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The Pension Issues in the new Member States

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"Some people tend to forget that the main purpose of pension schemes is to provide a secure income to people in old age; they seem more interested in other issues, such as the development of equity and bond markets."

Odile Quintin, Director General, DG Employment and Social Affairs, The European Commission, Brussels.

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EXECUTIVE SUMMARY

The enlargement of the European Union in 2004 offers an opportunity to compare the state of affairs related to pensions and more particularly to supplementary pensions - which are those in addition to state pensions (also called legal/first pillar/statutory pensions) - as they exist today in the 10 new Member States (NMS) with that in the original Member States (EU-15).

The purpose of this report is to encourage mutual learning by offering research, seeking responses and opinions from stakeholders from the NMS as well as experts from the EU-15. The captured opinions of 86 respondents, throughout the enlarged European Union to an in-depth questionnaire, help to identify best practices and to formulate a number of issues for further consideration. The stakeholders originate from all sub-sectors of the pensions industry, private and public sectors and generally express their personal view, which do not systematically reflect that of the official organisation they belong to. We have highlighted differences as well as similarities that came out of our findings with the sole purpose to stimulate debate and hopefully inspire readers.

Common challenges but different impact among Member States

All current 25 Member States have to face longevity i.e. the ageing of their populations and the impact thereof on public versus private pension provision and on public and private sector finances.

The population of the NMS in aggregate is at present slightly younger than that of the EU-15 but this advantage will gradually disappear. The fertility rates in the NMS are similar to those encountered in the EU-15 and are generally insufficient to renew the population. As a consequence the old-age dependency ratios like in most of EU-15 are expected to more than double between now and the year 2050 in several NMS, among which Poland, the Czech and Slovak Republics, Latvia, Lithuania and Slovenia.

To make matters worse, there is persistent high unemployment not only in most of the NMS, but throughout most of the EU-25 and there has been a tendency to anticipating retirement well before legal retirement ages, particularly but not only in countries like Italy and Belgium that can least afford it due to their much higher than average level of public debt.

Unemployment is generally higher currently in the NMS than in the EU-15 particularly among the young. This is alarming in Poland, the Slovak Republic and (to a lesser extent) in the Baltic States. The much higher economic growth rates in these countries, if persisting, will most likely bring some relief.

Public finances in several NMS are in good shape and public debt expressed as a percentage of GDP is generally lower than the EU-15 average.

Capital markets in the NMS as elsewhere are strictly organised on a national basis and generally characterised by insufficient listings, weak (stock) market capitalisations as well as by insufficient liquidity and trading volumes. The local debt markets are equally small; capital market instruments and techniques are generally insufficient or in a development phase. There is, therefore, a substantial potential for financial sector growth. The question is whether these circumstances that are expected to evolve over time are not prone to systematic risk if pension assets were to be invested for the larger part on local markets as is the case in Poland, for example. In this respect, membership of the EU and in the future of the EMU may bring welcome relief, as well as increasing participation in global markets.

The response to the challenge of ageing and the respective role of public versus private provision – whether collective or individual – is a matter of competence of each Member State and therefore differs greatly not only between countries but also for seemingly similar groups as well as provision within Member States, for a complex number of historic, social, economic and financial reasons as well as because of policy choices that have been made in the past.

If anything, there is variety and complexity and there is not such a thing as a unique model nor a blueprint that can or should be followed. This multitude of systems and types of provision is both enriching and complicating; enriching because it allows for mutual learning; complicating because it does not allow to converge to a unique system, to a “one for all” solution, at least not in the foreseeable future.

Pension reform: from a mono pillar to a three-pillar pension system

In the EU-15 - although it is not a coherent group of countries - an approach by which the risks are shared and therefore mitigated as they are spread over 3 pillars i.e. the state pillar supplemented by an occupational pillar and by a third individual pillar is favoured. The financing of these pillars is generally complementary as well: PAYG or PAYG plus funding for the first pillar and funding for the other pillars. The second pillar

differs considerably between Member States in terms of importance, coverage, financing methods and types of plans.

Although the report focuses on supplementary pensions, a lot of attention is given to state pension as well because both are invariably interwoven.

A majority of the NMS have engaged in pension reform, which means that their mono pillar pension system evolved to a three-pillar system. These pillars are differently conceived - but not everywhere - compared to what they represent in the EU-15, which may lead to confusion because different terminologies are used between the Member States. We refer to the report for further clarification on this.
The first pillar (disregarding pensions for civil servants) is usually PAYG-financed in the EU-25 increasingly combined with unallocated funding (the so-called reserve funds in e.g. Sweden, Ireland and France, which are non-contributory funds but financed by governmental annual contribution) as well as with mandatory individual accounts (in Sweden and in 6 NMS) or with collective funding as is the case in e.g. Finland and Denmark (premium-reserve schemes).
In 6 out of the 10 NMS (Poland, Hungary, the Slovak Republic and the Baltic States) the first pillar has been partially replaced by mandatory funded individual accounts, which are called the second pillar but which we call the first pillar bis, so as to differentiate it from the second occupational pillar in the EU-15.
Poland and Latvia like Sweden earlier on, have adopted a Notional Defined Contribution system for the first pillar, which, despite clear advantages explained in the report remains, nevertheless, PAYG-financed and therefore vulnerable to ageing.

The advantages of the first pillar are considerable as they ensure universal participation (coverage), inter- and intra-generational solidarity and low operating costs and all interviewed pensions stakeholders agree that it is and needs to remain the basis of the pension system, and therefore of social protection, on which the other pillars are built.
For the first pillar to survive the ageing wave – as it is vulnerable to a combination of longevity, insufficient fertility and insufficient activity rates insofar it is PAYG-financed – all respondents agree that it needs to be reformed if it is to be preserved.

The first pillar bis in the aforementioned 6 NMS is an achievement in terms of risk shifting from the state pillar/statutory pensions directly to individuals. There are, however, risks in privatising the social security pension pillar. These countries have opted for a partial privatisation as they usually maintain a reduced PAYG social security pillar, which is complemented by a mandatory individual and funded first pillar bis. There are major costs for several decades implied by such transition to funding and these are one of the reasons why funded individual accounts have not as yet been introduced in the first pillar in the United States, despite many years of considering these. If the US, having the strongest economy as well as the most sophisticated, diversified and liquid capital market in the world raises this problem, one can imagine the importance of transition in other countries.

Whereas the 6 NMS are generally (and with exceptions) advanced to the EU-15 with regard to reform of the first pillar, there are risks in this development because individuals are on average much less capable of bearing investment, longevity, annuity and other risks than governments or employers, sectors of industry and other groups. The shift of a lot of the (future) liabilities of the state pillar (social security unfunded pensions) to individuals is not considered as an improvement by a majority of the respondents from the EU-15. In their view, the risks/liabilities have not disappeared; they have merely been shifted around and have now been put on the much weaker shoulders of individuals, which they consider a step backwards. It therefore seems that the discussion on the respective merits of both approaches needs to be engaged in.

The Community "acquis" and the role of the European institutions versus the Member States

According to the principles of sovereignty and subsidiarity, Member States are competent in pension matters, the European level much less so except for the basic Treaty freedoms i.e. for cross-border issues and on the basis of the Capital Movements provisions of the Treaty.

The NMS have to adopt the so-called Community "acquis" because of them being members of the Union, like any other Member State.

The roots of the Community "acquis" are the basic freedoms enshrined in the Treaty (free movement of workers, freedom of establishment, freedom to provide services and free movement of capital). These are reinforced in pension matters by Regulation

1408/71, which aims at protecting the social security rights of persons moving within the European Union and the Directive on equal treatment for men and women. Related to supplementary pension provision, by the Life Insurance Directives, the Directive on IORP 2003/41/EC – the so-called "Pension Fund Directive" - and the different measures to ensure the safeguarding and portability of vested rights.

A majority of the respondents does not see major obstacles to adopt the Community "acquis" although they hesitate on which regulation applies to which institutions, particularly for the first pillar bis, which does not exist as such in the EU-15 and the pension institutions in the third pillar, which may be personal as well as occupational in some of these countries, which is not the case in the EU-15.

An overwhelming majority of respondents from the NMS sees parts of the Pension Fund Directive as essential and therefore to be of general application irrespective whether the institutions are subject to the Directive or not. These parts are:

- legal separation of the assets of pension funds from the sponsor
- prudent person rule and
- information requirements, including the Statement of Investment and Risk Principles (SIP), which are particularly important in a system where the individual bears all the risk.

Given the fact that EU Member States, and not the EU itself, are competent in pension matters, one can wonder whether there is a role for the EU level or not.

The respondents believe that the EU should be an enabler, co-ordinator as well as a stimulator. It also has specific competences that are derived from the basic Treaty freedoms.

The so-called Lisbon strategy requires the co-ordination by the EU of national pension policies with respect to public finances, employment and social cohesion by means of the so-called Open Method of Co-ordination (OMC). The general objectives of the OMC related to pensions – for which Member States remain responsible – are laid down in 11 principles and aim to achieve and preserve adequate, financially sustainable and modern public and private pension schemes in response to changing needs of societies and individuals. Whereas adequacy refers to sufficient pension provision and to the social role of pensions, sustainability concerns the economic and financial capacity to ensure adequate pensions. The OMC offers an opportunity for benchmarking/peer group comparison and mutual learning. It is, therefore, an

invaluable instrument to facilitate co-operation among the Member States and should be encouraged as much as possible. A second round of comparison is expected in 2005 and should this time include all the 25 Member States and supplementary pension systems. There is plenty of room for the Member States to ensure that these objectives are respected as long as they do not compromise the basic freedoms laid down in the Treaty. The respondents welcome the opportunity of mutual learning and exchange of information offered by means of the OMC.

The cost of adequate pension provision will be staggering in the years ahead due to longevity and other factors that cannot be escaped; therefore sustainability is an issue of major concern. It will be imperative that appropriate measures are implemented so as to ensure that the resources that are going to weigh heavily on our economies and public finances are optimally deployed.

Issues for further consideration

The respondents – and we are very grateful to them – have given us plenty of ammunition to carry the discussion forward. We have, combined with our research, tried to represent their opinions and formulated a series of "issues for further consideration" to the best of our abilities.

The objectives of the Open Method of Co-ordination

The OMC, as an efficient tool for sharing of experience and mutual learning, should be encouraged as much as possible and Member States should contribute to the best of their abilities to the next round of Strategic National Reports in the summer of 2005 to ensure that all opportunities of mutual learning and enriching comparisons are maximised and exploited.

The NMS may have experience to share in first pillar pension reform while the EU-15 in the collective approach (e.g. multi-employer plans) and occupational pension funds.

Ref. the objectives of adequate, financially sustainable and modern pensions, progress still needs to be made. Although it is early days the level of pensions to be reached with funded plans, taking into account the reduction of PAYG plans in the NMS, gives serious doubts about adequacy. Individual DC plans may be inappropriate to ensure adequate and sustainable pensions because the outcome is too dependent on the vagaries of the capital markets unless the levels of contributions are substantially increased and therefore sufficient to ensure adequate pensions.

The trend to individualisation appears at all levels of the pension systems in a majority of the NMS i.e. mandatory DC individual accounts in the first pillar bis and voluntary DC individual accounts in the second and/or third pillars. It has, therefore, weakened/excluded social protection, social cohesion and solidarity, which are major objectives of the OMC. The room for solidarity has been seriously reduced. The biometric risks are rarely covered by supplementary schemes and there is no redistribution between generations or between high and low-earning workers of the same generation ("inter- and intra-generation solidarity"). The risk of interrupted careers and/or periods of low earnings, which were covered by the PAYG first pillar, is henceforth shifted onto the individual. Furthermore the individual is placed in an uncomfortable position. The state pension being generally low – and tends to lower – this is not sufficient to ensure adequate pensions for the elderly (first objective of the OMC) and the need for supplementary pension provision is substantial.

The more appropriately the individual will be informed on the pension income he will receive at retirement, the better he will understand the necessity to augment his legal pension with supplementary pension provision. This would improve the coverage of the supplementary plans, which is a major handicap in several Member States and hence their funding degree that is still insufficient in the enlarged European Union.

Risk and financing diversification

A large majority of respondents considers a three-pillar pension system to be best practice to cope with the challenge of ageing. A combination of statutory, occupational and individual pensions, financed by means of both PAYG and funding, allows for risk diversification. Member States should have wide choice to define the respective role and importance of each pillar. They should also target ranges of replacement income to be achieved from each pillar as well as the overall maximum replacement income from all pillars combined for taxation purposes.

Some countries among the EU-15 have low ambition levels for the first pillar (e.g. the United Kingdom and Ireland) and may face increasingly inadequate legal pensions and therefore the risk of poverty for millions of people.

In these countries one of the solutions may well be to reinforce the role of the first pillar and e.g. to make the second pillar compulsory. Other possibilities exist as well. As Dalmer Hoskins, the Secretary General of the International Social Security Association stated in 2003, there are questions and options to be considered:

"*The debate about the future of pension programs, public or private, must take into account not only the economic arguments but also the public policy objectives. What level of security does a nation wish to afford its elderly? What level of sharing across the generations is acceptable to workers and employers? What is the extent of trust that citizens can place in their government to honour the promises made to future generations of pensioners?"*

The NMS, at least the 6 referred to earlier on[1], have found a solution in lowering the burden of PAYG in the state pillar and replacing this with mandatory funded individual accounts. This is in itself a good solution but it is generally a much more expensive than combining PAYG pensions with unallocated reserve funds, which can benefit from economies of scale. Individual accounts are very expensive to run among other because they are too small for a long period. In the US, the current discussion is about how to avoid the cost of administering small accounts. The idea is to first invest through a central scheme until a certain critical mass for individual accounts has been acquired. After this threshold has been reached, members would have the option to stay in this sort of default fund or to roll over their account to a provider of their choice. The experience with the so-called PPM-system in Sweden, admittedly in different circumstances, where too much choice is offered (over 600 funds) and where in 2004, 91% or so of the participants made no active choice and therefore landed in the default fund, indicates that individual accounts and choice have their limitations.

It is clear that individual accounts are more certain for individuals than reserve funds on which governments could renege if necessary; it is also clear that with such accounts individuals are in a weak position to bear investment, longevity and other risks.

There is no doubt that some of the NMS are advanced compared to some of the EU-15 Member States in terms of risk shifting; the questions are whether individuals, society as a whole and the supervisory systems are better off and which other risks have been created and whether these are manageable. If not, sooner or later, such risks may fall back on governments i.e. on future generations of taxpayers.

In a paper published in the Financial Times on September 17, 2004 John Nuggeen and Prof. Avinash Persaud state that regulators have tried to reduce risk but that this is futile: a large proportion of risk is inherent: it cannot be reduced, only shifted around. The authors make the following comparison: "*it is like squeezing toothpaste out of a*

[1] Poland, Hungary, the Slovak Republic and the Baltic States

tube with the top still on: all you do is moving the toothpaste from one end to another. They claim that *"shifting of risk may actually make matters worse. If banks* (or for that matter governments) *unload risk to insurers and pension funds, these in turn offload it to individuals. Is society as a whole better off? Should regulators now start assessing every citizen? Who might be called on to bail them out? The overall result,* the authors state*, is a more expensive, less efficient and more risky system*".

Risk sharing plans

A (new) partnership will need to be found between employers and employees through some form of risk sharing plans adapted to the needs of both and these must be flexible as they will differ from country to country and from group to group. It will be necessary to find ways how to motivate plan sponsors, particularly employers to engage in supplementary pension provision and to arrange for appropriate tax incentives as well as to provide for good enough annuities at a reasonable price. Pure individual defined contribution (DC) plans – as opposed to collective DC plans - may place too much risk on individuals and may be unnecessarily expensive. If individuals therefore invest in less risky assets, the return will be lower, the contributions higher or the pensions lower. What may be needed are defined benefit (DB)-type plans with a lower ambition level to which employers can commit and to give individuals the opportunity for additional savings in DC form if they aim at higher pensions. It is also preferable that these lower DB plans are offered to more people and to make them compulsory if they have to replace part of the first pillar. Alternatively, the DC collective plans (as in Denmark) allow for solidarity and benefit from economies of scale comparable with defined benefit plans. This is a means to reduce the burden of the social security pillar and the EU-15 should learn from the 6 NMS in this respect, except for individuals taking all the risks.

What is needed in pension provision, whether public or private, is to apportion risk to the parties that are best able to bear it. There is no doubt that the State can bear more risk than groups and groups more than individuals. New ideas for risk sharing are therefore required if one wants to provide for funded pensions efficiently at an affordable cost.

One of the advantages of DC individual plans is that people tend to work longer when avoiding to retire in adverse market conditions or because they are afraid of "running out of the money". Whilst this may look good, the fact that they may refrain for

consumption is not good and only adds to Europe's subpar growth. If one knows that over 50% of the retired live on pensions only in the EU-15 and a much higher percentage in the NMS, this poses a real problem. DB-type plans may, on the other hand, give an incentive to retire early or make retirement neutral; people will be able to consume normally as there is no risk of running out of the money if they receive their monthly pension. These options, in an ageing society are very important.

Employers also need to be convinced about the pension deal that needs to remain attractive for them, hence the opportunities offered by well balanced risk sharing. Some experts are clear about the choice between DB and DC. Roger Urwin who is the head of the investment practice at Watson Wyatt in London was quoted in the Financial Times on January 13, 2003 saying (in a UK context): "I*t would be a tragedy if in 10 years time DC is the dominant type of pension schemes. I have yet to be convinced that DC can deliver adequate benefits and good security for every worker.*"

Occupational pension schemes and coverage

Another big challenge apart from motivating employers will be to increase participation in the occupational pillar without making it compulsory except, as said, if it were to replace part of the first pillar.

The occupational pension pillar is weakly developed in general in the NMS, which have mostly preferred an individual approach in the 1st pillar bis and in the third pillar. A collective approach may, nevertheless, bring several advantages:

- group solidarity
- economies of scale
- balanced role for the social partners in a paritarian structure
- optimised investment return
- risk sharing
- cost reduction.

One can, however, justify the dominance of individual open funds offered by financial institutions in the NMS by the fact that domestic enterprises are neither sufficiently and appropriately experienced nor familiar with developing and managing pension funds for their workforce. Furthermore, these do not generally have the critical size to do it efficiently. There are good examples how these issues may be solved (through e.g. multi-employer and sectoral plans) in e.g. the Netherlands and in Denmark and mutual learning and benchmarking of the second pillar may help in this respect. The next OMC

round, in which occupational pensions must be included, will offer the necessary information on this. Whilst willing to avoid any sort of paternalism, the experience of the EU-15 in occupational pensions may bring tangible solutions to the ageing issues that all Member States have to face.

EET tax system

The best incentives - next to less regulation/more appropriate regulation (by simplifying access and decreasing administrative and other burdens) and risk sharing - to make occupational pensions more attractive and affordable for employers and other sponsors (e.g. sectors, professional and regional groups) are more tax deductibility where appropriate and the EET tax regime. Tax deductibility should always be limited by the pension target defined by each Member State in terms of replacement income to be achieved from each pillar as well as the overall maximum replacement income from all pillars for taxation purposes. The EET tax regime i.e. whereby contributions and investment income/capital gains are tax exempt and pensions or lump sums are taxed should be encouraged because it is tax deferral for participants and for the tax authorities, giving well balanced incentives.

Asymmetric information gaps

The supplementary pension markets in the NMS countries (mandatory or voluntary) are by and large dominated by financial services providers whereas occupational pension schemes in the EU-15 are mainly offered through non-profit making organisations (pension funds) and insurance companies. The risk of asymmetric information of individuals that deal directly with financial institutions is high and is clearly the Achilles' heel of this sort of plans as one of the respondents stated. Transparency and protection of the individuals are, therefore, essential and encompass a high level of disclosure to individuals and to the Supervisory Authority, more comprehensive supervision and making providers/sellers responsible and accountable. There is a need for comprehensive disclosure by the providers as well as need for independent investment and risk advice to eliminate or at least decrease existing asymmetric information gaps and to ensure adequate financial education.
It is absurd to assume that an ordinary citizen can choose among 500 or more funds (as with the PPM-system in Sweden); logically he can choose among 6 or, say, 7 alternative possibilities at the most. In some of the NMS e.g. Poland, choice should be

wider than is presently the case - and it is also absurd to assume that participants can understand highly sophisticated investment products. The individual has to rely on advice and needs to be protected from (some types of) advisers.

The way forward

Europe, it is often said, needs new ideas. Ageing and pensions are a field where the EU level can enable, co-ordinate and stimulate new initiatives.

The European institutions have no blueprint for pension reform but are in close co-operation with the Member States responsible for the broad policy objectives and the 11 principles related to pensions earmarked by the European Council referred to in the report; they should, however, not accept that such reforms be set by other institutions or organisations apart from the Member States themselves.

Ageing is a global challenge of hitherto unknown proportions that is going to affect our economies, public finances and the life of European citizens profoundly. Most if not all will agree that some but by no means all European Member States have a good balance of public, private (occupational and personal) pension provision and that progress has been made in general; they will also agree that this effort has to be reinforced in the years ahead.

The report is conceived as a support to this continuing effort. Other leading economies around the globe face similar challenges and may, at least some of them, be in a worse position when compared with the EU. The question in a EU context is what are adequate pensions and what is sustainable and affordable as to their financing. The EU-25 is one of the largest economic blocks in the world, which offers enormous opportunities for investment and for efficiency. These opportunities have to be better exploited. Investment diversification does not stop at the borders of the EU nor at those of traditional asset classes, which are bonds and equities. There are windows of opportunity in other asset classes as well in the much faster growing NMS and in other young economies around the world that still exist but that will gradually close in the future. As long as they exist they should be embraced.

INTRODUCTION

This report, based on EU-wide research, focuses on the extension of the so-called Community "acquis" related to supplementary pensions to the new Member States (NMS), which adhered to the European membership on May 1st, 2004. By comparing the pension systems of the EU-15 with those of the 10 NMS and confronting these latter with the Community "acquis", the report culminates in issues for further consideration, with due respect for local differences.

Following the achievement of the “Rebuilding Pensions Report” in which Pragma Consulting was engaged in 1997 through 1999 on demand of the European Commission in co-operation with European and North American co-sponsors and which was of substantial support for the Commission as a reference document for the Directive on the Activities and Control of the Institutions for Occupational Retirement Provision (IORP), several co-sponsors (financial institutions and pension funds) and Pragma Consulting convened with the Directorates General of Economic and Financial Affairs, Internal Market and Social Affairs and Employment to identify other research projects, which could be of interest to the Commission.

After having obtained the commitment of two of the largest European pension funds – Algemeen Burgerlijk Pensioenfonds (ABP), the pension fund for the Dutch civil servants and Stichting Pensioenfonds voor de Gezondheid, Geestelijke en Maatschappelijke Belangen (PGGM), the pension fund for the Dutch health care sector – and after having discussed this with the European Commission’s services, Pragma Consulting engaged in this project called “*The pension issues in the new Member States*[2]”.

The ratio legis of this research was explained by the fact that pension provision in the NMS is suffering from the same weaknesses as is the case in the EU-15 Member States. If anything, the situation is worse. These countries have or had a major ageing problem combined with excessive promises in the unfunded first pillar (and for civil servants). They suffer from high unemployment and structural discrepancies. They have - in general - insufficient provision in the second private (or semi-public) pillar and

[2]These are: Estonia, Latvia, Lithuania, Poland, the Czech Republic, the Slovak Republic, Hungary, Slovenia, Cyprus and Malta.

the degree of funding (or absence thereof) differs substantially among these countries as well as when compared with the situation in a majority of the EU-15.
Some (e.g. Poland, Hungary, Latvia) moved to a system of individual or semi-collective defined contribution (DC)-type provision inspired by the World Bank model whereby social protection, social cohesion and solidarity have sometimes been excluded or at least reduced. In these applications assets may be locked for a large part in local capital markets (existence of quantitative restrictions) and plan members and retirees take the investment and longevity risks. With the market declines and volatility experienced over the last several years pensions security may have been substantially weakened.
This project aims at comparison and mutual learning. The objective is not to propose a blueprint or a "one for all solution". By presenting the current situation in the EU-15 and the Community "acquis" and by seeking reactions from stakeholders from the NMS as well as from experts from the EU-15, the report brings forward a number of issues for further consideration, all related to the common challenge of ageing.

