a consultation on the topic in September 2008 and this was followed up by a Public Hearing in May 2009.¹⁴

There has not been a decision on the way forward yet. This is because, in the meantime, the EU had elected a new European Parliament in June 2009 and appointed a new European Commission. But the work continues. A recital in the Solvency II Directive politically commits the European Commission to develop, together with CEIOPS, a proper system of solvency rules for occupational retirement provision. It would probably be desirable to have a solution in place by the end of 2012 when Solvency II becomes operational. There are strong interactions between pension funds and insurance undertakings. These interactions can be direct

through competition in the same market, or indirect through risk transfer via, for example, the markets for buy-ins/buy-outs, longevity swaps and annuities.

In going forward, it may be necessary to develop a risk-based supervision of pension funds that avoids pro-cyclical regulation. It is also important to clarify the scope of the pension schemes to be covered: DB, DC, hybrid schemes.

But the main controversy concerns the capital requirements. One question is whether long-term solvency rules should be combined with short-term liquidity needs. It may also be more appropriate to harmonise the protection level in a way that allows one to combine own funds with sponsor covenants and other security mechanisms. Sender¹⁵ suggests that regulation should provide incentives to build internal models. Moreover, there are no solvency rules for DC schemes to deal with, for example operational risk and liquidity risk.

Finally, it should also be borne in mind that the international accounting standards for the sponsoring undertakings (IAS 19) are being revised and this may have an impact on the valuation of pension fund assets and liabilities.

In going forward, it will be necessary to strike the right balance between pension cost and pension security.

CONCLUSION

Demographic ageing is here to stay even after the financial crisis. Society has to be consulted on how to shape the 'Silver Society'. Ageing in the EU demands action and the window of opportunity is closing rapidly. Internal Market regulation has to be adapted to the changing environment and requirements. This means taking measures to promote cross-border activity for IORPs and review the adequacy of solvency rules.

The next years will probably see EU initiatives regarding pensions. This was announced by European Commission President Barroso. At this stage, however, no further decisions have been taken yet.

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