Whilst the research effort was independent, several services of the European Commission (EC), more precisely DG Employment and Social Affairs and DG ECFIN, have expressed their interest in the project and participated in the evaluation of this effort. The different phases of the project were evaluated by a so-called "Steering Committee", composed of representatives of the European Commission and of the co-sponsors, which gave guidance to Pragma Consulting. DG Internal Market and DG Taxud (Taxation) have also supported this initiative.
We hope that this report will help in the objective to avert the old age crisis by proposing issues that not only can be considered in the NMS but also may inspire reform in the EU-15.

The recommendations and the identified best practice framework are sourced from the answers of 86 respondents, from all sub-sectors of the pensions industry throughout the enlarged European Union to an in-depth questionnaire, as presented in Annex 2. We captured opinions of stakeholders in the NMS and of a number of experts from the EU-15 on the so-called Community "acquis" and on "best practices" related to supplementary pensions in the EU-15 and the applicability thereof in the NMS. We also

sought opinions as to how we should go forward with supplementary pension provision in the Union, considering the challenges of ageing.

This report is Pragma's sole responsibility and cannot, therefore, commit the European Commission.

With such a far-reaching questionnaire there are obviously substantial differences between countries and practices and we have tried to take these into account to the best of our abilities.

THE GENERAL CONTEXT: DEMOGRAPHIC, ECONOMIC, LABOUR AND FINANCIAL TRANSFORMATION IN THE 10 NEW MEMBER STATES

The objective of this chapter is to highlight the key demographic, economic, employment and financial indicators, which may have direct or indirect impact on the pension systems and their development in the 10 New Member States (NMS).
These indicators have been compared where possible with the averages for the EU-15 and the EU-25.

I. Main demographic factors

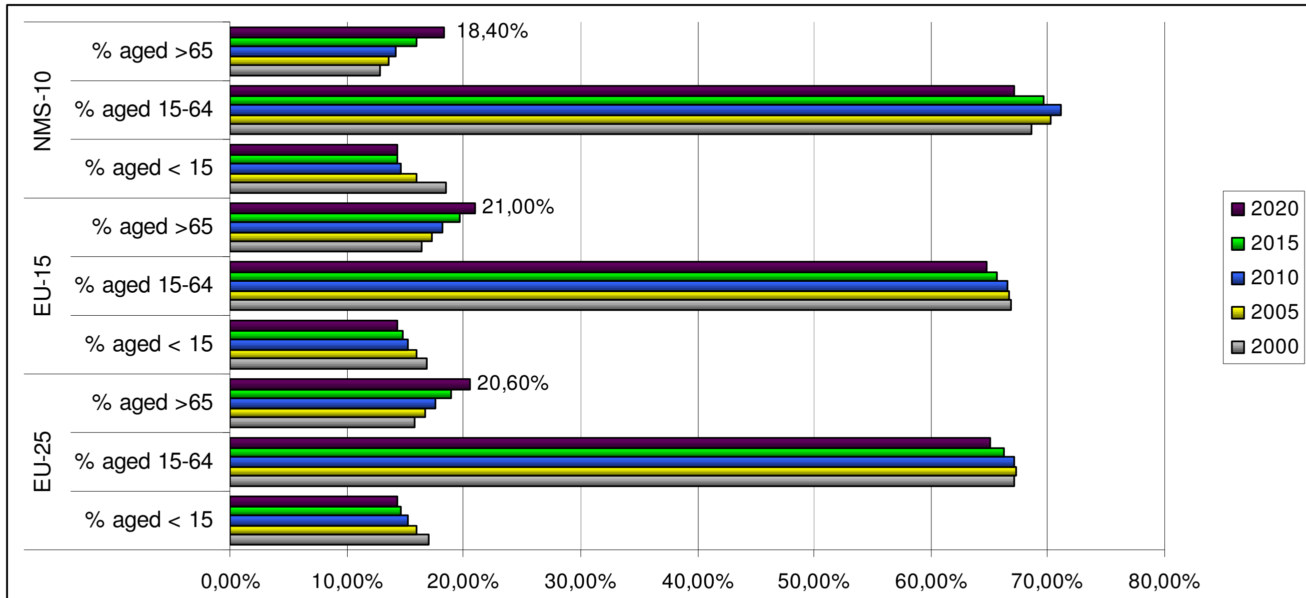
The total population, its structure and evolution influence on the old-age dependency ratio.

The current population of the NMS amounts to 74,2 million; it represents 19.4% of the EU-15 population and 16,2% of the enlarged European Union of 457.3 million[3].

Projections until 2020 forecast a slight decrease in the total population of the NMS and a small increase in the total population of the EU-15 resulting in an overall small decrease.

[3] Source: The World Bank – mid 2004

Figure 1: Evolution of the structure of the population by age groups (2000-2020)



Sources: United Nations, The World Bank and Pragma Consulting

The population of the NMS is on average slightly younger than that of the EU-15. The demographic challenge (ageing) will, therefore, affect the NMS later.

Except for the Czech Republic, Hungary and Slovenia the relative weight of the persons under age 15 is somewhat greater than for the EU-15 but it is expected to decrease to the same level as the EU-15 in 2020 (i.e. just over 14%) whereas the percentage of total population over age 65 falls below that of the EU-15 (though increasing).

The other relevant demographic factors in the pensions area are life expectancy and fertility rates.

Table 1: Life expectancy and fertility rates in the New Member States (2002)

	Life expectancy at birth (in years), 2002		Fertility rate (children per woman), 2002
	Men	Women	
EU25	**74.8**	**81.3**	**1.5**
EU15	**75.8**	**81.9**	**1.5**
Czech Republic	72.1	78.7	1.2
Estonia	65.3	77.1	1.4
Cyprus*	76.1	81.0	1.5
Latvia	64.8	76.0	1.2
Lithuania	66.3	77.5	1.2
Hungary	68.3	76.6	1.3
Malta	76.1	81.2	1.5
Poland	70.4	78.3	1.2
Slovenia	72.7	80.5	1.2
Slovak Republic	69.9	77.8	1.2

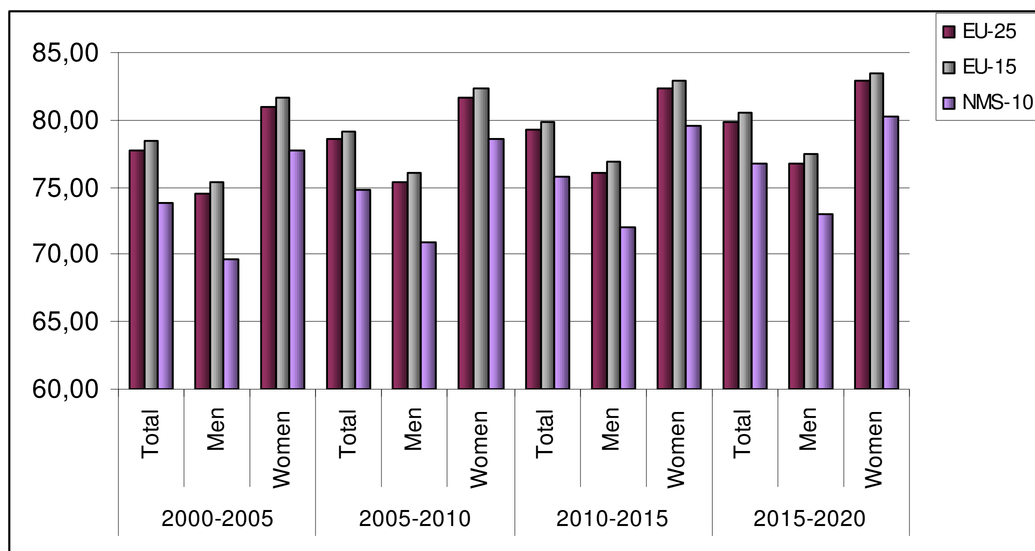
* Life expectancy: Cyprus 2001

Source: Eurostat: "The new EU of 25 compared to EU15", News Release 36/2004, 11 March 2004

Except for Cyprus and Malta, life expectancy in the NMS is substantially below the EU-15 average and therefore decreases the average for the EU-25.

The fertility rates are equally lower in the NMS except for Malta and Cyprus.

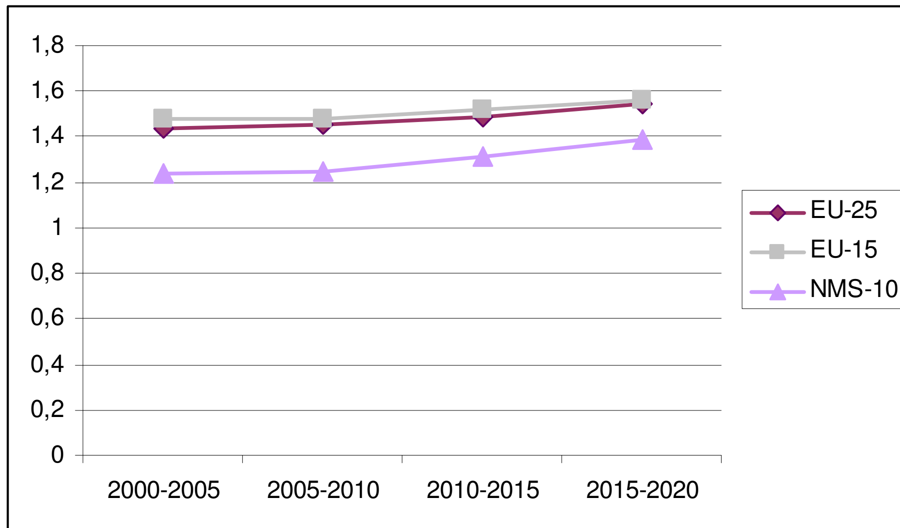
Figure 2: Life expectancy: projections (2000-2020)



Sources: United Nations, The World Bank and Pragma Consulting

Figure 2 shows a clear lengthening of life expectancy between 2000 and 2020 in the EU-25. The life expectancy rates will equally increase in the NMS for the same period but remain substantially below the EU-15 figures.

Figure 3: Fertility rates: projections (2000-2020)



Sources: United Nations, The World Bank and Pragma Consulting

Fertility rates are expected to increase up to 2020, particularly in the NMS but they will remain insufficient to renew the population (under the norm of 2.1 children per woman).

A final important indicator is the average real retirement age of the working population.

Table 2: Average real retirement ages in the New Member States

	Average exit age from the labour force 2001
EU25	**60.0(e)**
EU15	**60.4**
Czech Republic	58.9
Estonia	61.1
Cyprus	62.3
Latvia	62.4
Lithuania	58.9
Hungary	57.8
Malta	n.a.
Poland	56.6
Slovenia	61.5
Slovak Republic	57.5

(e) estimate

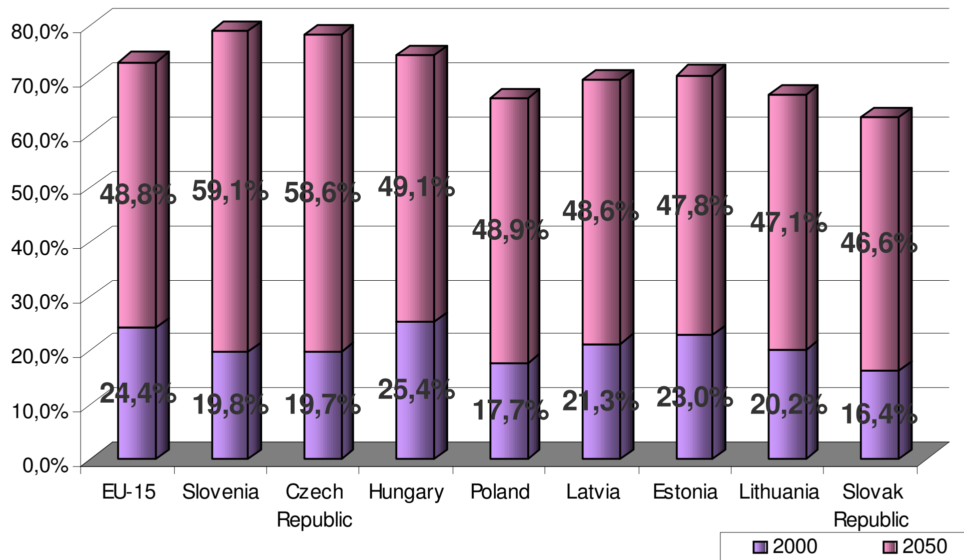
Source: Eurostat

Except for Estonia, Latvia, Slovenia and Cyprus, the effective retirement ages were below the EU-15 average in 2001. Overall, these are well below the statutory retirement age.

The earlier retirement ages influence on the old-age dependency ratios, which are the number of persons 65 years and over as a percentage of those aged 15 to 64 years. As a consequence, because people enter the workforce on average much later than age 15 and retire on average around age 60, it would be better to express old-age dependency ratios as people over 60 as a percentage of those aged 20-60, which makes the old-age dependency ratios worse than those presented in Figure 4.

Figure 4: Old-age dependency ratios

People over age 65 as a percentage of those aged 15-64 in 2000 and projected to 2050



Source: Allianz Dresdner Asset Management

Except for Hungary, the old-age dependency ratios were better in the NMS than in the EU-15 in 2000. One can see an expected dramatic increase in 2050 to approximately the levels of the EU-15 and much worse in Slovenia and the Czech Republic.
The increase is phenomenal in Slovenia, the Czech and Slovak Republics and Poland. Ageing comes later in the NMS but the acceleration is quicker.

II. Main macro-economic factors

The aggregate GDP of the NMS amounted to 4.70% of total EU-15 GDP at the end 2003, with an average GDP per capita well below that in the EU-15. Opposed to this, in terms of economic growth, the NMS are performing substantially better than their EU-15 counterparts (particularly the Baltic States).

Table 3: GDP in the New Member States (2003)

	GDP		
	bn euro, 2003	GDP per capita in PPS (EU = 100)*	Annual growth rate**
EU25	**9738.8**	**91**	**0.9**
EU15	**9301.8**	**100**	**0.8**
NMS-10	**437.0**	**48**	**3.9**
Czech Republic	75.7	63	2.9
Estonia	8.0	45	5.1
Cyprus	11.3	76	2.0
Latvia	9.9	42	7.5
Lithuania	16.1	42	9.0
Hungary	73.2	56	2.9
Malta	4.3	67	0.4
Poland	185.2	42	3.8
Slovenia	24.5	71	2.3
Slovak Republic	28.8	47	4.2

*Data are expressed in terms of Purchasing Power Standards (PPS), a unit that is independent of any national currency and which removes the distortions due to price differences. The PPS values are derived by using Purchasing Power Parities (PPPs), obtained as a weighted average of relative price ratios in respect of a homogeneous basket of goods and services, comparable and representative for each country.
** % change on previous year; calculated on data at constant prices

Source: Eurostat: Economic data pocket book 2/2004

It is expected that the NMS will grow much faster than the EU-15 and than the EU-25 average in the coming years very much like happened to e.g. Portugal and Greece after their accession. The Economic Policy Committee of the European Commission has projected the period needed to reach 75% of the EU average GDP per capita.

Table 4: Years needed to reach 75% of the EU-15 average for GDP per capita

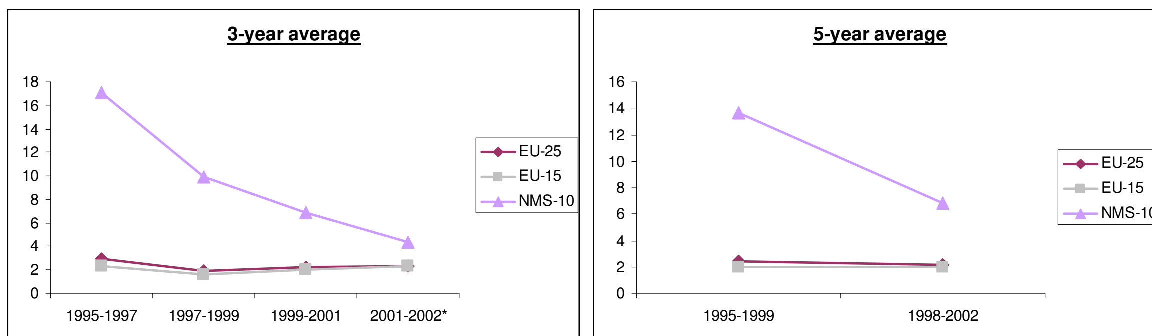
	Average growth rate achieved 1995-2002 (%p.a.)	Growth rate assumption as from 2004 (%p.a.)	Years needed* to reach 75% of the EU-15 average	Scenario: Years needed to reach 75% of EU-15 average with 0.5 percentage point higher growth	
Czech Republic	1.7	3.9	19	15	(-4)
Estonia	4.9	5.1	23	19	(-4)
Cyprus	3.6	3.8	1	1	(-)
Latvia	5.6	6.0	24	21	(-3)
Lithuania	3.9	5.0	28	23	(-5)
Hungary	3.9	4.1	24	19	(-5)
Malta	3.3	3.7	25	18	(-7)
Poland	3.9	3.7	50	37	(-13)
Slovenia	3.9	3.7	7	5	(-2)
Slovak Republic	3.7	4.5	22	18	(-4)

* at assumed growth rate as from 2004 (2.4%)

Source: EC DG ECFIN. "Key structural challenges in the acceding countries: the integration of the acceding countries into the Community's economic policy co-ordination processes". July 2003.p.10

If future GDP growth is 0.5% higher than assumed (e.g. for Poland 4.2% p.a. instead of 3.7%) one sees that the period is very much shortened (for Poland by 13 years), hence the vital importance to grow as fast as possible.

Figure 5: Inflation averages (1995-2002)



Sources: United Nations, The World Bank and Pragma Consulting

The evolution of inflation rates between 1995 and 2002 indicates the considerable progress made by the NMS to converge to the Maastricht criteria in this respect.

Inflation remains, nevertheless, a concern in several of the NMS and greater price stability still needs to be achieved, particularly before their entry in the Euro-zone.

III. Labour markets

An important factor that has considerable influence on sustainability of pensions is the characteristics of the labour market.

Table 5: Unemployment in the new Member States (July 2004)

	Unemployment rate* July 2004, in %			
	Total	Male	Female	Under 25
EU25	**9.0**	**8.3**	**10.0**	**18.0**
EU15	**8.1**	**7.4**	**9.0**	**15.9**
Czech Republic	8.8	7.4	10.5	19.9
Estonia	8.8	9.0	8.7	18.5
Cyprus	4.5	4.0	5.0	10.2
Latvia	10.6	10.3	10.8	16.9
Lithuania	11.3	10.2	12.4	22.0
Hungary	5.9	6.0	5.8	12.8
Malta	8.7	7.4	11.5	20.2
Poland	18.8	18.0	19.7	39.1
Slovenia	6.2	5.8	6.8	15.0
Slovak Republic	15.9	15.1	16.9	25.9

* Unemployment rates represent the number of people unemployed (aged 15 to 64) as a percentage of the labour force. The labour force is the total number of employed and unemployed people.

Source: Eurostat News release 106/2004-1 September 2004

Labour markets in the NMS are suffering from high structural unemployment and insufficient job creation. This will no doubt be alleviated due to high economic growth. The unemployment rates are particularly worrisome in Poland, the Slovak Republic and in the Baltic States to a lesser extent. This has a substantial impact on the participation in supplementary pension systems and mandatory individual accounts (see 2b) p.46).

The unemployment rate among the young (under age 25) is excessive in Poland, the Slovak Republic and Lithuania.

Table 6: Employment in the new Member States (2003) and progress towards the Lisbon and Stockholm targets[4]

	Total employment rate		Female employment rate		Older workers' employment rate (55-64)	
	2003	Gap below 2010 target	2003	Gap below 2010 target	2003	Gap below 2010 target
2010 Target	**Lisbon targets**				**Stockholm target**	
	70%		**More than 60%**		**50%**	
EU25	**62.9**	**7.1**	**55.0**	**5.0**	**40.2**	**9.8**
EU15	**64.3**	**5.7**	**56.0**	**4.0**	**41.7**	**8.3**
Czech Republic	64.7	5.3	56.3	3.7	42.3	7.7
Estonia	62.9	7.1	59.0	1.0	52.3	>
Cyprus	69.2	0.8	60.4	>	50.4	>
Latvia	61.8	8.2	57.9	2.1	44.1	5.9
Lithuania	61.1	8.9	58.4	1.6	44.7	5.3
Hungary	57.0	13.0	50.9	9.1	28.9	21.1
Malta*	54.5	15.5	33.6	26.4	30.3	19.7
Poland	51.2	18.8	46.0	14.0	26.9	23.1
Slovenia	62.6	7.4	57.6	2.4	23.5	26.5
Slovak Republic	57.7	12.3	52.2	7.8	24.6	25.4

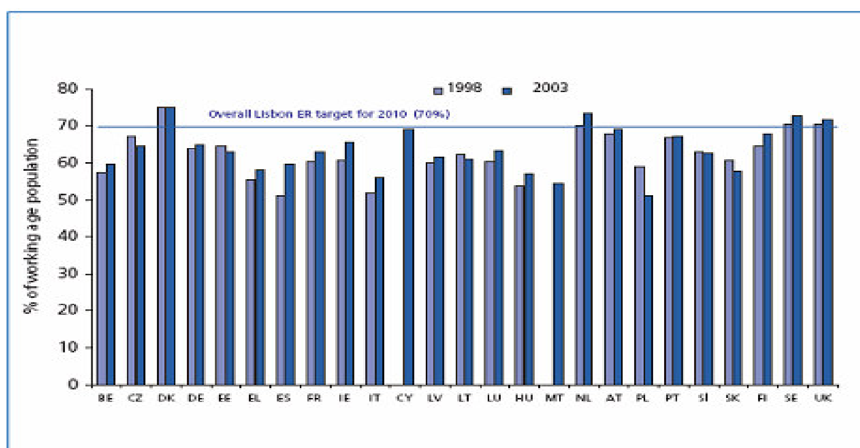
Employment rates represent employed persons as a percentage of the same age population (15-64 years)
* Figures 2002
The column "Gap below 2010 target" is for illustrative purposes only, since the 2010 target is for the EU overall and not individual Member States. ">" indicates that the respective target has already been exceeded by the Member States concerned
Source: DG Employment and Social Affairs. "Employment in Europe 2004 – Recent Trends and Prospects". August 2004. p.27

Table 6 shows clearly that the Lisbon objectives and targets are not reached and may not be reached for a long period. The employment rate[5] is generally lower than in the EU-15 average except for the Czech Republic and Cyprus. Female employment is, however, generally higher than the EU-15 average, except for the Slovak Republic, Poland, Hungary and the extreme case of Malta.

[4] The Lisbon European Council of 2000 set as a strategic goal to raise the employment rate to as close to 70% as possible by 2010 and to increase the employment rate for women to more than 60% by the same year. The Stockholm European Council of 2001 added a new target for raising the average EU employment rate for older men and women (aged 55-64) to 50% by 2010.
[5] The employment rate represents the number of persons in employment as a percentage of a age-specific population [e.g. employment rate for the elderly (aged 55-64)].

Employment rates among people aged 55-64 substantially differ between countries but are better than the EU-15 average in some NMS (i.e. the Baltic States, the Czech Republic and Cyprus) and worse in Poland, Hungary, the Slovak Republic, Slovenia and Malta to a lesser extent.

Figure 6: Evolution of employment rates in the 25 Member States (1998-2003)



* Data for Malta refer to 2002 only, for Cyprus to 2003 only and for Luxemburg to 1998 and 2002.
Source: Eurostat

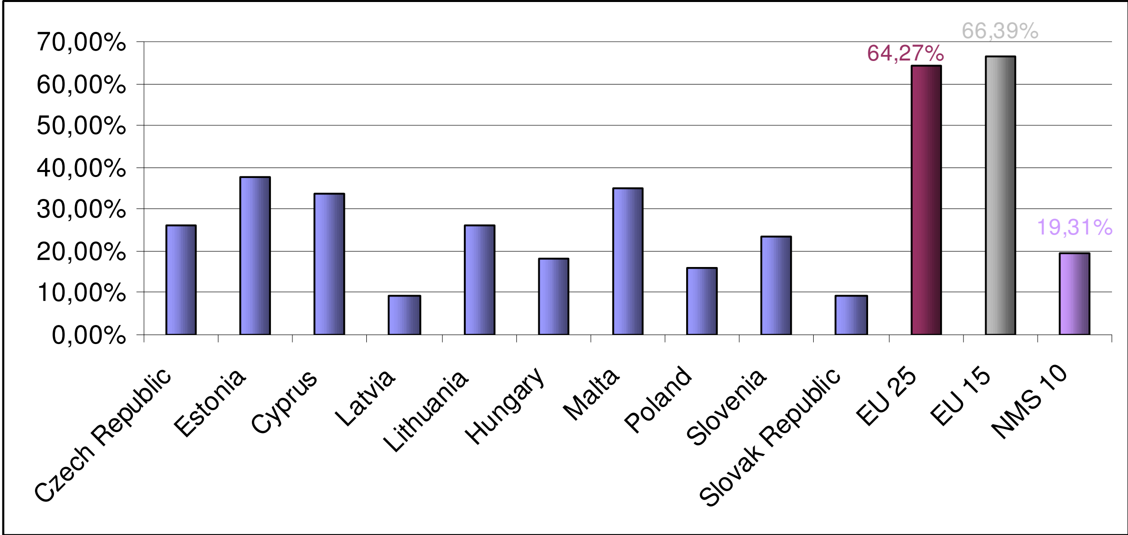
IV. Financial transformation

Capital market restructuring, bank restructuring in terms of balance sheet reinforcement, productivity and privatisation have added to financial sector stability in the NMS. Although important progress with regard to financial sector regulation and supervision has been achieved in general, this remains uneven between countries. With some exceptions, the privatisation process is largely completed.

Despite noticeable progress, the NMS still have a substantial gap with the EU-15 when comparing stock market capitalisation in percentage of GDP and in terms of liquidity, trading volume and the level and quality of financial intermediation. The potential for financial sector growth is, in general, substantial.

Insufficient development of the capital markets is one of the main impediments to make funded pensions successful, particularly when quantitative investment restrictions for pension assets tend to lock the assets in the domestic markets and when one realises that e.g. aggregate stock market capitalisation of the NMS represented only 1.38% of that of EU-15 (at the end 2003).

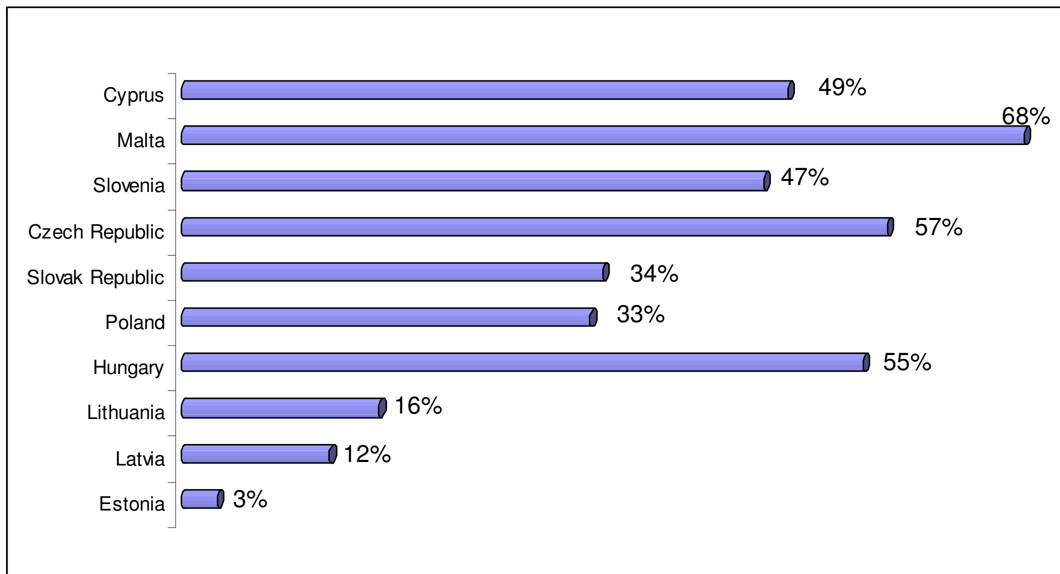
Figure 7: Market capitalisation in % of GDP (end 2003)



Sources: Eurostat, Pragma Consulting

Figure 8: Outstanding debt[6] in the new Member States

Amount of debt outstanding at the end of 2002 (as a percentage of gross domestic product, end-of-period volume, nominal value)



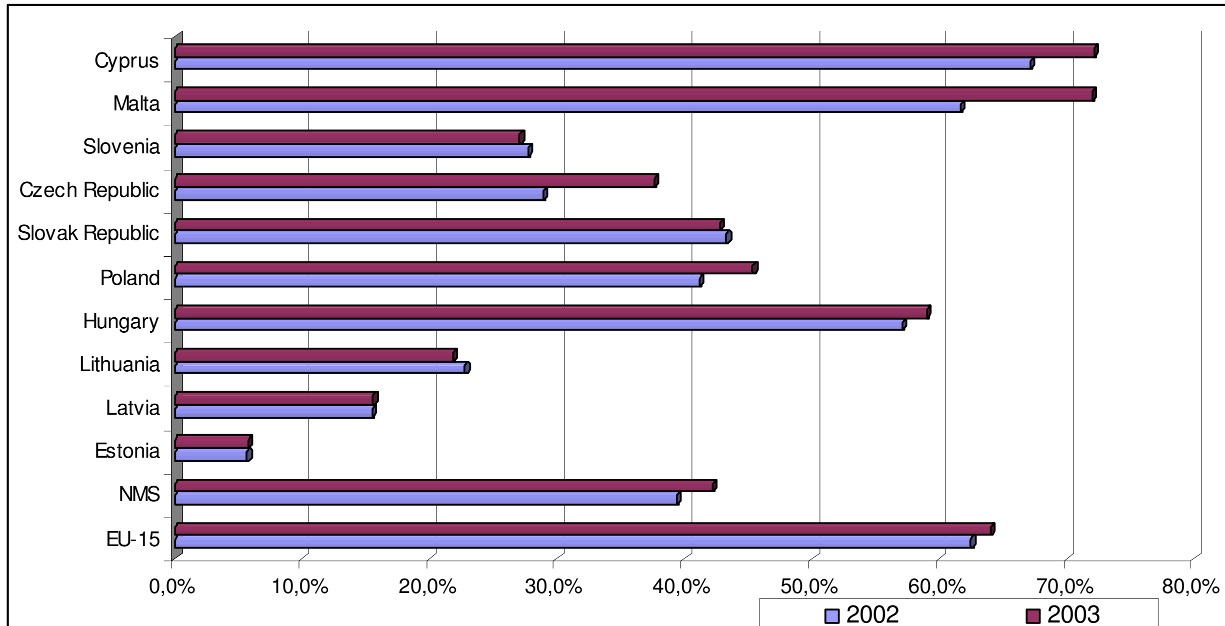
Source: European Central Bank. “Bond markets and long-term interest rates in European Accession Countries”. October 2003. p.12

The total amount of outstanding debt (primary and secondary markets) in the NMS represented, at the end 2002, less than 50% of GDP except for Hungary, the Czech Republic and Malta where it was higher.

The central government is the largest issuer of debt (see Figure 9), followed by the financial sector. Debt issued by other than the financial sector is, with a few exceptions (e.g. Malta and Poland), insignificant.

[6] Debt securities refer to securities other than shares excluding financial derivatives.

Figure 9: Government debt[7] in the new Member States (in % of GDP)



Source: EC DG ECFIN. "EMU after 5 years". 15 July 2004.p.150.

With a small local debt market (e.g. the Baltic States, Poland and the Slovak Republic) and equally tiny stock market capitalisation, particularly in Latvia, the Slovak Republic and Poland, and all the problems of quality and liquidity this entails, there is obviously an issue of (market) specific risk and a lack of size and choice when pension institutions invest largely in the local market. Membership of the European Union and global diversification will give access to much wider and liquid markets and adherence to the Euro-zone will eliminate currency risk (though currency hedging is currently perfectly possible).

However, in order to profit from these advantages, market infrastructure should be improved, a.o. in terms of access to providers, independent advisors (actuaries, investment consultants, etc.) and impact of supervision.

In the run up to membership of the EMU there will be more convergence of economies and financial indicators; furthermore market structure, access and depth will continue to

[7] Maastricht definition

improve. There may well be a “golden age”, which needs to be exploited to a maximum related to pensions.

THE PENSIONS LANDSCAPE AND REFORM PROCESS IN THE ENLARGED EUROPEAN UNION

I. Introduction

The objective of this chapter is to highlight the substantial differences between the pensions systems in the EU-15 and the NMS.

For a majority of the NMS, their pension system - which originated during the previous regime - was until recently mono-pillar as it relied exclusively on the unfunded first pillar. In recent years, this system faced increasing financial and other difficulties and has been reformed in a majority of the countries, a process, which is continuing.

II. The three-pillar pension system

The responses to the questionnaire confirm that a three-pillar pension system, as opposed to a mono-pillar system, is good practice because by combining PAYG and funding, it provides for risk diversification with regard to the sources of pensions financing and income.

The application of this pillar structure substantially differs, however, between the EU-15 and the NMS. To make things more difficult, a majority of these latter applies the World Bank terminology, which differs substantially from terminology used in the EU-15.

In the terminology used by the World Bank the second pillar consists of mandatory funded pensions (whether occupational or personal) and the third pillar of voluntary funded provisions (whether occupational or personal). In the European terminology, the second pillar refers to occupational pensions (whether mandatory or voluntary) and the third pillar to individual pensions. The report adheres to the European terminology.

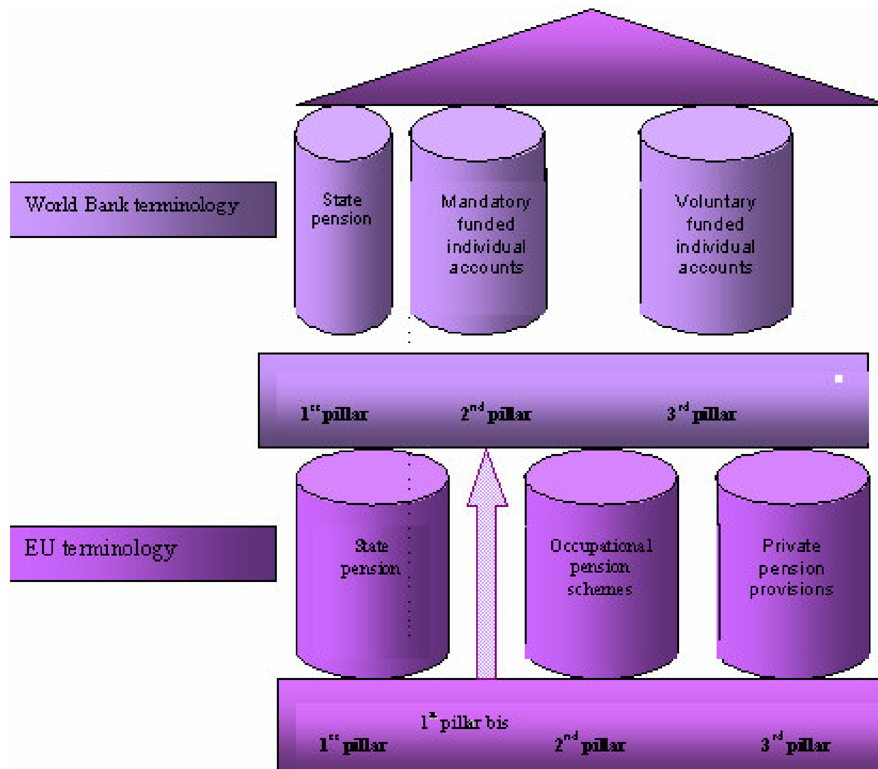
The World Bank three-pillar system

Has inspired several NMS and differs substantially from the practice in the EU-15. It encompasses:

1. A PUBLIC PILLAR, financed by payroll taxes (i.e. social security contributions) or general revenue, which focuses on redistribution. It aims to provide for a social safety net for the elderly, particularly for those whose lifetime income was low.
2. A SECOND PILLAR, which is funded and whereby mandatory individual contributions are invested to pay for future pensions. It operates like a DC-type plan. It is privately and competitively managed and mandatory to ensure maximum participation.
3. A THIRD PILLAR consists of voluntary retirement savings.

Figure 10 is an attempt to illustrate the differences between both terminologies and to make these understandable.

Figure 10: The three-pillar pension system in the European Union



Source: Pragma Consulting

1. The three-pillar pension system in the EU-15

At present, the pension systems in the EU-15 can be subdivided in 3 distinct pillars, the boundaries of which are somewhat blurred in some Member States.

1a) The first pillar/statutory pensions

These schemes form part of the social security system for private sector employees (and the self-employed) and are usually financed on a Pay-As-you-Go (PAYG) basis by means of social insurance contributions supplemented by general taxation, and by means of budgetary expenses for civil servants, who have mostly[8] separate systems. Only the Danish first pillar is partially tax-financed (and partially funded).

[8] Not everywhere: e.g. in the Netherlands the first pillar is of general application for all residents, including the civil servants.

Although statutory (social security) systems are usually separated from the state budget, (large) transfers from this, which a.o. pay for the shortfall and ensure solidarity elements (e.g. coverage for unemployment periods, sickness, etc.) are common.
These transfers have grown rapidly and are expected to grow ever quicker due to a.o. ageing, hence risk to jeopardise public budgets.
Next to the predominant PAYG-financing, some funding elements have been introduced in several Member States.
In Denmark, the tax-financed basic flat rate scheme is complemented by compulsory fully funded supplementary public pension schemes (ATP and LD).
In Finland, first pillar pensions consist of the PAYG-financed state pension scheme combined with statutory occupational pension schemes, which are partially funded (principally the TEL system[9]).
The Swedish pension reform, implemented in 1998, introduced, next to the flat and earnings-related PAYG public schemes, a new funded element (the public premium pension scheme/PPM-system) in the form of DC-type individual accounts. Furthermore, a reserve fund, the state owned Swedish National Pension Fund[10], *'AP-fonderna',* (managed by AP1 through 4 which are four independent and competing funds), functions as a financial buffer within the PAYG-system. The Sixth Fund has an equally buffer function, but has special investment rules.
France is a special case: it has PAYG-financed statutory pensions but also two major compulsory supplementary schemes on the national level, Arrco and Agirc[11], which operate on a PAYG basis. Arrco covers the "non cadres" for earnings between one and three times the social security contribution ceiling whereas the "cadres" (management level) are covered by the Agirc scheme for earnings between one and eight times this

[9] The national pension in Finland is supplemented by an earnings-related pension program, which reduces by degrees the national pension. The purpose of the earnings-related scheme is to ensure that the consumption level attained by all wage and salary earners and self-employed when working is maintained at an appropriate level after retirement. The most important program is the Employees' Pension Act (TEL) ('Työntekijän Eläkelaki'), which covers the majority of private sector employees and came into force in 1962.
[10] The Swedish National Pension Fund (NPF) was previously organised into six different Fund Boards. The First to Third NPFs have mainly invested in interest-bearing securities, the Fourth and Fifth NPFs have invested in stocks, and the Sixth Fund has had the special task of investing in small and medium-sized Swedish companies. On 1st May 2000, the first to fifth Fund Boards were converted into four independent funds.
[11] Both are grouped under the name "Groupement d'Intérêt Economique – GIE Agirc Arrco" since July 2002 but remain two schemes operating independently.

ceiling. Agirc and Arrco are in fact the second pillar but are now considered to be part of the first pillar.

Furthermore, several Member States have created so-called “demographic reserves”, which are buffer funds meant to support the PAYG schemes. Significant reserves have existed in Luxembourg, Sweden, Denmark and Finland for a long time in the forms referred to above whilst reserve funds have recently been established in France, Ireland, Belgium, the Netherlands, Spain, Greece and Portugal. Only a few of these are real diversified and invested funds for the moment.

Annex 3 summarises the financing methods in the first pillar in the EU-15.

The first pillar offers unique advantages, among other:

- universal application,
- basic security and solidarity between members and beneficiaries as well as intergenerationally,
- low operating costs and
- not sensitive to financial market volatility except for the funded part but all the more so to demography for the PAYG part.

Most will agree that these pensions need to be preserved and adapted to future challenges.

1b) The second pillar

Second pillar pensions can be referred to as “occupational pensions” because these are linked to a professional activity and usually organised as group schemes set up in the framework of a company (company plans), of groups of companies (multi-employer plans) or of sectors of industry or professional groups (industry or sector-wide and professional plans[12]). In the EU-15, generally in an employment relationship both employers and employees contribute to occupational pension schemes.

The second pillar differs considerably between Member States in terms of importance, coverage, financing methods and types of plans.

i) Financing methods and structure

Currently, financing methods in the EU-15 for the second pillar are, in order of importance: funding, book reserves and PAYG. The Netherlands, the United Kingdom,

[12] E.g. for doctors, nurses, lawyers, architects, painters, etc.

Sweden, Ireland and Denmark have achieved high levels of funding expressed as a percentage of GDP whereas Germany, Austria, Luxembourg, Sweden and Spain (where they are phasing out) all apply book reserves as one of the financing mechanisms, to a larger or lesser degree always, however, in combination with funded plans. France has, for historic reasons, opted for PAYG-financing but offers insured and therefore funded plans as well. Few will contest that external funding in the second pillar is good practice under current circumstances of ageing as it allows for financing risk and pension income diversification as well as for separation of the pension assets from those of the sponsor.

Funded second pillar pension plans are usually provided for by means of group life insurance contracts or by institutions for occupational retirement provision, commonly called "pension funds". These latter represent roughly two thirds of the total EU-15 second pillar funded assets and insured plans one third.

ii) Risk diversification/coverage

In the Netherlands, the coverage levels in the second pillar are very high, well over 90% of eligible persons even though the system is not mandatory. In the United Kingdom, Germany, etc., these coverage levels are below 50%. In the Netherlands the pension from the second pillar represents over 40% of total average pension income, about equal to that of the first pillar. In the United Kingdom it is also close to 40% of total pension income but that it is true only for less than 50% of the eligible population and due to an excessively low first pillar pension.

iii) Types of plans

Most occupational pension plans are currently collectively organised, which offers considerable advantages such as economies of scale, inter- and intragenerational solidarity for DB and DC collective plans and a balanced role for the social partners. Individual plans are those whereby the employer is usually not involved in the management of the supplementary plan or only enables these. This is for example the case in the United Kingdom with the so-called "Stakeholder Pensions", in Ireland with the "Personal Retirement Savings Accounts" and in Germany with the "Riester individual pensions". These are voluntary plans for employees but employers have to make such products accessible insofar as they do not offer an occupational pension scheme. Similarly in Italy, employees have access to so-called "open" pension funds if

no closed company or sector fund is on offer. Individual plans are most commonly offered in the third pillar[13].

Furthermore, there is wide use of both defined benefit (DB) and defined contribution (DC)-type plans. With DB schemes, the sponsors (e.g. employer(s), sector, etc.) guarantee a certain level of benefit at retirement whereas with DC schemes, the sponsors commit to a certain level of contributions only. This is not a black versus white situation and there is a tendency to combine DB and DC in many different ways, called usually cash balance plans in the United States. A better name for these would be risk sharing plans as the risks/surpluses/deficits can be shared between sponsors, members and beneficiaries in proportions agreed upon. There is also a large variety of DB and DC plans on offer, which differ considerably [for DB e.g.: final (average) salary, career average revalued salary plans, etc.] [DC: individual versus collective with or without interest rate or capital guarantees, etc.].

DB-TYPE PLANS are based on the principles of group solidarity (for example, a waiver of premiums in the event of unemployment, sickness or disability), collectivity (for example, level premiums/contributions for the whole group, irrespective of age or sex) and continuity. The investment, annuity and longevity risks are shared among the group and with the plan sponsor, who takes on the ultimate risk and has to restore funding in the event of a shortfall that is deemed to be permanent. Alternatively the sponsor is entitled to the (investment) surplus if and when occurring unless plan rules/regulation stipulate otherwise.

In terms of total second pillar pension fund assets currently existing in the EU-15, approximately 75% can be called DB[14] and 25% DC but DC is growing rapidly particularly – but not only - in the United Kingdom and Ireland. DB plans are predominant in Germany, the Netherlands, Portugal, Ireland, the United Kingdom, Finland, Belgium and Austria to a lesser extent. In Italy, DB plans are still predominant in terms of assets but these are phasing out following the 1995 reform, which made DC mandatory for the future. DC plans are predominant in Denmark, Sweden and Spain (with substantial differences).

DC Collective plans with guarantees

There is a heavy price to DC plans with minimum return or capital (money back) guarantees. In Denmark, for example, the recent consecutive years of negative equity returns combined with the very low interest rates have put pension plans in a difficult situation as they guarantee (for older contracts) up to a high 4.75% return p.a. Such guarantees require caution with regard to investment diversification and may, therefore, reduce investment opportunities and potential return.

Over-regulation and accounting rules

[13] Individual life insurance and/or open pension plans/funds, which are usually offered by the banks and/or through investment funds (individual retirement savings plans).

[14] If one adds a small percentage of mixed systems to DB schemes

of DB plans have discouraged employers in several Member States and made them switch to DC plans, sometimes with insufficient contributions levels to assure adequate pensions. There has been risk shifting from the public sector/first pillar to the second pillar and from DB plans to DC group plans or to DC third pillar, individual plans. There have been cases (e.g. in Germany) where employers have attempted to terminate second pillar pension plans altogether (and not only for new employees). The shift from DB to DC is mostly not a fair deal in terms of cost/benefit levels and may be particularly cumbersome in countries with insufficient legal pensions[15]. The levels of contributions generally fall short of those required to ensure adequate replacement levels and their outcome is too dependent on the volatility of the capital markets. This is, or may be, worrying in view of the ageing problem as it could jeopardise the European objective of adequate pensions, better coverage and increased security. One of the biggest challenges for the European Union in the immediate future will not only be the ageing process but also how to motivate plan sponsors/employers and how to share risks adequately.

1c) The third pillar

These are voluntary individual pension savings for retirement, not linked to a professional activity, generally provided by insurance companies and/or banks or other financial institutions (investment funds mainly).

These plans are usually available to all income tax payers up to a highly varying (from modest to considerable) amount that is exempt.

2. The state of affairs in the 10 new Member States

The three-pillar pension system in the NMS differs substantially from the above-described system and is closer to the “World Bank model” (see box on p. 37), which is largely applied in Latin America for example.

One needs to distinguish between two main groups among the NMS in terms of pension reform. A first group - Estonia, Latvia[16], Hungary, Poland and the Slovak Republic - has adopted a radical pension reform resulting in a three-pillar system, as

[15] See for example the Turner report in a UK context. “Pensions: challenges and choices. The first report of the Pensions Commission”. UK. 2004

[16] But not Lithuania, which has adopted a “hybrid” system whereby a voluntary pillar is financed with contributions from the public first pension pillar.

they conceive it and a reduction of contributions for social security pensions in favour of (individual) pension arrangements with the introduction of a mandatory funded second pillar, on top of a substantially reduced Pay-As-You-Go (PAYG) first pillar. A second group – the Czech Republic and Slovenia – has attempted to modernise and rationalise the pension system by encouraging voluntary private pension provision whilst maintaining the first pillar as much as possible.

Malta and Cyprus are special cases with a quasi-mono pillar. In Malta, the second pillar (occupational pension schemes) does not exist[17] and the third pillar is only in the stage of being developed. A proposal is under consideration for a three-pillar system comparable to that existing in the EU-15. Although the 2002 Special Funds Act regulates the statutory basis for the registration and supervision of second and third pillar pension schemes, none has been established up to now and their regulatory framework is still being debated. In Cyprus, private supplementary pensions are under the form of provident funds. Provident funds are saving schemes providing for cash benefits in the event of termination of employment, permanent incapacity for work, retirement and death. These are financed by periodical contributions of employees or of employers and employees. Mandatory supplementary schemes exist for employees of certain public sector companies.

2a) The first pillar/statutory pensions

i) Financing methods

These schemes are generally financed on a PAYG basis by means of social security contributions, supplemented when necessary out of general taxation.

In several countries, these schemes have been partially complemented by a compulsory fully funded pillar (first pillar bis), generally under the guidance of the World Bank. This is the case for Hungary (1998), Poland (1999), Latvia (2001), Estonia (2002) and the Slovak Republic (2005) - with Lithuania being a special case (voluntary approach – see footnote 16 p.43).

[17] In Malta, occupational pension funds were terminated in 1979 with the exception of those for civil servants employed before 1979, who are eligible to a service pension equal to two thirds of final salary.

In general, the first pillar gives right to pension annuities, which tend to be low and are not sufficient to ensure adequate pensions for the elderly. Additional retirement provision to complement the state pensions is, therefore, vital.

In addition to their mandatory funded first pillar bis, Poland and Latvia have redefined social security pensions as a notional defined contribution (NDC) system, as it exists in Sweden. This NDC system adjusts pension expenditure to contribution revenue by recording contributions in notional (i.e. fictitious) individual accounts, which are remunerated by an administratively fixed rate of interest. In this system, at retirement, the individual's pension is based on the addition of lifetime recorded contributions and interest rate added and the total value is transformed into an annuity that reflects the individual account balance as well as the life expectancy of the individual's age cohort at retirement age. The greatest advantage of NDC systems is the link established between benefits and life expectancy - which encourages people to work longer - and that between contributions and revenues.

As the word notional indicates, NDC schemes are not backed by reserved funds but remain entirely PAYG. It is a mistake to compare them with government bonds. Bonds are a legally enforceable promise. Notional accounts are an administrative tool that can be changed unilaterally at any time. In addition, they present a major risk at maturity, when they are converted to an annuity. The level of the annuity depends to a large extent on the singular interest rate chosen, which is an administrative rate, not a market rate.

Poland introduced a demographic reserve fund (DRF) in 2002 to be financed with possible surpluses of social security contributions in addition to a levy of 0,1% on gross pay in 2002 and 2003 and 0,15% in 2004. This DRF can be partially privately managed by open pension funds (to a limit of 15% of total assets). The investments rules for this DRF are quite liberal in terms of asset classes but foreign diversification is not allowed.

2b) Mandatory funded individual accounts[18] (first pillar bis)

Five countries[19] – i.e. Hungary, Poland, Slovak Republic, Latvia and Estonia - have adopted the so-called World Bank model[20] with the introduction of mandatory funded individual accounts, which are privately managed arrangements, called pension funds.

This system can be compared with the Swedish PPM-system. In this latter, choice between over 660 investment funds is offered to individuals. This extensive offer seems exaggerated and is criticised (see box). Choice is rightly far more limited in the NMS to the point that it is insufficient and the fund managers are rarely allowed to offer several funds – generally limited to 3 (see Annex 10). This has been somewhat improved in Poland since January 1st 2005, when the fund managers are allowed to manage two open funds ("A-type and B-type open pension fund"), which differ in terms of allowed investments[21]. It is felt by respondents that this is still insufficient.

The Swedish Premium Pension Authority (PPM)

Set up in 2000, it offered a choice to individuals among 86 fund managers and 664 funds and a default fund (AP-7) at the end of 2003. Because 91% of participants made no choice in 2004, the system is currently under review. The three main areas of concern are:

1. the information and assistance given to participants by fund managers and by the PPM.
2. the number of funds on offer and their composition from the perspective of clarity, simplicity, usefulness and risks for participants
3. the fees of fund managers and their impact on the cost of the system over the long-term.

i) Structure

The pension plans are of the defined contribution type.

Contributions are paid exclusively by employees except for Estonia and Lithuania, where employers also contribute and in the Slovak Republic where solely employers contribute to the mandatory tier. In Hungary, employers may pay a further 3% of voluntary contributions to the mandatory individual pension funds. In practice, they prefer to contribute to the voluntary pension funds, which are more flexible. A

[18] Second pillar in the World Bank terminology
[19] Although participation is voluntary in Lithuania, this will be treated here because the structure is quite similar to that in the other 5 countries where participation is mandatory.
[20] This system has also been introduced in Bulgaria, Croatia, Kazakhstan, Kosovo, Macedonia and Russia

[21] The B-type pension fund is available exclusively to people aged over 50 years and invests exclusively in bonds and treasury bills.

percentage of social security contributions, which differs between countries, is allocated to the funded tier (1st pillar bis) (see Annex 4).

In Hungary, the contributions are collected through separate legal entities, which are non-profit institutions, set up by the sponsoring employer(s) or other founders such as groups of employees and employer's associations, professional chambers, voluntary pension funds or local authorities.

In Poland, the contributions are levied through Open Pension Funds (OFE[22]), which do not have legal personality. OFE are created and managed by dedicated pension fund management companies (PTE[23]). PTE operate as joint-stock companies whose sole activity is the creation and management of funds as well as the representation of the funds' members. PTE manage the assets for a fee and their shareholders are approved financial institutions.

In the Baltic States, the assets are accumulated in a fund (pool of assets) - which does not have legal personality – established and managed by fund management companies (1) or by life insurance companies licensed by the State to manage mandatory pension funds (2); both are referred to as "*pension accumulation companies*"[24].

In the Slovak Republic, the so-called "*retirement management companies*" are joint stock companies generally set up by banks or other financial institutions.

Except in Hungary, neither the employers nor the employees have, therefore, the right of initiative to set up a first pillar bis pension fund. In practice, Hungarian employers and employees do not use this possibility due to a.o. excessive administration burden.

[22] OFE- Otwarty Fundusz Emerytalny i.e.open pension fund
[23] PTE- Powszechne Towarzystwa Emerytalne i.e. fund management companies
[24] Latvia is a special case; see iii) p.3

Table 7: Overview of the combination of PAYG public pillar and mandatory funded first pillar bis in countries where the reform is implemented

Characteristics	Estonia	Latvia	Lithuania	Hungary	Poland	The Slovak Republic
Public first tier	Traditional PAYG scheme; private tier complementary	Notional defined contribution (NDC) scheme; private tier complementary	Traditional PAYG scheme; private tier complementary	Traditional PAYG scheme; private tier complementary	Notional defined contribution (NDC) scheme[1]; private tier complementary	Traditional PAYG scheme; private tier complementary
Private mandatory funded second tier (1st pillar bis)	Mandatory for workers born after 1983 and optional for other workers	Mandatory for workers below age 30 and optional between ages 30 and 49	Voluntary	Mandatory for new entrants to labour market and optional for other workers	Mandatory for workers born after 1968 and optional for those born between 1949 and 1968[2]	Mandatory for workers below aged 35 and optional between ages 35 and 55; over 55 it is not allowed
	Individual contribution rate: 2% + 4% employer's contribution	Individual contribution rate: 2% to be gradually increased to 10%	Individual and employer's contribution: 2.5% to be gradually increased to 5.5% in 2007	Individual contribution rate: 7%	Individual contribution rate: 7%	Employer's contributions: 9%
	From 2002	From 2001	From 2003/2004	From 1998	From 1999	From 2005

1 The NDC system is compulsory for all people born after 1948. The persons born before 1949 remain in the old system. This situation differs with that in Latvia, where the NDC system applies to all workers

2 Since 2000, the system is also mandatory for the workers born between 1949 and 1968.

Source: Holzmann, R., Orenstein, M. and Rutkowski, M. “Pension Reform in Europe: Process and Progress”. The World Bank 2003. p.50 adapted by Pragma Consulting

ii) Transition issues

The transfer of contributions from the unfunded social security pillar to the funded individual accounts raises the question of transition issues and costs.

The transition costs i.e. reduction of social tax revenues because of transfers to first pillar bis accounts, result from the fact that one generation has to pay for pensions twice: first, to meet existing PAYG entitlements to retirees (unfunded liabilities) and secondly for their own funded pensions (funded liabilities).

The induced fiscal burden is estimated in the range of 0,5 to 2,0 % of GDP p.a. for several decades[25].

Table 8: Estimation of transition costs (as a percentage of GDP p.a.)

	2005	2010	2015	2020
Estonia	0.6	0.75	0.83	0.83
Latvia	0.5	2	2	2
Hungary	0.8	1.3	1.4	1.5

Source: Gesellschaft für Versicherungswissenschaft und-gestaltung e.V. (GVG) “Study on the social protection in the 13 applicant countries”. January 2003 adapted by Pragma Consulting on basis of the responses to the questionnaire.

Forecast figures for Poland were not available; only past data were provided.

Table 9: Estimation of transition costs (as a percentage of GDP p.a.) in Poland

	1999	2000	2001	2002	2003	2004
Poland	0.35	1.05	1.14	1.22	1.26	1.32

Source: Gesellschaft für Versicherungswissenschaft und-gestaltung e.V. (GVG) op.cit. adapted by Pragma Consulting on basis of the responses to the questionnaire.

In the Slovak Republic, no precise estimations have been made. These costs should, nevertheless, not exceed 1% of Slovak GDP yearly (in 2005 circa SKK 15 billion or EUR 0.36 billion) to respect a political commitment taken with respect to the Maastricht criteria.

Generally speaking, temporary solutions to finance the reduction of revenues in the unfunded first pillar have been adopted. Some countries have alleviated the high

[25] Source: Fultz, Elaine.” Recent trends in pension reform and implementation in the EU Accession Countries”. June 2003.p.9.

transition costs by phasing in the financing of the first pillar bis gradually. For example, the Hungarian government relies on a combination of benefit cuts in the public scheme (e.g. by means of less generous indexation) and government subsidies to face the transition costs and on a gradual increase of the contribution rate to the funded part. The Slovak Republic plans to set up a “reserve solidarity fund”, which aim to cope with the deficit of the PAYG pillar due to the shift of contributions to the first pillar bis.

iii) Asset Management

The assets are privately managed by professional fund providers, which are regulated and supervised by the government. The role of this latter has, therefore, for that part shifted from that of a provider to that of a regulator and supervisor.

The case of Latvia stands out because its State Treasury was the asset manager for the first 2 years and the investments were at that time restricted to government securities and bank deposits. As from January 1st, 2003 the market has been opened to professional fund providers.

The employees are given a choice among fund providers as well as the right to switch their accounts from one to another.

In Poland, the law authorizes switching every two years; in the event of earlier switching, a transfer fee is charged to the member. In Latvia and Estonia, switching is limited to once per year. In Lithuania, it is not allowed to switch between fund providers during the first three years.

Except in Poland where the fund managers are recently allowed to manage only two funds, these may manage several funds in the other countries.

In Lithuania, fund providers are legally obliged to offer at the minimum a so-called “conservative fund”, which is exclusively invested in bonds issued by Lithuania or other EU Member States or guaranteed by central and local authorities or by their central banks. In the Slovak Republic, the so-called “retirement management companies” are obliged to offer three types of portfolios as follows:

1. a conservative one invested exclusively in fixed income instruments
2. a balanced one with a maximum of 50% in equities
3. a dynamic one with a maximum of 80% in equities.

iv) Minimum guaranteed return

There are no minimum guaranteed returns in the strict sense but rather relative performance guarantees.

In Poland, the internal benchmark is calculated on the basis of the 36 month[26] weighted average rate of return of all open pension funds[27]. The minimum required rate is the lower of the following two values: 50% of this weighted average rate or the average rate reduced by 4%. Both measures are determined every six months[26]. The fund provider is obliged to ensure the minimum guaranteed return; if he is unable to meet this commitment, the Guarantee Fund[28] will be used to compensate or the State in last resort.

In Hungary, the minimum guaranteed return[29] cannot be lower than 80% of the market index of government paper with over one year maturity, which is published by the supervisory authorities annually[30]. The excess return above 200% of the market index has to be held in a fluctuation reserve. This internal reserve accumulation within the pension plan and a depletion mechanism aim to ensure the minimum guaranteed return. In contrast with Poland, the Hungarian pension funds or asset managers cannot be held liable in the event of missed targets.

In the Slovak Republic, the supervisory authority calculates every day an annual average rate of return of all pension funds, in function of their portfolio type (conservative, balanced and dynamic; see p.50), from which the so-called retirement management companies can differ in pre-set ranges. In case of rate of return below the average market, these need to compensate for the difference.

[26] Since April 2004. Before, the calculation was performed quarterly on the basis of 24 months.
[27] Equal to the sum of each fund's rate of return multiplied by its average market share
[28] Fund providers have to contribute 0,1% of the net value of the assets to this fund so that the total value of the assets of the Fund does not exceed 0,1% of the cumulative net asset value of all the open funds.
[29] This is calculated on basis of net returns.
[30] This minimum return guarantee is complemented by a second guarantee set up by the Hungarian government: a minimum pension equal to 25% of the first unfunded public pension pillar is guaranteed to those who have accumulated at least 15 years of contributory service years in the mixed system. The guarantee fund is pre-funded i.e. pension schemes pay 0,3 – 0,5% of the members' contributions thereto. The commitments of the Guarantee Fund are backed up by the Government. It has to be added that except for very low salaries the income replacement ratio from the first PAYG and funded pillar at normal retirement age is very low (10 to max.20%). This income replacement ratio is also low in other NMS. It is in Hungary somewhat compensated by a relatively well-developed third pillar.

This requirement of a minimum guaranteed return does not exist in the three Baltic States.

It is to be noted that minimum return guarantees exist in several EU-15 Member States (e.g. Denmark, Belgium, etc.) for second pillar DC-type plans. They also exist in several Latin-American countries. They are generally, as they are structured in Latin America, perceived as giving an incentive to mediocrity and may lead to distortions of competition i.e. to uniformity of asset allocation and excessive similarity between portfolios and returns and may therefore induce specific/systemic risk.

2c) The second pillar

The occupational pillar like it exists in a majority of the EU-15 (described in 1b) p.40) hardly exists in the NMS.

Some of its characteristics are found in the third pillar in the NMS where it exists and which is generally a combination of occupational and private individual schemes. This is the case for example in Poland and Hungary.

In the Czech Republic, the creation of occupational pension schemes has been rejected.

These existed in the Slovak Republic but are replaced by the mandatory 1st pillar bis (see 2b) p.46).

i) Structure

In the Slovak Republic, the voluntary supplementary pension insurance companies (i.e. SPIC, Doplnková dochodková poistovňa), set up in 1996, are non-profit organizations founded by employers and/or trade unions. Since the 1st pillar bis has entered in force in January 2005, the financial institutions, which provide for the mandatory funded individual accounts, are also licensed to provide for voluntary open funds under the third pillar, so that the initiative offered to employers and trade unions to set up a pension fund is no longer available.

In Slovenia, the reform to a mandatory 1st pillar bis, like it exists in Poland or Hungary for example, has been rejected. There exists, however, a mandatory second pillar, exclusively aimed at "*persons performing particularly hard work and work harmful to health, and persons performing professional activities, which cannot be successfully performed after attaining a certain age*". The exclusive State-managed fund centralises all mandatory contributions and the asset management may be outsourced.

The voluntary supplementary schemes are occupational funded schemes organised as separate entities (joint stock companies or mutual funds). Although employers or a group of employers can decide to set up a pension fund, these are normally set up by banks, insurance companies and so-called "Pokojninska druzba", i.e. insurance companies dedicated to the second pillar. These are, therefore, exclusively open funds and closed funds do not exist except for public sector employees. It was decided to set up a pension fund for sector-public employees, which will be managed by the State-founded "kapitalska druzba".

These supplementary pension schemes are of the DC-type and financed by both employers and employees. They cover 25 to 30% of the working population in the private sector.

ii) Asset management

In Slovenia, providers can be:

- mutual pension funds, on the condition that they have at least 1,000 members and a minimum initial capital of SIT 50 million (equivalent to € 208,500)[31].
- pension companies, if they have at least 15,000 members and a minimum initial capital equivalent to 4% of the value of the fund.

Both must guarantee a minimum return, which shall not be lower than 40% of the average annual interest on government bonds with maturities exceeding one year, issued in the two previous years.

2d) The third pillar

These are generally voluntary private pension savings schemes, for which the State provides (limited) tax incentives in some cases (see Table 10). In several NMS, these may be occupational pension schemes as well, to which the employer contributes on behalf of his employees.

[31] 100 SIT equals to € 0.4171 (as at November 15, 2004)

Table 10: Tax incentives for contributions to the third pillar

Countries	Tax incentives
Estonia	√
Latvia	√
Lithuania	√
Hungary	√
Poland	X
Slovak Republic	X
Czech Republic	√
Slovenia	X
Malta	X
Cyprus	X

√ stands for yes
X stands for no

Source: Pragma Consulting on the basis of the responses to the questionnaire.

With the exception of Hungary, countries which have adopted a mandatory funded pillar (1st pillar bis), have a relatively low penetration rate of voluntary pension funds. This is expected to change in Poland (expansion of IKE[32] accounts).

It has to be underlined that the existence of the third pillar is quite recent in the majority of the countries.

In the Czech Republic, individual and voluntary supplementary third pillar pensions exist since 1994 and are subsidised by the State. These are available to any Czech citizen from age 18 onwards. Employers are also involved because they are authorised to contract pension plans for their employees in the third pillar (up to 3% of the employee's gross salary). These schemes are, by definition, DC plans. Participants are entitled to receive either lump sums or annuities according to the agreed contract. Between 40 and 45% of the working population is covered under the third pillar pension (public and private sectors together).

In Hungary, voluntary pension schemes are authorized as from 1993 and employers can administer these additional pension savings as a "benefit" to their staff. Employers contribute usually between 4 and 5% of salaries to these voluntary schemes, on behalf of their employees. There are approximately 1.2 million participants, which is approximately 9% of the total population. The regulation is similar to that for the

[32] IKE-Indywidualne Konto Emerytalne i.e. Individual Retirement Account (IRA)

mandatory funds (see 2b) p.46) with a few differences in terms of participation (voluntary) and quantitative investment restrictions (see Annex 7).

The Polish system distinguishes between qualified third pillar plans - which can be organised on a voluntary basis – and non-qualified third pillar plans, which may take the form of stock-purchase plans or stock-option plans.

The qualified third pillar plans include a special form of insurance i.e. the Employee Pension Programs (EPP), which can be executed:

a. as employee pension funds
b. on the basis of a contract with an investment fund
c. on the basis of a contract with an insurance company
d. on the basis of a contract with a mutual insurance association.

Trade unions can play an important role in the creation of these programmes. At the end of 2002, 197 employers had established such plans. The employer pays "basic" contributions up to 7% of wages and the employee may contribute. These plans may be considered as second pillar pension provision under the European terminology. Last year, 230 programs covered only 1% of the working population.

The third pillar remains, however, negligible in Poland in terms of accumulated assets as well as number of participants (see Annex 6).

In Estonia, individuals can contribute to a voluntary third pillar plan (which is exclusively individual) by:

a. opting for pension insurance policies offered by licensed private insurance companies or
b. opting for units of pension funds managed by private asset managers.

In terms of the working population, approximately 10% from both the public and private sectors is covered by the third pillar.

In Lithuania, Latvia and the Slovak Republic, third pillar schemes may be individual or occupational. Nevertheless, there is no operating third pillar scheme up until now in

Lithuania whereas there are one closed[33] and three open pension funds[34] currently in operation in Latvia. Latvian law defines the closed and open pension funds as follows:

1. Closed pension fund: the participants may be only the persons who at the moment of affiliation are employees of one or several founders (shareholders) of the pension fund
2. Open pension fund: individuals, directly or through the employers, entering into a contract, may be affiliated under the provisions of the law. The founders (shareholders) of the open pension fund may be only a bank or a life insurance company.

These plans are, generally speaking, subject to less investment restrictions than the pension funds under the mandatory pillar (1st pillar bis), which are considered to require more security and protection given their mandatory features.

The success of these individual plans is still limited. By the end of 2002, only a few thousand individuals participated.

In Slovenia, the third pillar market refers exclusively to personal individual accounts but is almost insignificant due to a.o. lack of tax incentives.

In the Slovak Republic, the third pillar, which is expected to be reformed in the near future, currently comprises approximately 500,000 participants and SKK 9 billion assets (equivalent to € 227 million[35]) managed by 5 licensed companies.

3. Main differences between the EU-15 and the NMS countries: summary

The main differences with regard to supplementary pensions between the EU-15 and the NMS are:

1. The quasi absence of occupational pension schemes in the NMS in which the social partners play a role. The supplementary pension markets in the NMS countries (mandatory or voluntary) are by and large dominated by financial services providers whereas occupational pension schemes in the EU-15 are mainly organised by non-profit making organisations (pension funds, a majority of whom delegate work to financial services providers including insurers) and insurance companies.

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[33] "Pirmais slegtais pensiju" fonds, which operates for employees of the two largest enterprises in Latvia (Lattelecom and Latvenergo).
[34] « Pensiju fonds Baltikums », « Parekss atklatais pensiju fonds » and « Unipensija ».
[35] 100 SKK equals to € 2.5240 as at November 15, 2004

2. Whereas in the EU-15 paritarian institutions are of varying importance, but exist in most countries, there is not even a legal framework for them in most of the NMS.
3. The dominance of DC-type accounts: whereas DB plans predominate in the EU-15, these do not exist in a majority of the NMS and are usually not legally allowed.
4. The dominance of open funds. As underlined by a respondent from Hungary, "*even when the pension institution is a non-profit organisation as in Hungary, it remains a business for financial institutions because affiliated providers within the same group can carry out asset management, record-keeping, etc. for the pension institution, while for companies it exclusively represents a cost element*." A major issue related to open pension funds is the decreasing number of providers in the NMS, which increases the risk of concentration. Few of the respondents are aware of this risk, as they seem to welcome concentration, which enables economies of scale. Annex 10 gives details on the number of pension entities and plans, which exist in the mandatory first pillar bis and in the voluntary pillar. These graphs do not give the evolution because the reform was quite recent in some countries. In Hungary and Poland, it appears that the number of providers decreased from respectively 25 and 21 at the end of 2000, to 18 and 16 at the end of 2003.

These main differences can be explained by the divergent approach: a collective approach based on risk sharing in the EU-15 versus an individual approach in the NMS countries.

Supplementary pension schemes have been introduced quite recently in the NMS. Domestic enterprises have no experience nor familiarity with such activities. In addition, most domestic enterprises do not have the critical size to manage pension funds efficiently. This is, however, not a good argument because they can always outsource tasks they cannot cope with. In the EU-15, there are ten thousands of small and medium-size pension funds and group insured plans. Finally, the development of closed funds in the NMS, where at all possible, is hindered by inappropriate and excessive regulation (e.g. minimum requirements, as is the case in Slovenia for

example). The existing open pension funds offered by financial institutions appear, therefore, to be the easiest way for employers to offer voluntary pension provision.

THE COMMUNITY "ACQUIS"

I. Introduction

This chapter aims at describing the Community "acquis" in the European Union regarding supplementary pensions.

In a strict sense, the Community "acquis" is defined as "*the body of common rights and obligations, which binds all the Member States together within the European Union. It is constantly evolving and comprises:*

- *the content, principles and political objectives of the Treaties;*
- *regulation adopted in application of the Treaties and case law of the Court of Justice;*
- *declarations and resolutions adopted by the Union*."

The NMS have to adopt the Community "acquis" like any other Member State. Derogations are granted only in exceptional circumstances and are limited in scope.

The EU has a role of co-ordination with regard to the first pillar i.e. social security schemes (a.o. by means of regulation 1408/71). In the field of supplementary pensions (occupational as well as personal), it endeavours to ensure the fundamental Treaty provisions and to maximise the potential of the Euro and the single financial market.

II. European Regulation

1. The basic Treaty freedoms

The European Community has limited competences regarding pension matters; these are in connection with the basic Treaty freedoms i.e. for cross-border issues and on the basis of the Capital Movements Provisions of the EC Treaty. The articles 39, 43, 49 and 56 guarantee free movement of workers, freedom of establishment, freedom to provide for services and free movement of capital and they prohibit restrictions to these freedoms including in taxation matters.

It has to be noted that article 136 of the Treaty encourages the Community and the Member States to have "*as their objectives the promotion of employment, improved living and working conditions, so as to make possible their harmonisation while the improvement is being maintained, proper social protection, dialogue between management and labour, the development of human resources with a view to lasting high employment and the combating of exclusion*."

Article 137 (1) enumerates points in which the Community should support and complement the activities of the Member States:

- "*improvement in particular of the working environment to protect workers' health and safety;*
- *working conditions;*
- *the information and consultation of workers;*
- *the integration of persons excluded from the labour market;*
- *equality between men and women with regard to labour market opportunities and treatment at work*."

2. Regulation 1408/71

This regulation[36] aims at the co-ordination of social security schemes to protect the rights of persons moving within the European Union. A person living in a Member State to whom Regulation 1408/71 applies is subject to the same obligations and benefits under the legislation of any Member State as the citizens of that State (equality of treatment). This regulation covers general and special contributory and non-contributory social security schemes. It applies to all sub-sectors of Social Security.

It encompasses two major principles, derived from the Treaty: the aggregation of insurance periods and transferability of rights.

Article 10: "*1. Save as otherwise provided in this Regulation, invalidity, old-age or survivors' cash benefits, pensions for accidents at work or occupational diseases and death grants acquired under the legislation of one or more Member States shall not be subject to any reduction, modification, suspension, withdrawal or confiscation by reason of the fact that the recipient resides in the territory of a Member State other than that in which the institution responsible for payment is situated*. (…)"

Article 45: "*1. An institution of a Member State whose legislation makes the acquisition, retention or recovery of the right to benefits conditional upon the completion of insurance period shall take into account, to the extent necessary, insurance periods completed under the legislation of any Member State as though they had been completed under the legislation which it administers*. (…)".

[36] Council Regulation (EEC) N° 1408/71 of 14 June 1971 on the application of social security schemes to employed persons and their families moving within the Community.

A new regulation[37] has been adopted following the several amendments and updates of Regulation 1408/71 but still needs to enter into force.

3. The Directives on equal treatment for men and women[38]

These Directives form part of the Community "acquis" and aim to ensure equality (of opportunities and treatment) for men and women in all statutory and occupational social security schemes.

This principle of equality between men and women has been re-affirmed by the European Court of Justice in its case law. In particular, in the Barber case[39], the Court confirmed that benefits paid by an occupational pension scheme are considered to be pay and must, therefore, comply with the principle of equal pay for men and women.

4. The protection of employees in the event of the insolvency of their employer[40]

The objective of this Directive is to guarantee payment of outstanding claims to employees in the event of insolvency of their employer. The definition of the state of insolvency has been clarified and extended by Directive 2002/74/EC[41]. "*An employer shall henceforth be deemed to be in a state of insolvency*, w*here a request has been made for the opening of collective proceedings based on insolvency of the employer, as provided for under the laws, regulations and administrative provisions of a Member State, and involving the partial or total divestment of the employer's assets and the appointment of a liquidator or a person performing a similar task, and the authority which is competent pursuant to the said provisions (a) either decided to open the*

[37] Regulation (EC) of the European Parliament and of the Council of 29 April 2004 on the coordination of the social security systems

[38] Directive 79/7/EEC of 19 December 1978 on the progressive implementation of the principle of equal treatment for men and women in matters of social security and Directive 86/378/EEC of 24 July 1986, as amended in 1996 by Directive 96/97/EC of 20 December 1996 on the implementation of the principle of equal treatment for men and women in occupational social security schemes.

[39] Barber case of May 17, 1990. Article 141 of the Treaty requires equal pay for men and women where they carry out the same work.

[40] Directive 80/987/EEC of the Council of 20 October 1980 on the approximation of the laws of the Member States relating to the protection of employees in the event of the insolvency of their employer. This Directive has been amended by Directive 2002/74/EC.

[41] Directive 2002/74/EC of the European Parliament and of the Council of 23 September 2002 on the approximation of the laws of the Member States relating to the protection of employees in the event of the insolvency of their employer.

proceedings, or (b) established that the employer's undertaking or business has been definitively closed down and that the available assets are insufficient to warrant the opening of the proceedings."[42]

The Directive allows limited exceptions for certain categories of employees, in specific cases.

5. The safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses[43]

Given economic trends and possible changes in the structure of undertakings, it appeared necessary to protect and safeguard the employees' rights in the event of a change of employer. This was the objective of the Council Directive of 14 February 1977, amended by that of 29 June 1998 and consolidated by that of 12 March 2001.

The scope of this Directive is the "*transfer of an undertaking, business or part of an undertaking or business to another employer as a result of a legal transfer or merger*" (art. 1.(a)). The rights and obligations arising from a contract of employment or from an employment relationship existing at the time of the transfer are transferred to the new employer. This does not include – unless Member States provide otherwise - the old-age, invalidity or survivors' benefits under supplementary pension schemes outside the statutory schemes.

Furthermore, article 3(4)(b) requires: "(…) *Member States shall adopt the measures necessary to protect the interests of employees and of persons no longer employed in the transferor's business at the time of the transfer in respect of rights conferring on them immediate or prospective entitlement to old age benefits, including survivors' benefits, under supplementary schemes referred to in subparagraph*."

The employees and/or their representatives ought to be informed by the former and the new employers of the transfer, the legal, economic and social implications and the measures envisaged in relation to the employees (art.7).

Member States are free to apply more favourable regulation to employees.

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[42] Article 2

[43] Directive 2001/23/EC of the Council of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses.

Article 10 foresees an analysis of the effect of the provision to be submitted by the Commission to the Council before 17 July 2006, which may propose amendments if it deems appropriate.

6. The Life Insurance Directives

Directive of 5 November 2002 concerning life assurance[44] aims to simplify and clarify all existing life insurance Directives, including the "Third Life Directive"[45] and the Directive as regards the solvency margin requirement for life insurance undertakings[46], whose purpose is the improvement of the provisions governing the calculation of the solvency margin requirements for these.

Any insurance undertaking, which is duly authorised in its home Member State, must be allowed to exercise the activities referred to in the Directive in all Member States ("European passport"). The Directive seeks to harmonise national laws as is necessary to permit mutual recognition and home-country control in relation to the establishment and calculation of technical provisions and lays down rules on the choice, valuation, diversification and location of the assets covering those provisions. It coordinates the actuarial principles that have to be respected by every insurance undertaking as regards the definition and calculation of technical provisions.

7. The Pension Fund Directive

The Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision (IORP) [47], hereafter called the "Pension Fund Directive", aims at the creation of a Community legal framework covering such institutions. In Article 6, an IORP is defined as:

"*an institution, irrespective of its legal form, operating on a funded basis, established separately from any sponsoring undertaking or trade for the purpose of providing*

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[44] Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance.

[45] Third Council Directive 92/96/EEC of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance and amending Directives 79/267/EEC and 90/619/EEC (third Directive)

[46] Parliament and Council Directive 2002/12/EC of 20 March 2002 amending Council Directive 79/267/EEC as regards the solvency margin requirement for life assurance undertakings.

[47] Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision

retirement benefits in the context of an occupational activity on the basis of an agreement or contract concluded:

individually or collectively between the employer(s) and the employee(s) or their respective representatives, or

with self-employed persons, in compliance with the legislation of the home and host Member States

and which carries out activities directly arising therefrom."

The Directive excludes[48] social security schemes (covered by regulation 1408/71), book reserves[49] and PAYG-operating institutions[50], (German) support funds (no legal rights to benefits) and group life insurance (covered by the Third Life Directive); furthermore, plans with less than 100 members may but must not be excluded by Member States.

The main objectives of the Directive are to:

1. ensure security on the asset and liability sides (prudential framework),
2. facilitate access by improving efficiency and affordability (therefore eliminating or at least reducing investment restrictions),
3. improve transparency ,
4. enable cross-border activities and
5. ensure level playing for similar operations.

To ensure these objectives, the Directive encompasses 5 groups of provisions:

i) First group: security on the asset and liability sides

- "fit" and proper criteria and legal separation of the assets of the pension fund from the sponsor,
- funding rules, technical provisions and actuarial valuations for DB-type[51] plans
- regulatory own funds

[48]Article 2. (2)

[49] Which exist mainly in Germany, Austria, Sweden, Luxembourg and Spain in which latter country they are being phased out.

[50] As in France; the French PAYG second pillar plans are, however, more and more considered to form part of the first pillar.

[51] Please refer to the glossary on p.iii for definitions of the terms. It has to be mentioned that the Pension Fund Directive does not refer explicitly to the distinction between DB and DC-type plans, notably because of the increasing existence of mixed schemes.

The regulations related to calculations and funding of technical provisions and to investment rules are to ensure security on the liability side whilst achieving greater efficiency and affordability on the asset side.

ii) Second group: facilitate access by improving efficiency and affordability (therefore eliminating or at least reducing investment restrictions)

- Investments based on prudent principles i.e. a qualitative rather than a quantitative approach to investments[52]. Member States can be more restrictive if appropriately justified[53]. In this case, the pension fund must be allowed to invest:
  - Up to 70% of the technical provisions for DB-type plans (and the remainder totally) or up to 70% of the whole portfolio for DC-type plans in shares, negotiable securities and corporate bonds
  - In non-matching currencies up to 30% of the technical provisions
  - In risk capital consistent with the prudent person concept.
- Rules may be stricter in the event of cross-border activity. The host Member State may, only if they themselves apply the same or stricter rules require:
  - A minimum of 70% of the assets that correspond to the activities carried out in the particular host Member State to be invested in shares, other securities treated as shares and debt securities which are admitted to trading on a regulated market or a maximum of 30% of these assets in shares, other securities treated as shares and debt securities, which are not admitted to trading on a regulated market
  - A maximum of 5% of the above-defined assets in the same undertaking and maximum 10% in undertakings belonging to a single group

[52] Article 18 (1): “Member States shall require institutions located in their territories to invest in accordance with the “prudent person” rule (…)”
[53] Article 18 (5) ”In accordance with the provisions of paragraphs 1 to 4, Member States may, for the institutions located in their territories, lay down more detailed rules, including quantitative rules, provided they are prudentially justified to reflect the total range of pension schemes operated by these institutions. (…)”

- A maximum of 30% of the above-defined assets in non-matching currencies
- Home Member States may require ring-fencing of the assets.

iii) Third group: improved transparency

- powers of intervention and duties of the competent authorities,
- information to be provided to the Supervisory Authority and to members and beneficiaries usually on request for these latter groups,
- annual report and annual accounts are mandatory,
- requirement of a Statement of Investment Policy Principles (SIP) in writing to be submitted at least every three years to the Supervisory Authority and on request to the members and beneficiaries. The Directive precises what needs to be provided: at least the investment risk measurement methods, the risk-management processes implemented and the strategic asset allocation with respect to the nature and duration of pension liabilities. This statement is to be revised every 3 years and without delay after any significant change in the investment policy.

iv) Fourth group: cross-border activities

- free provision of services
- mutual recognition of supervisory principles
- co-operation between competent authorities
- prudential rules of the home Member State
- social and labour law of the host Member State

v) Fifth group: level playing for similar operations

- coherence with life insurance directives
- option for Member States to apply provisions of specific articles of the Pension Fund Directive to insurance companies for similar activities[54]
- obligation to ring-fence assets and liabilities.

[54] Art. 4: "Home Member State may choose to apply the provisions of articles 9 to 16 and articles 18 to 20 of this Directive to the occupational retirement provision business of insurance undertakings, which are covered by Directive 2002/83/EC. In that case, all assets and liabilities

Member States are required to regularly exchange information and experience with the Commission related to their progress on implementing the Directive and to the difficulties they might encounter to do this. The Commission is expected to issue a report reviewing the application of the Directive[55] by 2007.

The deadline for implementation of the Directive by the Member States is September 23, 2005. The implementation of articles related to regulatory own funds (art.17(1)) and to investment in the sponsoring undertaking (art. 18(1)(f)) may be postponed i.e. a transition period of maximum 5 years thereafter is granted (until September 23, 2010).

8. The Directive on safeguarding the supplementary pension rights[56] [57]

The objective and scope of this Directive is defined in article 1: "*The aim of this Directive is to protect the rights of members of supplementary pension schemes who move from one Member State to another, thereby contributing to the removal of obstacles to the free movement of employed and self-employed persons within the Community. Such protection refers to pension rights under both voluntary and compulsory supplementary pension schemes, with the exception of schemes covered by Regulation (EEC) N° 1408/71*".

This Directive ensures the safeguarding of supplementary pension rights; it does not cover the "portability" of supplementary pensions i.e. the possibility of acquiring pension rights and keeping pension entitlements by transferring them to a new scheme in the event of professional mobility.

According to article 4, Member States are obliged to take the necessary measures to ensure the preservation of vested pension rights for members of a supplementary pension scheme in the event of moving within the European Union or on changing jobs/plans within a Member State.

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corresponding to the said business shall be ring-fenced, managed and organised separately from the other activities of the insurance undertakings, without any possibility of transfer.

[55] More particularly the application of Article 18 related to investment rules; the progress achieved in the adaptation of national supervisory systems and the application of the second subparagraph of Article 19(2), in particular the situation prevailing in Member States regarding the use of depositaries and the role played by them where appropriate.

[56] Council Directive 98/49/EC of 29 June 1998 on safeguarding the supplementary pension rights of employed and self-employed persons moving within the Community

[57] Directive 2001/23/EC of the Council of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses.

Article 6 allows a person posted to another Member State to continue to contribute to the scheme in his "home" Member State.

Article 7 requires adequate information by employers, trustees or other persons responsible for the management of the scheme to the employees moving within the European Union, particularly referring the available choices and alternatives.

The situation in the NMS: Pragma research

It is not Pragma's role to evaluate whether the NMS comply with EU regulation. This is a very complex legal process carried out by the competent services of the European Commission.

The following comments are derived from the answers of the respondents to the questionnaire. These reflect personal opinions of pensions stakeholders throughout the EU-25.

The scope of these different EU texts and their application in the NMS pose a problem to assess the degree of compliance in these countries. Respondents hesitate on which regulation applies to which institutions, particularly for the first pillar bis, which does not exist as such in the EU-15 and the pension institutions in the third pillar, which may be personal as well as occupational in some of these countries (which is not the case in the EU-15).

Ref. the first pillar bis (mandatory supplementary pension schemes), a large majority of the respondents in Poland, Hungary, the Slovak Republic and the Baltic States consider that these are covered by the Regulation n° 1408/71 because they form part of the social security system and are, therefore, excluded from the scope of the Pension Fund or Life Insurance Directives.

According to the respondents, the following institutions, per country, would fall under the scope of the Pension Fund Directive:

Table 11: Pension institutions subjected to the Pension Fund Directive, according to the respondents

Countries	Institution
Estonia	None
Latvia	Closed and open pension funds other than under the first pillar bis
Lithuania	None
Poland	Employee Pension Plans or Employee Retirement Programs
Hungary	Voluntary Pension Funds[1]
The Slovak Republic	None
The Czech Republic	None
Slovenia	Pension funds offered by pension companies, insurance companies and pension mutual funds (“kaptalska druzba” and “pokojninska druzba”)
Malta	In the future when they will be set up: Retirement schemes registered under the Special Funds Act, 2002 Parties related to retirement schemes, retirement funds and related parties registered under the Special Funds Act, 2002
Cyprus	Semi government organisations with more than 100 members Municipalities with more than 100 members

[1] The Hungarian government has recently decided that these funds will not fall under the scope of the Pension Fund Directive. Despite the fact that these funds have a lot of occupational characteristics, they are not based on an agreement between the employer and his employees and have therefore been excluded from the Directive.

Source: Pragma Consulting on the basis of the responses to the questionnaire.

It has to be noted that the Pension Fund Directive needs to be implemented by all Member States at the latest on September 23rd, 2005 and several of these, including in the EU-15 still hesitate on which institutions fall under its scope.

Third pillar pension institutions are also generally considered as not falling under the scope of the Pension Fund Directive or the Life Insurance Directives (in Estonia, Lithuania, the Slovak and Czech Republics[58].)

This does not exclude that the respondents are – for a large majority – in favour of an extension of the scope of the Pension Fund Directive given its rational principles and objectives to ensure adequate and secure pensions.

The requirement of legal separation of the assets of pension assets from the sponsor of the Pension Fund Directive should be of general application to all pension funds (irrespective of the scope of the applicable EU regulation). Particularly, the respondents from the Czech Republic encourage this since there is currently no legal separation of the pension assets [i.e. for pension funds set up under the Act n°42/1994 Coll. on the pension co-insurance with a state contribution (3rd pillar)] from the assets of the financial institutions, which manage these i.e. the capital of shareholders and all liabilities towards clients are booked on the same balance sheet and invested as one entity.

The prudent person rule (Pension Fund Directive art. 18) is a second element to be applied to any pension fund or institution. Currently, the assets of pension funds (mandatory individual pension plans as well as voluntary pension plans) in several NMS as well as EU-15 Member States are subject to quantitative investment restrictions, particularly for equity and foreign assets. (see Annex 7).

[58] The pension funds set up according to the act. N° 42/1994 coll. on the pension co-insurance with a state contribution.

Irrespective whether mandatory and/or voluntary pension funds are subject or not to the Pension Fund Directive, investment restrictions do not only violate the free movement of capital (a basic Treaty requirement) but have also negative effects on funding and costs, on the investment management industry and on the overall economy and capital markets (see box). These should, for these reasons, be eliminated or at least reduced. Although all respondents require the abolishment of investment restrictions in both the mandatory and voluntary pillars, it is interesting to notice that often where

Negative effects on funding:

1. Quantitative investment restrictions make it difficult to take the liabilities of a fund into account in a way that reflects all relevant aspects of those liabilities. For example, a mature pension fund will have liabilities with a shorter time horizon and higher risk aversion than a pension fund, which is not mature.
2. Quantitative investment restrictions are inflexible and cannot be changed rapidly in response to changing economic circumstances and movements in the securities, currency, and real estate markets.
3. Quantitative investment restrictions encourage the investment strategy of pension funds to be conducted so as to conform to the legal restrictions rather than to attain good returns, the reduction of risk and other objectives that would benefit the fund.
4. Quantitative investment restrictions encourage pension funds established in a Member State to be treated by the national government of the Member State as a means of financing its budget requirements.

Negative effects on the investment management industry:

1. Quantitative investment restrictions discourage the appointment, by the body with overall responsibility for the conduct of the fund, of investment managers with the skills to achieve high returns and reduce risk through investment in a wide range of asset classes and outside the home country of the fund.
2. Quantitative investment restrictions discourage competition among investment managers as they have limited opportunity to exercise their investment skills if their primary role is ensuring that fund portfolios comply with legal restrictions.
3. Quantitative investment restrictions discourage the development of a skilled investment management industry, as there is limited opportunity for investment management companies to grow if the market for their services is too small.

Negative effects on the economy:

1. Quantitative investment restrictions encourage the inefficient allocation of capital and therefore prevent levels of economic growth and increases in employment, which would be attainable in the absence of such restrictions, from being achieved.
2. Quantitative investment restrictions increase the cost of labour by increasing the contributions that need to be paid by an employer to ensure that their employees will receive a satisfactory retirement income. They, therefore, hinder the creation of jobs.

Mandatory quantitative limits, which differ from country to country, do not make sense and would undermine the whole structure of the EMU and of capital market integration.

limits exist they are not fully utilised. Annex 11 shows that there is still a margin between the statutory investment limits and the actual investments in these assets.

The requirement of minimum guaranteed returns or average performance[59] results (or may result) in the fact that asset managers do not dare to deviate from the average asset allocation, which may lead to herding behaviour, systematic underperformance and a too short-term oriented and expensive investment policy and application.

The existence of quantitative restrictions may to some degree lock the assets in the domestic capital markets. The overwhelming majority of the respondents states that their local capital markets in terms of size, quality, liquidity, availability of products/asset classes and transaction costs are not appropriate to meet the increasing demand due to the growth of, among other, pension assets. The majority of the respondents expects that their capital markets will broaden, following their membership in the European Union and particularly after they will have entered the Euro zone, like for example happened with Portugal and Greece to a lesser extent.

The articles in the Pension Fund Directive ref. funding rules, technical provisions and actuarial valuations are not relevant in the NMS because all plans are of the DC-type.

In Slovenia, pension plans are of the DC-type with a minimum annual guaranteed return. If this minimum return is not achieved, the provider has to compensate for this in a short period.

In Malta, although pension funds currently do not exist, the authorities took into account the Pension Fund Directive when elaborating the Special Funds Act 2002.

Annex 12 lists the responsible supervisory authorities for each type of pension funds in the NMS. Respondents from the Czech Republic and Slovenia do not consider the structure of their supervisory authorities appropriate. This is due to the absence of one single authority responsible for supervision. In the Czech Republic, there are four supervisory authorities[60], whose powers are unclear and the system is cost inefficient.

In Slovenia, there are currently two supervisory authorities depending on the type of the pension fund providers, which apply different regulation. This should be

[59] in case of non-compliance, the pension fund providers have to inject further sums in the fund to compensate for the difference with the internal benchmark (Poland, Slovenia and the Slovak Republic).

[60] i.e. the Czech Securities Commission (investment companies and brokers), the Czech National Bank (banks), the Office of the Supervision on small saving banks ("Kampelicky") and the Office of the State Supervision in Insurance and Pension Funds (3rd pillar).

standardised by having one single supervisor irrespective whether the services are provided by a pension fund, a bank or an insurance company.

The respondents state that article 11.4 of the Pension Fund Directive on the information to be provided to the members and beneficiaries should also be applied throughout the NMS for mandatory and voluntary pension funds, irrespective whether these fall under its scope or not because it relates to key information requirements, which are essential particularly in countries where DC plans dominate and where the members need, therefore, to be appropriately informed.
The article relates to:

- the target level of the retirement benefits, if applicable (specific to DB plans)
- the level of benefits in case of cessation of employment
- where the member bears the investment risk, the range of investment options, if applicable, and the actual investment portfolio as well as information on risk exposure and costs related to the investments
- the arrangement relating to the transfer of pension rights to another institution for occupational retirement provision in the event of termination of the employment relationship.

The respondents add that the information to be provided should also encompass individual account statements and actuarially forecasted benefits.

The requirement of a Statement of Investment Principles (SIP) is a fourth element welcomed by the respondents from the NMS, who consider that the pension fund providers should be responsible for this.

It can be assumed, based on some comments of respondents that cross-border activities will face similar obstacles as those existing in the EU-15 i.e. diverging taxation and social and labour regulation. In general, pension fund providers need to be licensed in the home Member State. The NMS will probably have to take measures to enable cross border activities. No obstacle has been mentioned in the responses because there are neither precedents nor cases for the time being.

III. The Open Method of Co-ordination

The Stockholm European Council in March 2001 adopted the so-called "Open Method of Co-ordination" for issues related to social exclusion and pensions. This method follows the logic of "*mutual learning, benchmarking, best practice and peer pressure to achieve objectives*". The first step is, therefore, to define common objectives, which are adequacy of pensions, financial sustainability of public and private pension schemes and modernisation of these.

Member States are encouraged to design appropriate implementation measures to realise these common objectives. As a first step, they have been required to each issue a national strategic report on adequate and sustainable pensions, to be reviewed regularly. These reports have been analysed and aggregated by the Commission and the Council in their joint report on adequate and sustainable pensions[61].

As to the above objectives: adequacy refers to sufficient provision/the social role of pensions and sustainability to the economic/financial aspects. To achieve these overall common objectives, 11 principles – indicated by a roman number in the box on p. 75 - have been identified and referred to in the Laeken summit conclusions[62] as it is important to develop clear and integrated strategies to cope with the ageing challenge. These do not only focus on the first pension pillar but on the two other pillars as well, which have an important role to play with respect to overall adequacy and sustainability of pension provision.

In the pension reform process, it will be important to keep in mind that financial sustainability cannot be achieved at the expense of the ability of pension systems to meet their social goals. Reforms that only focus on financial sustainability are likely to generate social problems and political pressure for increased expenditure. This implies considering the financial as well as the social implications of reforms, analysing the impact of ageing on the three pillars and taking account of other consequences of ageing, particularly for labour markets, financial markets and health care systems.

These principles form part of the Community "acquis".

By the middle of 2005, the NMS will issue - on an equal footing with the EU-15 - national strategy reports on pensions containing an analysis of the situation in their

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[61] Joint report by the Commission and the Council on adequate and sustainable pensions from the Economic Policy Committee and the Social Protection Committee to the Council of 3 March 2003 (6527/2/03 REV 2)

[62] 14-15 December 2001

respective countries, documenting the state of reform of their pension systems and setting out their strategies in the light of the common objectives agreed for the OMC on pensions.

The common objectives related to retirement provision of the Open Method of Co-ordination

1. ADEQUACY OF PENSIONS i.e. to safeguard the capacity of pension systems to meet their social aims of providing safe and adequate incomes to retired persons and their dependents and ensuring, in combination with health and long-term care systems, decent living conditions for all elderly persons;
   i. Preventing social exclusion i.e. ensure that older people are not placed at risk of poverty and can enjoy a decent standard of living; that they share in the economic well being of their country and can accordingly participate actively in public, social and cultural life.
   ii. Enabling people to maintain living standards i.e. provide access for all individuals to appropriate pension arrangements, public and/or private, which allow them to earn pension entitlements enabling them to maintain, to a reasonable degree, their living standard after retirement.
   iii. Strengthening solidarity i.e. promote solidarity within and between generations.
2. FINANCIAL SUSTAINABILITY OF PUBLIC AND PRIVATE PENSION SCHEMES so that the future impact of ageing does not jeopardise the long-term sustainability of public finances nor the ability to meet fundamental goals of budgetary policy (in terms of overall tax burdens or spending priorities) and does not lead to an unfair sharing of resources between generations;
   iv. Raising employment levels i.e. achieve a high level of employment through, where necessary, comprehensive labour-market reforms, as provided by the European employment strategy and in a way consistent with the Broad Economic Policy Guidelines (BEPG)
   v. Extending working lives: ensure that, alongside labour-market and economic policies, all relevant branches of social protection, in particular pension systems, offer effective incentives for the participation of older workers; that workers are not encouraged to take up early retirement and are not penalised for staying in the labour market beyond the standard retirement age; and that pension systems facilitate the option of gradual retirement.
   vi. Making pension systems sustainable in a context of sound public finances i.e. reform pension systems in appropriate ways taking into account the overall objective of maintaining the sustainability of public finances. At the same time, sustainability of pension systems needs to be accompanied by sound fiscal policies, including where necessary, a reduction of debt. Strategies adopted to meet this objective may also include setting up dedicated pension reserve funds.
   vii. Adjusting benefits and contributions in a balanced way i.e. ensure that pension provisions and reforms maintain a fair balance between the active and the retired by not overburdening the former and by maintaining adequate pensions for the latter.
   viii. Ensuring that private pension provision is adequate and financially sound i.e. ensure through appropriate regulatory frameworks and through sound management, that private and public-funded pension schemes can provide pensions with the required efficiency, affordability, portability and security.
3. MODERNISATION OF PENSION SCHEMES in response to changing needs of society and individuals i.e. to enhance the ability of pension systems to respond to the changing needs of society and individuals, thereby contributing to enhanced labour market flexibility, equal opportunities for men and women with regard to employment and social protection and a better adaptation of pension systems to individual needs.
   ix. Adapting more flexible employment and career patterns
   x. Meeting the aspirations for greater equality of women and men
   xi. Demonstrating the ability of pension systems to meet the challenges i.e. make pension systems more transparent and adaptable to changing circumstances; develop reliable and easy-to-understand information on the long-term perspectives of pension systems, notably with regard to the likely evolution of benefit levels and contribution rates; promote the broadest possible consensus regarding pension policies and reforms and improve the methodological basis for efficient monitoring of pension reform and policies.

The situation in the NMS: Pragma research

The respondents from the NMS are particularly concerned with the adequacy of their pensions, the employment level, the balance between rights and obligations and the transparency and predictability of their pension systems.
The experts from the EU-15 equally select maintaining adequacy as an issue of concern. They also emphasise ensuring sound and sustainable public finances and promoting intergenerational fairness.

The objective of **maintaining adequacy of pensions** is a first priority for all the Member States, according to a majority of respondents. The differences are enormous. This is either a problem of adequacy (e.g. the United Kingdom) or sustainability (e.g. Spain and Italy).
In the NMS, the dominance of DC pension schemes, combined with state pension levels[63] generally proportionally much lower than the average, high unemployment and the parallel economy, may compromise this objective. Poverty in old age is still a big problem in many countries with pension benefits clearly not adequate to alleviate this.

The transition costs due to the shift from PAYG to funding in the social security pillar raise the issue of **intergenerational fairness** in the countries where the reform has been adopted.
Based essentially on individual accounts, the pension systems in the NMS have substantially reduced the room for **solidarity**.

Raising the **employment** level is a necessity in all EU-25 but particularly in several NMS (see Table 5 p.30) and a pre-requisite for the financial sustainability of public pension schemes. Unemployment levels are on average higher in the NMS than in the EU-15.

The NMS have already made effort to achieve **greater equality between women and men**. The first pillar bis follows the same regulation as the PAYG first pillar related to the statutory retirement ages, which differ between men and women. Several countries

[63] Pension levels are affected by low earnings level. On average, first pillar pensions range between 45-50% of average net income after 35 contribution years, with substantial differences between countries.

have adopted reforms to gradually equalise retirement ages. This is the case in Estonia (63 years), Hungary (62 years), Latvia (62 years by 2009), Lithuania (62 years by 2009) and the Slovak Republic (62 years). Slovenia and Poland maintain different retirement ages: respectively 63 and 65 years for men and 61 and 60 years for women. In general, the pension funds – in the mandatory and voluntary systems – are open funds, which do not give direct right to an annuity payment. The individual needs to buy an annuity from an insurance company and the tables of conversion differ between men and women.

Transparency and predictability of the pension provision need also to be improved as this seems to be a weak point in the NMS. The Community "acquis" requires high levels of security and transparency.

Although the 11 objectives of the OMC seem to constitute an exhaustive list, one major objective seems to be currently lacking particularly but not only with regard to the situation in the NMS: **adequate and unbiased information and education of individuals**. In a pension system, which tends to be more and more individualistic and that is exposed to asymmetric information, it is vital that individuals understand how the system works and what they can expect in terms of replacement income. Also, they are in need of being able to make qualified investment choices.

The respondents from the NMS welcome the initiative of the OMC, which allows them to share experiences with the other Member States, a.o. with regard to occupational pension schemes. This could boost the development and “governance” of these schemes in the region.

IV. Ongoing initiatives

An efficiently functioning Single Market for occupational pensions is essential to ensure that citizens are able to exercise their rights of free movement enshrined in the Treaty. The powers of the EU, as defined in the Treaty are, however, fairly limited in taxation and social (protection) matters, as these require unanimity voting. This explains why the European Commission is handicapped to take initiatives in these areas, which, related to pensions, often are major obstacles to benefit from these basic freedoms (of free movement of people and capital).

1. Social issues: Portability[64] of supplementary pension rights

Vesting periods[65] and limited portability of DB-type pension plans within Member States and between these used to be major handicaps for mobility of plan members and their pension rights in some (but not all) Member States. DC schemes in their simplest form (e.g. if they offer individual property rights) and personal pension plans (third pillar pensions) do not face such problems and may therefore be more suitable from the perspective of mobility.

The social partners have been consulted to improve the portability of supplementary pension rights and their suggestions have been summarised in two communications of the Commission[66]. By means of these, the Commission expresses its intention to define a general framework setting minimum requirements to ensure improved portability of occupational pension rights within the European Community.

2. Taxation issues

Taxation can be a major obstacle to the basic freedoms enshrined in the Treaty. It may cause undesired effects of double taxation or non-taxation of pension benefits. Although the European level has limited competence in taxation matters, long expected progress is finally emerging after the Commission's Communication on the Elimination of Tax Obstacles to the cross-border provision of occupational pensions[67], issued in April 2001 (the "Taxation Communication"), and a series of judgements of the European Court of Justice (ECJ), the most recent and important being the so-called

[64] The European Commission defines the term "portability" as the possibility of maintaining pension entitlements in the event of professional mobility. This is different from "transferability", which refers to one specific way of achieving portability, namely by transferring a capital representing the acquired pension entitlements from one scheme to another.

[65] A vesting period is the minimum scheme membership period required in order to acquire a pension entitlement.

[66] Communication from the Commission SEC/2002/597 of 27 May 2002 - First stage consultation of social partners on the portability of supplementary pension rights, followed by the Communication from the Commission SEC/2003/916 of 12 September 2003 – Second stage consultation of social partners on measures to improve the portability of occupational pension rights, whose scope is exclusively occupational pension arrangements (second pillar).

[67] Communication COM (2001) 214 from the Commission to the Council, the European Parliament and the Economic and Social Committee of 19 April 2001 on The elimination of tax obstacles to the cross-border provision of occupational pensions

Danner[68] (October 3, 2002) and Skandia[69] (June 26, 2003) cases. Finally, the Commission, after these judgements, has initiated infringement procedures against several Member States that (may) discriminate in taxation matters.

The "Taxation Communication" seeks a co-ordinated approach rather than attempting to achieve harmonisation. The main message is that Member States are not allowed to restrict the freedom to provide services and the free movement of workers by refusing tax deductibility of pension contributions paid to pension plans in other Member States. It therefore calls for the elimination of unduly restrictive or discriminatory tax rules and presents measures to safeguard tax revenues of the Member States. Under nearly all existing bilateral tax treaties pension benefits are taxable in the country of residence of the pensioner. A common concern of the Member States is that they might be unable to tax benefits for which they have given tax exemption on contributions, if they allowed their residents to participate in foreign pension schemes. They fear that their tax authorities would not be informed of the payment of benefits or that taxpayers might not declare them, and that therefore cross-border pension provision could lead to evasion of tax.

In order to remedy this and to safeguard the tax revenues of the Member States, the Communication encourages automatic exchange of information between tax authorities on benefits paid by pension institutions to residents of another Member State, on basis of article 9 of the so-called Mutual Assistance Directive[70]. Furthermore, the Communication encourages a broader application of the so-called EET taxation principle by which contributions and investment income are tax-exempt (i.e. tax deferred) and the pensions or lump sums are taxed. The EET principle offers the advantage to encourage the accumulation of pension assets thanks to the tax deferral on contributions.

A large majority of the EU-15 applies the EET system, be it with substantial differences in the allowed deductible levels of contributions and in applications of taxation or quasi taxation (e.g. social security solidarity contributions sometimes apply).

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[68] Case C-136/00. The ECJ ruled that Finnish tax legislation violated Art.49 of the Treaty which deals with the freedom of services. It says that Mr Danner's German contributions should benefit from the same tax deductibility as if they had been contributions to a Finnish scheme.

[69] Case C-422/01. The ECJ rejected Swedish treatment of pension taxation and gave employers the right to claim tax deductions for premiums towards occupational pension plans sold by life insurance companies domiciled in another EU Member State.

[70] Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation

Although a Commission Communication must not be implemented by the Member States, it has or can have a moral value as it gives policy orientations.

The ECJ has reaffirmed several times the basic Treaty freedoms. The Wielockx[71], Danner and Skandia cases reverse the earlier Bachman judgement[72] of the ECJ. As long as the so-called Bachman doctrine prevailed, tax deductions on contributions to a pension plan located in another Member State could be refused by the tax authorities of the Member State where the deductions were applied for.

The European Federation of Retirement Provision (EFRP) has issued a new proposal ("EIORP 2005, the EFRP model for pan-European pensions") with regard to a pan-European institution for occupational retirement provision, which aims to allow for cross-border pension provision without adverse tax, social and labour market consequences between Member States as each so-called "national section" of an EIORP would comply with the national requirements to which a domestic pension fund is subjected.

The situation in the NMS: Pragma research

The portability of supplementary pension rights is relatively easier in the NMS given the dominance of DC individual accounts without minimum guaranteed return and capital guarantees.

Ref. the mandatory funded 1st pillar bis, there is no real obstacle to the portability of acquired rights within the country itself. There is generally speaking full and immediate vesting of all contributions. As explained, there exist some limitations to switch from one fund to another but these do not represent major obstacles and are considered necessary to avoid excessive shifts (and costs) between funds like for example Chile experienced in the past[73]. A large majority of the respondents states that the stipulations regulating switching should not be changed except in Lithuania, where the respondents would like to see these to be eased.

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[71] Wielockx case (C-80/94) of 11 August 1995. The ECJ stated that a Dutch rule denying the right of deductibility of provisions made to a pension reserve by a non-resident self-employed person was contrary to article 43 of the Treaty.

[72] Bachman case (C-204/90) of 28 January 1992. The ECJ ruled that restricting the deductibility of contributions paid to Belgian institutions might be justified by the need to preserve the cohesion of the Belgian tax system.

[73] In Chile and Mexico, switching between funds increased substantially costs a few years ago. Transfers in Poland were evaluated at 400,000 in 2002, which cost some 2% of annual premiums.

Between Member States, the situation is worse for three main reasons:

1. the first pillar bis is specific to a limited number of countries
2. regulation and taxation differ
3. contributions have to be paid to a fund, registered in the home country.

Ref. the voluntary pension funds, the issues are similar to those in the EU-15: different taxation systems, vesting periods and regulation are obstacles to the portability of the acquired rights. Furthermore the transaction fees charged when shifting from one open fund to another substantially hinders the mobility for plan members and their pension rights.

The EET taxation system is largely applied in the NMS.

The respondents in the NMS are in favour of this EET system, for the mandatory as well as the voluntary pension funds. The respondents from Lithuania and Latvia do not agree with this statement, proposing a full exemption/no taxation in the first pillar bis because this forms part of the social security system. A Latvian respondent advises to grant tax exemptions on social security contributions for pension contributions made by the employer on behalf of his employees in the voluntary system. Respondents from Lithuania ask to exempt premiums from VAT.

Simplified overview of the taxation systems in the NMS (funded pension funds, all pillars confused)

	EET	ETT	TEE	TTT	EEE
Estonia	x				
Latvia	x				
Lithuania			x		
Poland	x		x		
Hungary			x		x
The Slovak Republic	x				
The Czech Republic	x				
Slovenia	x				
Malta	x				
Cyprus	x				x

For more detailed information, see Annex 8

Source: Pragma Consulting

V. Conclusions

In general, the respondents from the NMS consider that the Community "acquis" will not have a major impact on the current state of pension systems in their countries. This can in part be explained by the substantial hesitation, which exists related to the

application of the Community "acquis" to their specific situation, particularly of the Pension Fund Directive[74].

The European Union should, therefore, adopt a common framework and clarify the scope of the Directives, particularly of the Pension Fund Directive. It is important to sort out which institutions are subjected to which Directives and whether some articles may be applied with exceptions or with transition periods in these countries. This particularly refers to the mandatory funded individual accounts (first pillar bis), which exist in Poland, Hungary, the Slovak Republic and the Baltic States.

It is advisable that appropriate measures are taken to ensure security because these pensions are replacing part of the first pillar and currently form the lion's share of funded pension provision in these countries due to the quasi-absence of occupational pension schemes.

[74] As explained, the situation of the pension systems in the NMS substantially differs with that in the EU-15 and makes comparisons and alignment difficult.

BEST PRACTICES IN THE EU-15

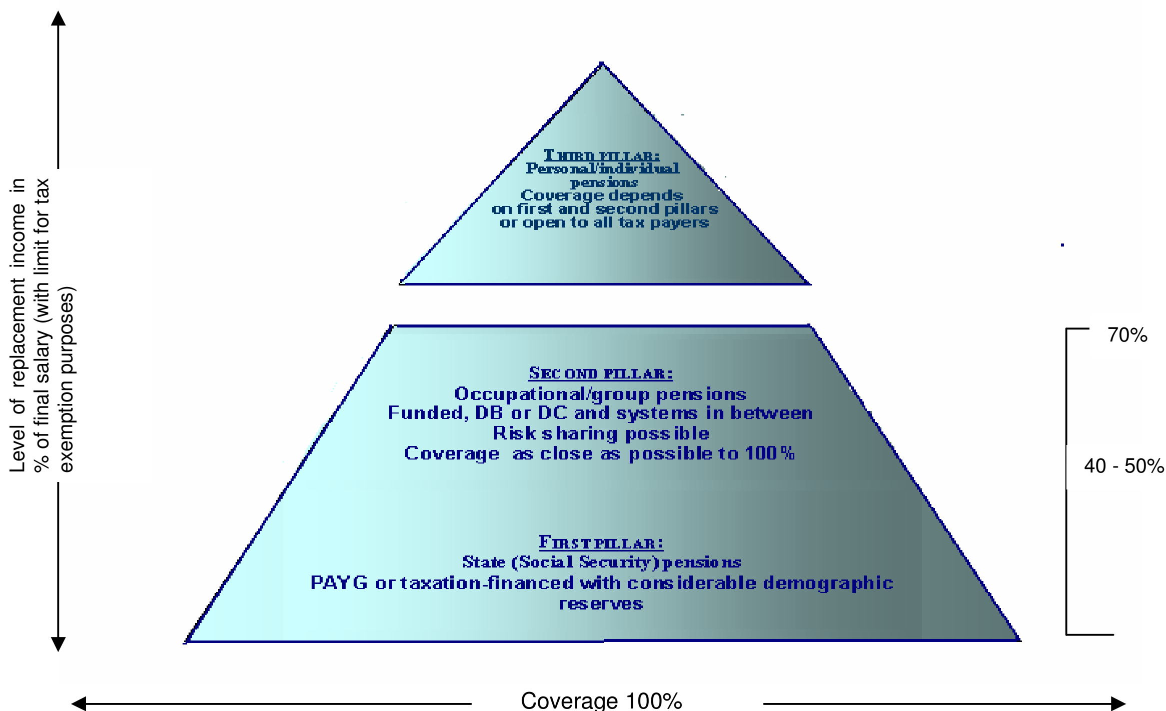
The EU encourages exchange of information between Member States by means of the Open Method of Co-ordination. In a broader sense, although not strictly forming part of the Community "acquis", the current state of affairs related to pensions and more particularly practical applications related to supplementary pensions in the EU-25 give useful leads to "best practices" in a perspective of mutual learning.
The objective of this chapter is to identify best practices in the EU-15 to better converge to adequate and sustainable pensions within a mutual learning framework. These have been submitted to the opinions of the experts and stakeholders in pension provision from the enlarged EU-25, who have expressed their personal opinions by means of the detailed questionnaire.

The overriding objective of providing adequate and sustainable pensions i.e. sufficient replacement income from different sources (legal, occupational and personal pensions) is more important than ever in view of the challenges of ageing. It is now widely accepted and a European policy priority that supplementary pensions are going to play a bigger role in overall pension provision. Because the challenges, risks and costs of ageing are gigantic, this three-dimensional pension provision should ideally be organised in a European conceptual framework. Member States should be free to define the respective role and importance of the three pillars, with the purpose to achieve a high degree of cohesion between social security and supplementary pensions and between themselves. These objectives are now agreed upon at the highest political level (joint report of the European Commission and the Council; see footnote 61 p.74) with a clear objective to achieve higher levels of efficiency.

I. The three-pillar pension system from a "best practices" perspective

The three-pillar pension system can be considered "best practice" because it provides for risk diversification and mitigation with regard to the sources of pension income and because it makes clear as to whom is responsible for what.
The following figure is an (oversimplified) illustration of a three-pillar pension system from a best practice perspective:

Figure 11: The pyramid of pension provision the EU-15



Source: Pragma Consulting on the basis of the responses to the questionnaire.

The opinions in the EU-25 and situation in the NMS

The following opinions are derived from the answers to the questionnaire and do not necessarily reflect the general consideration.

The implementation differs because it is highly dependent on the importance and specific characteristics of the first and second pillars in each Member State as well as on the income level of individuals. The lower this level, the more the relative importance of the first pillar should be. Each Member State should define target levels of pension pay-out (or of replacement income levels) from each pillar. The following percentages and ranges are supported by an overwhelming majority of the respondents:

		% of total pay-out	Ranges
first pillar	European terminology	60%	Min. 40% max. 70%
second pillar		30%	Min. 20% max. 50%
third pillar		10%	Min. 10% max. 20%.

These percentages are not a random choice but take into account the reality in the EU-15 as well as the objectives and principles of the OMC. They take into account e.g. the current situation in the United Kingdom and Ireland, where legal pensions are relatively low and the Netherlands, where occupational pensions (the second pillar) already reach over 40% of total pay-out and where coverage is very high.

The respondents also state that the financing of pensions in the public sector should be similar to funded occupational and personal pension schemes in the same manner as in the private sector.

Whereas some NMS (i.e. Poland, Hungary, the Slovak Republic and the Baltic States) are ahead of some other Member States with regard to pension reform in the first pillar because they have introduced funding elements, they are lagging with respect to occupational pensions, which latter are a growing part of total pension provision in the EU-15.

Though pension reform has (recently) been implemented in some NMS, the depth of these reforms and their applications differ often substantially from the objectives and principles of the OMC.

A large majority of the responses suggests that the NMS need to review this reform process, particularly Poland, Hungary, the Slovak Republic and the Baltic States, where the trend to individualisation has weakened social protection, social cohesion and solidarity (OMC objectives) and underestimated the advantages that the collective approach and economies of scale in the occupational pillar can bring in terms of investment return, risk and cost containment.

Social protection could be compromised because a significant number of people risk not accumulating sufficient assets to ensure adequate pensions. There is little if any redistribution between generations or between high and low-earning workers in these individual accounts, hence greater social inequity.

The critical issues that need to be addressed, according to the respondents, are:

- the need to reduce costs overall, particularly administrative and marketing costs without hindering competition,
- the elimination of excessive regulation that works counterproductive and creates a false illusion of security,
- the decreasing number of providers which leads to an excessive concentration,
- the need to protect members from excessive market volatility. As the individual bears the investment risk, this may cause serious distortions and inequity,

- the need for independent investment and risk advice i.e. to eliminate or at least decrease the asymmetric information gaps,
- the elimination of the investment risk distortions. These are created by a.o. the investment restrictions, which result in concentration of the assets on the domestic market and by the imposed minimum guaranteed return, which has proven to be extremely expensive and leads to herding behaviour with providers offering the same asset allocation and risk-return mix and to distortions, even elimination of competition. It may also increase systemic risk.

1. Best practices in the first pillar

Best practices in the first pillar	
1.	MANDATORY COVERAGE
2.	LOW COSTS
3.	EACH MEMBER STATE DEFINES THE LEVEL OF REPLACEMENT INCOME to be attained respecting adequacy and sustainability criteria
4.	INTRA- AND INTERGENERATIONAL SOLIDARITY
5.	PAYG OR TAXATION-FINANCED WITH CONSIDERABLE DEMOGRAPHIC RESERVES to cope with the ageing process. Demographic reserve funds, competitively managed (as in Denmark, Sweden, France and Ireland) and partial funding (as in Sweden and Finland) are applications that may reverse or at least mitigate the (financial) burden of ageing

The opinions in the EU-25 and situation in the NMS

Respondents from EU-25 agree that the first pillar needs to be preserved given its considerable advantages (see p. 40) and that this can be best achieved if this pillar is adapted.

In some Member States, change would not imply a decrease of the level of public pensions – e.g. in the United Kingdom it may have to be raised if poverty needs to be avoided in the foreseeable future (also because the second pillar is inadequate in that

country due to insufficient coverage and to the sudden shift from DB to DC with much lower contributions[75]). In other Member States, it means that the financing mechanism insofar as it relies essentially on PAYG needs to be changed to a combination of (less) PAYG and (more) funding. In a third group of Member States, where the pay-out of legal pensions exceeds levels of sustainability, the remedy may be a combination of lower state pensions with more funding (in the first pillar) and a greater role for occupational pensions. This latter does not seem to materialise, at least not everywhere, and where it does, not sufficiently mainly because employers are less and less motivated for supplementary pension provision.

All respondents agree that state pensions should be **partially funded**. EU-15 respondents are in favour of **unallocated funding** i.e. demographic reserves/reserve funds, which should be administered on the level of each Member State. National reserves should be sizeable enough to benefit from economies of scale and could be split up in several competing funds (as is the case in Sweden – AP-funds), if each of these would have sufficient critical mass.

Best practices for **asset management of reserve funds** derived from the responses are either (1) partial internal management and the remainder to be outsourced to a number of specialist managers by means of open tenders or (2) a split up in a number of funds that are partially internally managed and partially outsourced to specialists. The first option refers to the examples of France and Ireland, where the management is partially handled in-house in combination with external specialist managers for specific mandates. The second option is currently applied in Sweden through the AP-funds.

Assuring competition is a key element of good practice for these reserve funds. Furthermore, these funds should be subject to high level specific disclosure requirements[76].

For respondents from the NMS, best practice is **individual accounts/notional or real property rights,** financed by both employers and employees. The mandatory funded individual accounts, like these exist in Poland, Hungary, the Slovak Republic and the Baltic States, are appropriate because they introduced funding elements in the PAYG

[75] Please refer to the Turner Report. Op. Cit.

[76] In Canada, the Canada Pension Plan reserve fund has top level disclosure features that are available to the whole population with the slogan “Canadians have a right to know”. Equally Europeans have a right to know and for that sake all citizens of all Member States.

first pillar. Nevertheless, their structure (i.e. pure DC plans) puts substantial risks on the individual and it remains to be seen whether people can cope with these, more particularly:

- the investment risk (volatility of both equities and bonds, as well as of other asset classes) has been passed onto the individual, who has to face uncertain benefit levels with the risk of a substantial mismatch between expected and real benefits in both directions: over- and undershooting.
- the "country specific" risk: The individual is also confronted with country specific risk/risk of insufficient diversification as the investments are to a large extent locked in domestic markets with inadequate possibility to diversify. With the market volatility experienced from 2000 onwards pensions security may have been substantially weakened.
- the longevity and the corresponding annuity risks have also been passed onto the individual, who may face inappropriate timing of market declines when retiring and incur as well annuity risk[77] i.e. inappropriate benefit levels due to uncertain and expensive annuities due to among other low interest rates and high cost margins.

These well-known risks may be aggravated by asymmetric information of participants i.o.w. the understanding of the risks/opportunities of investments may be suboptimal[77].

Furthermore, the generalisation of individual accounts seems problematic unless the costs for the administration of these accounts can be decreased. In addition to supporting all the risks alone related to his funded account, the individual is generally in weaker position to negotiate favourable conditions with the financial institutions/providers than a group.

Unanimously, the respondents from the 6 countries, where the first pillar bis exists, consider that the right of initiative to set a first pillar bis pension scheme should not be extended to employers and/or sectors of industry because this is part of the legal pension. They do, however, support that the development of truly occupational pension schemes/a second pillar on the level of companies, sectors of industry and/or professionals is good practice as it triggers the benefits of economies of scale and of a better functioning of capital markets (more participants/more competition).

[77] Please refer to the Turner Report Op.Cit.

Some respondents from the NMS consider that demographic reserve funds should be introduced as they could help to solve the problem of ageing. This seems compatible with the existence of mandatory funded individual accounts and as believed by a respondent from the Slovak Republic demographic reserve funds should be of inspiration for ongoing reforms.

The funded **assets** of the first pillar (and first pillar bis) should be **appropriately diversified** in terms of asset classes and risk taking.

The identified best practice to ensure the greatest possible diversification is to abolish investment restrictions i.e. the assets should be invested globally and in a wide range of asset classes/risk buckets. Given that these assets are part of statutory pensions, security and prudence must be assured as well as achieving the highest possible return. To conciliate these (conflicting) objectives, the "**prudent man rule**", as required by the Pension Fund Directive, seems the most appropriate way forward.

2. Best practices in the second pillar

Best practices in the second pillar

1. MANDATORY COVERAGE (at the minimum for the element that replaces part of first pillar) OR AS CLOSE AS POSSIBLE TO 100% BY MEANS OF COLLECTIVE LABOUR AGREEMENTS (CLA'S) for sectors of industry or professional groups or VOLUNTARY coverage (initiative of plan sponsors) on the condition, if voluntary, that coverage is sufficient on the national level and that the lowest possible number of people are let out. CLA's and company plans not only allow for higher coverage, they also facilitate solidarity elements (e.g. coverage of career interruptions due to unemployment or sickness) and for CLA's, mobility at the national level (within the same sector, professional group)
2. FUNDING
3. SUFFICIENT DEGREE OF GROUP SOLIDARITY COMBINED, WHERE POSSIBLE, WITH CHOICE/INDIVIDUAL RESPONSIBILITY
4. ECONOMIES OF SCALE
5. ALLOWANCE OF ALL TYPES OF PLANS
6. FROM A RISK PERSPECTIVE, DB AND DC COLLECTIVE PLANS ARE BETTER THAN PURE DC INDIVIDUAL PLANS. (see Annex 13)
7. AS TO RISK SHARING FOR DB PLANS: WHEN THE SPONSOR TAKES THE RISK (e.g. financing, investment shortfall and longevity/annuity risks) he is in principle ENTITLED TO THE INVESTMENT SURPLUS ABOVE CERTAIN REQUIRED BUFFERS. The sponsor may, however, negotiate with plan members or their representatives to share these risks and therefore also the surplus or engage in cash balance/risk-sharing plans that are adaptable to the risk and/or cost tolerance (of sponsors and of members/beneficiaries).
8. THE COMMITMENT OF THE SPONSOR may also be LIMITED TO FINANCING ALL OR PART OF THE COST OF THE PLAN. IN THIS CASE (e.g. pure DC individual), THE MEMBERS AND BENEFICIARIES TAKE ALL THE RISKS AND THEREFORE NEED MORE PROTECTION. This higher level of security ought to be best achieved through more stringent transparency and fit and proper criteria of providers to be imposed by the Supervisory Authorities.
9. NEITHER MINIMUM GUARANTEED RETURNS NOR CAPITAL GUARANTEES SHOULD BE IMPOSED. This does not mean that sponsors cannot offer such plans with guarantees if they prefer these and accept the consequences thereof but it is not good practice to impose them by regulation. In any case for pure DC plans, the full costs, the benefit levels attainable and all available choices/options ought to be documented and regularly communicated to members so that they can make appropriate and informed decisions as to the investment choices, risks and costs they can afford. For such group plans where the members and beneficiaries bear the risks, there are still major advantages of economies of scale (to be gained) and therefore of efficiency and cost saving that makes them better practice than individual plans. DB plans need equally to achieve higher levels of transparency but may need less disclosure insofar as the commitment of the sponsor(s) is fully secured. Best practice is to achieve a right balance between products with minimum guarantees, which aim to decrease the risks but invariably lower potential return and products without any guarantee, which are generally more risky but allow for higher return.

The overall objective is adequate and sustainable pensions in a framework of efficiency, security, transparency and affordability with considerable room for plan sponsors/employers to control and monitor the cost consequences of the commitment in which they engage.

The opinions in the EU-25 and the situation in the NMS

There is a substantial difference in the conception of the second pillar between the NMS and the EU-15 (see point 3 p.56).

Respondents agree that the role of the PAYG state pension will continue to decrease in the future and that, therefore, the development of funded plans in the 2nd and 3rd pillars is essential. Nevertheless, these are currently not sufficiently provided for in a majority of EU Member States to adequately compensate for the erosion of first pillar provision.

The second pillar, as it currently exists throughout the EU-15, is - with exceptions e.g. the Netherlands and some Nordic countries - highly deficient in terms of coverage[78], security, solidarity and efficiency. The situation is worse in the NMS, where the occupational pillar hardly exists.

The widest possible coverage/participation level in the second pillar is particularly important in countries, where the level of pension benefits from the first pillar is low or decreasing. In this case, it could be preferable to make the second pillar compulsory by means of DB plans, DC collective plans or DC individual plans with for these latter sufficient (minimum) contribution levels to ensure adequate pensions at retirement.

Given the existence of mandatory individual funded accounts in 6 of the NMS, it may be not necessary to make the coverage of the second pillar compulsory in these countries unless the overall replacement levels obtained are not sufficient, which may well be the case for some countries.

For the other NMS – and maybe for the above also – (quasi) mandatory coverage in the occupational pillar by means of CLA's appears to be the solution to the risk of insufficient coverage. With this objective of **wider coverage** in mind, it is important that occupational pensions are offered on all levels i.e. of sectors of industry, professions, companies including small ones and regions.

[78] In the EU-15 coverage is on average 1/3rd for private sector employees (but 91% in the Netherlands and 85% in Denmark)

To expand coverage, tax incentives need to be raised as well as awareness of individuals with regard to the level of pension benefits they may expect from the statutory pillar (first and first pillar bis). This latter requires appropriate and efficient information and education to motivate people to contribute to supplementary pension schemes. This could be built through co-operation between the State and the social partners.

Because **group plans**, when collectively managed and assuming an adequate critical mass, are more efficient than individual accounts, a solution must be found for small companies that often do not offer pension plans. **Multi-employer plans**, which would allow to achieve the required critical size/mass to run pension schemes efficiently, seem to be an adequate response to this problem as well as group insurance.
A large majority of respondents from the NMS supports multi-employer plans[79] offered by financial institutions rather than by trade organisations.

External funding is overwhelmingly considered to be the best financing method of occupational pensions. Higher level of self-investment than that the Pension Fund Directive permits should, however, not be out-ruled as this could be the right type of incentive for employers[80]. In that case, a mutual insolvency insurance system should be established and great care should be given to the protection of participants.

The level of **solidarity** in occupational pension schemes should be a matter for employers/social partners to decide upon. Best practice requires that solidarity should include - as a minimum - coverage of long-term disability/invalidity. This could be done by means of a waiver of contributions/premiums that cover periods of disability/invalidity to ensure that full pension rights are preserved. Some respondents from the NMS would like to see unemployment as well covered but this does not seem good practice. The costs of this type of solidarity could be controlled by for example, limiting the coverage period.

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[79] The respondents from Slovenia, Lithuania, Hungary and the Slovak Republic were particularly interested in such plans.
[80] Under strict conditions and for a to be specified transition period.

A renewed effort to **motivate employers** and other sponsors is required to make the second pillar accessible, efficient and adequate and to avoid its decline. Their role should not be limited, as seems to be increasingly the case, to paying (part of) the contributions or making the structure available only. People are on average not able to produce higher returns when on their own as they cannot on average bear similar (investment) risks as groups; portfolios will become suboptimal and costs will be considerably higher so that one can be certain that half contributions (as is the case in the United Kingdom for new DC plans) will result in (considerably) less than half pensions. New layers of poverty, aggravated by insufficient coverage, are going to creep up, particularly but not only in the United Kingdom and Ireland. "*Unless new government initiatives can make a major difference to behaviour it is unlikely that the present voluntary private system combined with the present state system will solve the problem of inadequate pension savings.*"[81]

It is noticed that when plans are set up on the level of sectors of industry or professions alongside company plans as in the Netherlands, that there is more resistance of DB-type plans. The same goes for Denmark where DC collective plans (with interest guarantees) prevail.

To make the second pillar more attractive for employers and other sponsors, tax deductibility should be improved and **the EET taxation system** generalised[82] (see 2 p.78).

Furthermore, **regulation** needs to be **simplified** and accounting rules made more **appropriate** in some countries. A **long-lasting legal and tax framework** is equally a necessity.

Risk-sharing is another possibility. Good practices in this field are limiting the costs for employers or other sponsors and limiting the downside risk for employees whilst sharing upside potential. The levels of downside risk protection and profit sharing can be agreed upon and leave ample room for negotiations and flexibility.

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[81] The Turner Report: op.cit. p.xiii

[82] To incentivise employers, social partners and other sponsors special tax allowances could be offered in the first year(s) of existence of a new plan; Portugal has offered these in the past.

Despite a shift to DC in some EU-15 Member States in recent times, there are still many sectors and companies in the same and other countries that believe that DB plans are the best solution and will be less expensive than DC individual plans of equal value. The reason is the powerful effect of economies of scale, which allows for higher performance, combined with better risk taking as well as lower costs to run these plans. The combination, it is said, is unbeatable and the difference over the long-term can be substantial (see Annex 14).

The **social partners** have a role to play in occupational pension provision. This is at the minimum **to enable** i.e. to make the structure of occupational pension provision available. Additionally, they should be responsible for the **supervision** of the fund and be, therefore, members of the Board of Directors. It is, however, important that they are sufficiently qualified to fulfil their role. They should, therefore, receive appropriate training and be assisted by independent specialists (actuaries, accountants, investment consultants, etc.). It is also important that they avoid short-termism as this may result in an over-conservative asset allocation, which implies inadequate returns over the long-term.

A large majority of the respondents believes that **the role of the State** should be limited **to enabling and supervising** supplementary pensions. Furthermore, there exists a risk of conflict of interest if the State would be a supervisor as well as a provider. The State should, however, be a provider of supplementary pensions for its own employees.

In terms of **pensions pay-out**, best practice, according to the respondents, is a **combination of annuities and lump sums**. Annuities are clearly best practice because they protect elderly individuals against bad luck and the (difficult) responsibility to invest appropriately as well as the risk of "running out of money". Above a certain amount, a lump sum option could be offered. A majority of the respondents proposed that annuities should be encouraged by a favourable tax treatment. Annuities are an expensive option because of the uncertainty of longevity and the current low interest rate levels and insurance companies are increasingly reluctant to provide these at appropriate costs. Also they cannot normally match the duration of the annuities and have therefore a mismatch risk. Draw downs i.e. regular

pension payments, which are not annuities, may be a cheaper alternative. Turner a.o. (op.cit.) proposes that governments may regulate the annuity market, offer annuities themselves or offer longevity bonds.

Annex 9 gives an overview of currently available pension pay-out systems in the NMS. In most cases, the pension is not paid directly by the funds but individuals are legally obliged to buy an annuity from an insurance company so that the longevity risk is covered by the annuity provider, who is also in charge of all the administration. There is no doubt that this approach is expensive and that there is room for improvement.

3. Best practices in the third pillar

Best practices in the third pillar

1. PERSONAL/INDIVIDUAL PENSIONS
2. OPEN TO ALL TAX PAYERS: the need and the use depend on the levels of replacement income achieved in the other pillars
3. Because the client in this case is the individual who bears all the risks, THE HIGHEST LEVELS OF PROTECTION are required to be combined with THE HIGHEST LEVELS OF EFFICIENCY AND THE LOWEST POSSIBLE COSTS

The opinions in the EU-25 and situation in the NMS

The third pillar encouraged by tax incentives offered to all taxpayers is clearly the preference of the respondents. The problem with this is that the tax deduction will be small and mostly used by those that do not need it. Alternatively it could be offered only to those that have not fully used their tax deduction in the second pillar e.g. due to a interrupted career and in this case they would be able to deduct up to the maximum allowance.

The third pillar in the NMS is not exclusively an individual pillar (see 2d) p.53). This leads to a difficult regulatory issue: should there be different types of regulation for the occupational and personal third pillars? Which Directives are to be applied in both cases?

II. Best practices related to the second pillar recommended in the "Rebuilding Pensions Report" [83]

The Pension Fund Directive, though limited in scope, is generally considered to be a major achievement towards adequate and sustainable occupational pensions as it supports security and efficiency. In a broader framework other initiatives, that clarify the Community "acquis" for the second pillar from the perspective of adequacy, security, sustainability, efficiency, transparency and affordability, are, among other, the Rebuilding Pensions Report, which was used by the European Commission as a source of inspiration when writing the Proposal for a Directive. It offered the opportunity to a large cross-section of European stakeholders to give their views on the way forward. These consultations resulted in the formulation of 50 recommendations conceived as a "European code of best practices".

The main recommendations/best practices of the Rebuilding Pensions Report

- ✓ To ensure security on the liability and asset sides
- ✓ To abolish quantitative investment restrictions and currency matching requirements
- ✓ To adopt a so-called Dynamic Minimum Funding Requirement (DMFR) for DB-type plans
- ✓ To approach security from a risk perspective for DC plans by means of a higher level of disclosure
- ✓ To mandate a Statement of Investment and Risk Principles (SIP)
- ✓ To make Boards of Directors/Trustees more professional, responsible and accountable
- ✓ To improve transparency by means of higher levels of disclosure to members, beneficiaries and the Supervisory Authorities
- ✓ To entrust more powers and means to the Supervisory Authorities

It was recommended to ensure (for DB plans) security on both the liability (actuarial valuations/funding of benefits) and asset sides (for DB and DC plans), as well as efficiency, transparency and affordability.

The abolition of quantitative investment restrictions and of currency matching requirements was equally recommended because these would not only harm each fund individually and raise its costs unnecessarily, but also complicate or even obstruct the functioning of an efficient capital market and the ability of companies and the public sector to raise capital efficiently at the lowest possible cost. Furthermore, such general restrictions, it was said, are not only contrary to the basic Treaty freedoms but also inappropriate for individual funds. Finally, they distort competition for asset

[83] European Commission. Rebuilding Pensions: Security, Efficiency, Affordability – Recommendations for a European Code of Best Practice for Second Pillar Pension Funds. 1999. Brussels: EC. It was preceded by a whole series of other reports, pamphlets and articles that have contributed to its writing and to setting the thinking path on which the Directive was built.

management and induce complacency with as possible consequences higher costs, lower returns, inappropriate risk taking and missed opportunities.

It was advised based on the consultation that the adoption of a so-called Dynamic Minimum Funding Requirement (DMFR) for DB-type plans, which is a flexible minimum funding requirement taking into account the asset structure/risk profile of each pension fund (e.g. by means of risk budgeting) and the liability structure/age profile of the specific group, was good practice. The Commission did not find sufficient support to include this recommendation in the Directive. The much weakened funding ratios in the bear market (2000-2002) after these recommendations were issued indicate that, with hindsight, such a system was worth considering.

The key components of the regulatory structure for financial security of funded systems and for the security of the rights of the beneficiaries were identified and the role of the Board of Directors/Trustees defined. The writing of a Statement of Investment (and risk control) Principles (SIP)[84] by the Board of each fund was recommended (and included in the Pension Fund Directive as art.12) as it was widely felt by respondents that Boards of Directors/Trustees were overly conservative and needed to be more professional, responsible and accountable, and that this would be beneficial to the capital markets at large and to the risk/return profile of each fund[85].

There were, in addition, a whole series of recommendations on transparency (which form part and parcel of security) including disclosure to members, beneficiaries and the supervisory authorities by means of a.o. annual accounts and annual reports, which have been included in the Directive (art.10). It was suggested to approach security from a risk perspective (i.e. who takes which type of risks) and that DC plans, which were considered to cope better with mobility than DB plans, may require more protection as they expose members and beneficiaries directly to market volatility/investment and sales pressure risks as well as to longevity/annuity risks (which is the case for some DC-type plans but not in the EU-15 for widely applied DC collective/insurance-type plans). In this respect, it was recommended to not achieve

[84] The Board of Directors of a fund must set out in writing their long-term attitude to risk, their return objectives and Strategic Asset Allocation (SAA) taking into account the liabilities of the fund.

[85] This was also recommended by Paul Myners/The Myners Report in the UK . HM Treasury. Institutional investment in the United Kingdom: A review.2001. London: HM Treasury.

this higher level of protection by means of more restrictions but essentially by means of a higher level of disclosure.

The opinions in the EU-25 and situation in the NMS

A substantial majority of respondents re-affirms the **need for a Dynamic Minimum Funding Requirement.** This is particularly liked by participants from EU-15 and to a lesser degree by those from the NMS because DB-type plans are quasi inexistent there. Nevertheless, they admit that this should be taken into account for the future given the potential development of risk sharing plans.
The lack of flexibility of measures that some supervisory authorities imposed during and after the recent bear market, has been criticised by the respondents from the EU-15 as being responsible for unnecessary pressure on DB plans, leading to their closing for new employees.

The requirement of **more protection by means of greater transparency, responsibility and adequate information** was confirmed by the overwhelming majority of respondents. The lack of appropriate communication and education of members in the DC market hinders its growth and development.
The **minimum information to be disclosed** should include:

1. the investment strategy/asset allocation, including explanations of main movements in the portfolio.
2. the risk/return profile
3. the expense ratio (i.e. a full cost disclosure)
4. the cost of annuities, including the effect of mortality improvements and of early payment of pensions.

More precisely, for the first pillar bis in the NMS, it was proposed that the following should be provided for:

- nature of the benefits promised (lump sums versus annuities) (at least once)
- information when the benefits become payable,
- investment policy/strategic asset allocation,
- risk profile of the asset structure (half yearly/annually),
- all charges (expense ratio) associated with each available investment choice (quarterly),

- recent and long-term investment performance and risk profile of the fund (tracking error, etc.) and
- a portfolio valuation on a regular basis.

Additionally, some suggested the information to include the legal structure and organisation of the plan, the code of ethics/licensing/fit and proper criteria imposed on providers and the cost of switching to another plan. Among the NMS, this information is nowhere complete, according to the respondents.
For DB-type plans offering insufficient security (e.g. due to underfunding), it is advised to inform members and beneficiaries at least once a year about the situation and about how appropriate funding will be restored, as long as underfunding persists.

Before providing for information to the individuals contributing to **DC-type plans**, it must be ensured that they have received **appropriate education** to be able to understand the information and to make appropriate choices. As to the financial education, individuals should be aware of the relationship between risk and return and how this varies across financial products/asset classes. It needs, however, to be avoided to overwhelm individuals with excessive information they cannot use or that will discourage them.

The **providers of supplementary pension plans and independent sources** (e.g. actuaries, investment consultants, etc.) have a **role to play** in offering investment education to individuals. A majority of the respondents considers that this is mainly the responsibility of the providers because independent sources are seldom available.
In the EU-15, objective information and figures are sometimes offered through local and European associations of pension funds or of insurance companies as well as through other organisations.
To avoid the risk of conflict of interests as much as possible, it should be ensured that the providers give **objective financial information**, without any recommendations, as these may be biased.
To compensate for the lack of independent sources of information, respondents from the NMS propose that the State and more particularly, the **Supervisory Authorities** should have all the necessary means at their disposal to **provide for comparative, quantitative and objective information** on providers and funds. It was also

suggested that the Supervisory Authority should publish performance data on a regular basis, something that is not done in the EU-15 as it is not considered to be their role.

ISSUES FOR FURTHER CONSIDERATION

The following issues for further consideration reflect the answers to the questionnaire and Pragma's research directly related thereto. Throughout these, terminology is used which may not be consistent for all Member States; in this case, the Glossary should be consulted for clarification (see p.i).

Although the expressed issues for further consideration are personal/individual and do not necessarily represent the general opinion, these are giving food for thought and contribute to making progress towards adequate and sustainable pensions. They focus mainly on the specific situation of the NMS and are addressed to the European Commission and the authorities in the NMS. Some may have wider usefulness in the EU-15 as well.

General

1. To cope with the challenge of ageing, a three-pillar system, which leaves room for the respective roles of social security, occupational and individual pensions and which also allows for an optimal combination of financing methods i.e. Pay-As-You-Go and funding is best practice because it allows for risk diversification.

    a. Member States should define the respective role and importance of each pillar. They should also target objectives and ranges of replacement income to be achieved from each pillar as well as the overall maximum replacement income from all pillars for taxation purposes.

    b. The role of statutory pensions (the first pillar) must be preserved and where necessary and possible enhanced.

    c. Supplementary pensions, and more particularly the second occupational and funded pillar, need to be expanded, if they have to partially replace and to better supplement statutory pensions. To fulfil this role, they need to respond to stringent criteria in terms of:

- -Coverage, which needs to be the widest possible, which poses the necessary choice between compulsion, quasi compulsion and voluntary participation
- -Security
- -Solvency
- -Degree of solidarity versus individual responsibility
- -Efficiency (with the objective of higher returns, better risk control and lower costs)
- -Transparency and a clearly defined role for the stakeholders
- -Supervision.

The Open Method of Co-ordination

2. The Open Method of Co-ordination, to which this report subscribes, needs to be promoted and encouraged as much as possible as an efficient tool for furthering the national policy debate, by means of useful and enriching comparisons between Member States.

   a. The Member States are invited, notably in the next round of the National Strategic Reports of the OMC in summer 2005, to put forward proposals to better converge towards adequate, financially sustainable and modern pensions. The collective versus individual approach could be compared; the experience with occupational pension plans and multi-employer plans could be shared, etc.

3. In this view, a common conceptual framework, including quantifiable criteria and vocabulary is needed to ensure the highest degree of comparability.

4. The Member States need to make progress to achieve the objectives and principles of the OMC (adequacy, financial sustainability and modernisation). Particular attention (in the NMS) needs to be given to the objectives of:

   a. Assuring and maintaining the adequacy of pensions given the generally lower state pension levels in the NMS even when the

mandatory individual pillar is included and the quasi absence of an occupational pillar,

b. Strengthening solidarity (given the dominance of DC individual plans),
c. Ensuring transparency and predictability, and facilitating labour market adaptability by making occupational pension provision more accessible and by ensuring adequate, appropriate and efficient financial information and expertise to individuals to gauge future income prospects and take necessary measures with full knowledge of the facts.

5. The sustainability of the pension systems remains a major issue in all Member States, and particularly in the NMS, where the funded elements are of recent date. Notional Defined Contribution systems, as existing in a few NMS, which remain PAYG-financed, do not constitute an alternative to unfunded systems and are not, therefore, a guarantee to ensure the sustainability of these pension systems in the future.

First Pillar

6. Financing of the first pillar should consist of a combination of PAYG and unallocated funding and not necessarily of PAYG and individual funding/accounts only.

7. Demographic reserve funds for the first pillar are good practice for all Member States as they decrease the burden of PAYG-financing in the ageing wave.

a. These could be managed internally in view of their size, in combination with partial outsourcing by means of open tenders. Alternatively, these could be split up in several competing funds per country if they have each sufficient critical mass to ensure optimal competition.
b. Assets should be diversified globally and essentially invested on liquid financial markets but with a certain allowance for illiquid markets/instruments and/or non-listed products (e.g.

private equity, venture capital, hedge funds, etc.) to benefit as much as possible from (global) diversification into a broad range of asset classes and securities and to reduce specific risk. Assets should be managed according to prudent person principles and no restrictions except those set by the Board of each fund should apply.

c. These funds should be subject to high level specific disclosure requirements.

Second Pillar

8. The creation of occupational pension schemes should be encouraged and second pillar coverage enhanced.

Financing, Organisation and Coverage

9. Occupational pensions should be best funded but self-investment, if this would generate greater adherence of employers, should be permitted for the NMS up to a level that could be higher than the limit allowed under the Pension Fund Directive for a to be specified transition period.

10. The second pillar could be mandatory at the national level to ensure perfect coverage, particularly if it replaces part of the first pillar (as is the case in the NMS) but should not necessarily (be mandatory) as this would be perceived as another tax but could be implemented by means of collective labour agreements to ensure coverage close to optimal. This should not exclude voluntary company plans, which already widely exist (in the EU-15) nor contracting out from industry-wide plans set up by means of collective labour agreements, by individual employers if they offer at least the same level and quality of benefits, and on the condition that much higher coverage levels than is presently the case would be achieved (in e.g. the United Kingdom, Ireland, Belgium, Germany, etc.).

a. If the public pension pillar (1st pillar) offers low benefits - or as the case may be in the NMS the first pillar and first pillar bis - the second pillar may need to be mandatory, to ensure sufficient coverage and replacement income; in that case,

defined benefit-type plans are good practice to ensure adequate pensions.

b. The problem of voluntary plans is insufficient coverage.

This can be best corrected with by:

- Offering appropriate tax incentives
- Raising awareness ref. the necessity to participate given the expected decreasing role of the public pension pillar
- Motivating employers and other plan sponsors (e.g. sectors of industry, professional and/or (inter-)regional groups) and by encouraging small companies to affiliate to multi-employer plans or to contract group life insurance.

11. Regional, inter-regional, multi-employer, sector and professional plans are good practice because such structures enable wider coverage.

Regulation, Funding, Accounting and Supervision

12. Regulation including the tax regime, funding requirements, accounting rules and supervision must be established for the long-term so as to create security and stability.

13. Pension funds should be efficiently managed with no or the least possible investment restrictions to avoid distortions, at the lowest possible cost with the objective of the best possible return/risk relationship for each fund. The specific regulation related thereto foreseen in the Pension Fund Directive and/or Life Insurance Directives should be applied by similar institutions in the NMS as these are of universal usefulness, even if some of these would for specific reasons not fall under the scope of these Directives.

14. Supplementary pensions should be allowed to be initiated and financed jointly by employers and employees in proportions they decide upon or by each of these groups separately.

15. Full funding is required in all circumstances; this requirement may, however, be too rigid because capital markets are inherently volatile.

a. If underfunding is due to market volatility, flexible refunding should be allowed over long enough time periods. In case of underfunding, a recovery plan should be established and

approved by the supervisory authority. A dynamic minimum funding requirement (DMFR) is good practice in this respect as it allows to be fund-specific by taking into account the asset structure, the risk budget and age structure of each group as well as the quality/financial strength of the sponsor(s).

b. If underfunding is structural, and for example due to insufficient contributions there should not be such flexibility, unless the supervisory authority allows for a refunding period in each specific case, taking into account the circumstances.

c. The counterpart of allowing for underfunding is to require buffer reserves in function of the risk budget and/or strategic asset allocation adopted by the Board of each fund. The Board should establish its investment policy in the Statement of Investment Principles (SIP) (Pension Fund Directive art.12). The Board decides about appropriate excess funding as well as on refunding and submits this for approval to the Supervisory Authority. Only when no agreement can be reached may the Supervisory Authority impose measures with respect to refunding the plan or excess funding. The imposed measures need to be long-term oriented and reasonable and should not cause problems for the sponsor(s) nor discourage them - unless immediate action is required - and need to take the asset structure, the age structure of the group as well as the quality/financial strength of the sponsor(s) into account.

d. Short-term refunding imposed by the supervisory authorities, unless in circumstances of emergency, may be disruptive and can lead to unnecessary closing of plans and should, therefore, be avoided.

16. Pension funds ought to be supervised on two levels:

a. Internally by a Board of Directors, who should ideally be assisted by internal staff and by external independent specialists such as accountants, actuaries, benefits and investment consultants. Any such delegation does not diminish

the obligations of the Board that remains fully responsible and accountable.

b. Externally by the Supervisory Authority. To fulfil its role adequately, more powers and means should be entrusted to the Supervisory Authority and the specific provisions of the Pension Fund Directive (art.14) applied. Furthermore, the OECD guidelines for best supervision practices could serve a useful purpose.

17.It may be good practice that there is one central supervisory authority for the whole financial sector (covering banks, mutual funds, insurance companies and pension funds and as the case may be other financial institutions with specific regulation for each of these). Separate supervisory authorities may lead to overlapping, risks, conflicting measures, excessive costs and inefficiency and are, therefore, not good practice, unless they would co-operate efficiently. This is not to say that the same rules should apply to different institutions aforementioned. On the contrary, specific rules should reflect the different nature of these.

Taxation

18.The EET tax regime (whereby contributions and investment income/capital gains are tax exempt and pensions or lump sums are taxed) should be preferred, as it gives well balanced incentives. This is tax deferral for participants and for the tax authorities: there should be no caps on contributions but constraints on redemptions: the capital built up should only be used for retirement income. An EEE regime, as proposed by some respondents, is not good practice as it would deprive the tax authorities of necessary tax receipts in the ageing wave.

Pension payments

19. A combination of both annuities (or regular draw downs) and lump sums ought to be possible but annuities/draw downs are normally to be preferred as these provide for regular income/greater security (no risk of "running out of the money").

a. Annuities/draw downs are also better to assure stable flow of taxable income for the tax authorities (in the ageing process).
b. Annuities/draw downs should have a more favourable tax treatment than lump sums.
c. Annuities are, however, extremely expensive under current circumstances of relatively low interest rates. Defined contribution type plans are particularly vulnerable to this.

20.A task force could be set up between the European Commission and the providers (e.g. pension funds, insurance companies) to examine how better annuity provision can be ensured and/or alternatives conceived.

21.Lump sums are prone to accidents and hold the risk of putting a burden on the taxpayer due to longevity. They should only be allowed insofar as such risk is eliminated.

a. Lump sums are a facility to receive (part of) the pension capital at once and could, therefore, be taxed at slightly higher rates than annuities unless lump sums are allowed for strictly defined social reasons or are immediately transformed in annuities, in which case, they are taxed as annuities.
b. An alternative could be to require annuity payments up to a certain level of income and allow for partial lump sums on top of this.

Role of stakeholders: the State, employers and other sponsors

22.The role of the State in the second pillar should be limited to being an enabler, regulator and supervisor, except that for its own employees it may also be a provider.

23.The role of employers and other plan sponsors should go beyond paying contributions or making the structure available only. These two options should, however, not be excluded.

a. If employers opt for paying contributions only, these should be defined by an independent expert (e.g. an actuary) using reasonable and realistic assumptions to attempt that these are

sufficient to provide for the pension level they are meant to cover.

24. Employers and other sponsors (employees, social partners in general) need to be motivated. They need to be appropriately informed about the reach, risks and limits of their commitment, irrespective whether this is of the defined benefit, defined contribution or other type.

   a. Employers must have the right of initiative and a wide choice of options regarding their commitment.
   b. The best incentives to make occupational pensions more attractive and affordable for employers and other sponsors (e.g. sectors, professional and regional groups) are:
      i. More tax deductibility (but always limited by the pension target) where appropriate and the EET tax regime
      ii. Less regulation/more appropriate regulation (by simplifying access and decreasing administrative and other burdens).
      iii. Risk sharing

Civil servants

25. There should be access to second pillar pension provision for civil servants to lower the burden of their (usually) taxation-financed pensions in the ageing wave and to mitigate the financing risks. These second pillar pensions for civil servants should be funded and as efficiently managed as those of the private sector. No special rules should apply.

Defined benefit versus defined contribution plans and risk sharing plans

26. Defined benefit-type plans must be encouraged as they allow for high levels of benefit security, solidarity and collectivity and protect participants and beneficiaries from market and longevity risks.

   a. With the objective to ensure wider coverage, it is better to have a large number of DB-type plans with modest ambition than only a few very good plans.

b. Referring to solidarity, it seems good practice to cover at least absence due to long-term disability by means of a waiver of premiums so as to maintain pension rights.

c. The increasing demands on defined benefit-type schemes and their sponsors (regulation, supervision and accounting rules), however well intended, are not always helpful to support their development. It is therefore advisable to simplify these and make the administrative burden on employers and other sponsors lighter.

d. Enhanced tax incentives could be considered in the first years of operation and for additional contributions to cope with underfunding that is not caused by insufficient contributions nor by suboptimal performance. The tax authorities, because this is tax deferral, will recuperate a multitude of these special allowances through the taxation of pensions in the ageing wave.

27.Risk sharing plans are good practice and should be encouraged. These plans also called hybrid plans or cash balance plans usually combine features of both defined contribution and defined benefit plans.

a. They can come in different forms (and are a matter of negotiation), for example:

- cost limits for employers and other sponsors,
- downside risk protection (money back guarantees) for members and beneficiaries with upside return potential for employers or alternatively for employers, members and beneficiaries.
- A fixed return for members and beneficiaries, e.g. 60% of government bonds interest rate and upside return sharing.

b. As opposed to defined benefit-type plans where the upside and downside potential is for the sponsor(s) unless otherwise decided upon, if the risks are shared, the surplus should be shared as well. The sponsor may negotiate with plan members

or their representatives to share shortfall risks as well as longevity risks.

28.Pure defined contribution individual plans are not necessarily best practice as they could make the pension system expensive and employees and beneficiaries run investment as well as longevity risk and may, therefore, require higher contributions to compensate for such risks. The DC collective plans (as in Denmark) allow for solidarity and benefit from economies of scale comparable with those of defined benefit plans.

29. Defined contribution plans with interest or capital guarantees imposed by regulation exist in several Member States. They may, however, distort the investment process and lead to lower returns and higher costs. They require more stringent investment regulation than defined benefit-type plans, which will normally make them more expensive for the same level of pensions.

Collective versus individual plans and open versus closed plans

30.The conditions for the administration and management of group plans need to be defined but no minimum number of participants nor a certain level of assets should be imposed, because small companies can always outsource to third party providers (e.g. to insurance companies) if they would not have the critical mass to handle the administration and management efficiently. This is widely done throughout the Community.

31. An alternative for small companies is to adhere to a multi-employer plan. Such plans should be ideally offered by trade organisations in competition with financial institutions.

a. Multi-employer plans, apart from sector, professional and regional schemes set up by collective agreements, should be developed and appropriately regulated in the NMS to compensate for the insufficient critical mass if that would be the case.

32.Open plans can co-exist alongside closed collective plans (as in Italy), particularly if there would be insufficient participation through these latter.

The number of providers of open plans (funds) and choice among funds ought to be increased to avoid excessive concentration.

33.With the objective of adequate choice (investment options/risk profiles) with which individuals can cope, it is advised to offer at least 3 or 4 options per provider in the first pillar bis, based on clearly distinguishable risk profiles. The option could be somewhat broader in the second and third pillars, e.g. 6 or 7 per provider. It is proven that choice beyond 6 or 7 options is counterproductive. More important is that financial institutions do not offer all the same products but specialise and differentiate, which will increase competition and decrease the potential of systemic risk.

a. Where the current system of licensing and remuneration of the management companies hinders competition, this should be modified or abolished to encourage wider competition and to achieve better returns.

Information, transparency and protection

34. Transparency is important for all types of plans, including for defined benefit plans be it to a lesser extent than for defined contribution plans. It should be geared to information the individual can cope with. Without financial knowledge and culture, transparency can be useless.

35. Defined benefit plans that are underfunded should be required to inform members and beneficiaries annually, and the supervisory authorities as often as required, about the situation and how it is being resolved, as long as underfunding persists.

36.For defined contribution individual plans (as opposed to DC collective plans) where the individual bears the risks, transparency and protection are essential and encompass:

a. a high level of disclosure to individuals and to the Supervisory Authority
b. more comprehensive supervision
c. making providers/sellers responsible and accountable.

This is the Achilles' heel for growth and development of defined contribution type plans and needs to be dealt with.

37.The individual approach to supplementary pension provision is common in a majority of the NMS. The risk of asymmetric information of individuals that deal directly with financial institutions is high. Consequently, there is need for comprehensive disclosure by the providers as well as need for independent investment and risk advice to eliminate or at least decrease existing asymmetric information gaps and to ensure adequate financial education. Individuals should, therefore, have assistance at their disposal to make qualified choices

a. By means of public education (call centres, websites, etc.) and/or independent, transparent, accurate and comparable data
b. Independent sources should provide for information/education ref. choice, risks, etc. but these are not always readily available. Providers should, therefore, be allowed to (continue to) provide for education under well defined conditions of supervision (Code of Conduct, license, fit and proper criteria) but should not be allowed to give recommendations. There are particular risks with tied sales forces. Education needs to be provided in an objective framework (including information on competitors).
c. The supervisory authorities in the NMS should ensure higher standards of information. They could be in charge themselves or under their supervision (it would be better that they outsource this at arms' length) of the publication of annual returns as well as of risks incurred and of total costs, including transaction costs and for making these available in a user-friendly manner.
d. In several of the EU-15 Member States, domestic associations of pensions institutions publish industry-wide national data either directly or indirectly and provide for objective information, which could be produced, if that were not as yet the case, in the NMS as well.

38. The information to be disclosed for defined contribution type plans before entering a plan and on a annual basis as well as each time an important event or change occur should be as complete and user-friendly as possible and contain:

a. Investment strategy/asset allocation
b. Investment choices/options
c. Risk profile of each option
d. Portfolio valuation
e. Each year amount accumulated and projected assets
f. Performance for the year and since inception
g. Full cost disclosure/expense ratios including transaction costs and transfer fees when changing plans
h. Cost of annuities and alternative benefits payments, when appropriate
i. Information on the financial strength of the provider.

39. There is a risk of overkill i.e. of too much information that members (who are not experts) cannot absorb. That is why the above information should be given in a concise and user-friendly form with clear indication on how and where to obtain more detailed information.

40. For open funds offered directly by financial institutions to individuals, the information to be provided should be as complete and user-friendly as possible and contain the same information as under 38 as well as:

a. The legal structure and organisation of the plan
b. Code of conduct/fit and proper criteria and license for providers
c. Nature of the benefit and when it becomes payable under which conditions.

41. Furthermore for defined contribution plans and open funds, the supervisory authority should require the providers to supply new participants with information on appropriate insurance these providers have subscribed to and what they cover in the event of problems/disruption, fraud and wilful misconduct.

42. The NMS should ensure that the content and quality of the information to be provided, its frequency and the speed of delivery are improved; this applies to both the first pillar bis and the second pillar.

Third Pillar

43. It is common practice throughout the Community, and particularly in the EU-15, to offer a third pillar with limited tax deductibility to all income tax paying citizens and this practice is widely supported by the respondents. Because Member States should define the respective role and importance of the 3 pillars, it may well be that they may wish to increase tax deductibility for those with incomplete careers so as to enable them to increase their total overall pension by means of the third pillar, always up to the maximum limits for tax deductibility (see 1.a p.101).

The specific case of the first pillar bis

44. The existence of a first pillar bis, which boils down to a partial privatisation of the first pillar, should not prevent the development of an occupational pillar by means of company, sector, professional, multi-employer and (inter) regional plans. Because the first pillar bis only replaces part of the first pillar (by means of mandatory individual funding) and not the second pillar, it should be complemented by occupational and personal pensions.

45. Individuals that bear the investment and other risks under the 1st pillar bis should benefit from a high protection level as this concerns their statutory pensions.

a. The European Commission should make clear to which specific regulation the first pillar bis should be subject to. Prudent principles similar to those provided for in the Pension Fund Directive should be applied as a minimum requirement (see also 52).

46. The governments of the countries where a mandatory first pillar bis has been implemented should be required to apply realistic long-term financial

projections to define the true transition costs as the impact thereof on public finances.

Capital markets and financial infrastructure

47.The capital markets of the NMS need to be widened and deepened by, among other, offering more asset classes and financial instruments/products and by ensuring better diversification of portfolios. Investment opportunities should not be limited to traditional products, such as government bonds and equities, but, where appropriate, be extended to e.g. low cost financial instruments apart from more sophisticated ones. These latter could be a.o.:

a. Corporate bonds and high yield bonds, mortgage bonds and other asset backed securities
b. Long dated bonds
c. Inflation-linked bonds
d. Certificates of deposits/commercial paper
e. Real estate, particularly securitised real estate
f. Derivatives
g. Private equity, venture capital, commodities and other alternative investments

The above list is only given for illustration purposes. Several of these may not or not always be appropriate investment vehicles for pension assets.
It is highly unlikely that (most of) the NMS will each be able to develop the above and other financial products, let alone achieve wide and deep enough markets for each of these. The same goes for a number of EU-15 countries. For this reason, a merger of (some) local exchanges/markets ought to be considered to obtain scale effects, as well as electronic trading platforms apart from trading through specialist houses/markets. Large cap stocks could be traded from one central place and there is room for local specialisation e.g. through small and mid cap stocks and bonds other than government bonds. Another option, if size is a problem, for local institutions could be offered by the Pension Fund Directive and to team up with other pension funds in the Union.

48. Financial institutions and investors in the NMS should not only count on themselves to achieve wider and deeper markets but attempt to make these more attractive for foreign investors

   a. There should be more listings of small and mid cap companies as well as e.g. common venture capital, private equity and infrastructure projects.

49. Capital outflows should be compensated by means of capital inflows. With appropriate measures, this can be achieved because the NMS have considerable cost (saving) advantages and higher economic growth than the remainder of the Union.

   a. Capital outflow of pension assets for diversification purposes should not be counted for in national accounts for the part that is invested in the remainder of the EU for an appropriate transition period. This would enable the NMS to quicker benefit from diversification that the wider EU (and global) capital markets offer.

50. The EU could support capital market development in the NMS, in close co-operation with these countries for example by:

   a. Issuing a Communication on best practices including minimum standards.
   b. Supporting education and conferences on best practices in co-operation with financial institutions and other specialists.
   c. Promoting access to a wide variety of financial instruments.
   d. Assuring greater competition and deregulation where appropriate.
   e. Requiring that the cost of cross-border transactions are decreased.

It is clear that the EU level can only do so much and that the financial sector is better suited to achieve this. The EU level can, however, be an enabler and a supporter of change.

51. The European Commission should, where useful, assist the NMS with the adoption of the Community "acquis". The first objective could be to define which institutions will fall under the scope of the Pension Fund Directive or the other directives (e.g. the Life Insurance Directives). It is advised to avoid to enact new regulation but it needs to be ensured that any pension system is covered by appropriate EU regulation and fulfils basic requirements of adequate and sustainable pensions.

52. The European Commission could, in close co-operation with the NMS, design a common policy framework for legal (1st pillar and 1st pillar bis) and supplementary pensions that can serve as a roadmap and source of inspiration for the NMS in their pension reform process. For example, several provisions of the Pension Fund Directive are relevant to the NMS and should be applied to all funded plans regardless whether certain institutions do or do not fall under its scope. Key requirements for supplementary pension provision in the NMS that are included in the Pension Fund Directive are:

a. Legal separation (art.8) of the institution (that is in charge of supplementary pensions) from the sponsor, irrespective whether the sponsor is an employer, a sector, etc. or a financial institutional as it is essential to protect the rights of members and beneficiaries.
b. Fit and proper criteria (art.9.1b) to be required from all services providers. They should be licensed by the supervisory authorities of the Member State where they have been established and supervised by the supervisory authorities of (all) Member States where they offer services. They should all be responsible and accountable.
c. Plan rules (art. 9.1c) to be enacted by all institutions that engage in retirement provision and these should be communicated to members and beneficiaries and to the supervisory authorities.
d. All institutions that offer funded retirement provision should adhere to the prudent person rule with regard to investments

and comply with the provisions of the Pension Fund Directive related thereto (art.18). A transition period of 5 years could be granted to the NMS.

(i) the most damaging restrictions should be eliminated first. For example:

- restrictions on foreign investment
- minimum requirements to invest in local government or other debt instruments
- currency matching requirements that are more restrictive than those foreseen in the Pension Fund Directive

e. The NMS should not restrict institutions from appointing investment managers or custodians that have been duly authorised in other Member States (art.19).

f. There should be amendments to national regulation, where appropriate, to allow for cross-border activities. This is an important objective that should apply regardless whether certain institutions do or do not fall under the scope of the Pension Fund Directive as it is derived from direct Treaty provisions (free movement of people and capital).

g. Level playing for insurance companies and other institutions ought to be achieved as required by the Pension Fund Directive (art.3 and 4).

Country-specific issues for further consideration

There are substantial differences related to supplementary pension provision among the new Member States and between these and the EU-15. This is the reason why we asked respondents in the NMS to add country-specific issues. Generally, these are already integrated in the issues for further consideration and we, therefore, list only specific ones here below, in order to take into account of these differences to the best of our abilities.

Estonia

1. Although the mandatory pension funds (1st pillar bis) are unlikely to be subjected to the Pension Fund Directive, the prudent man rule should be applied ref. investments. The limit on investments in equities, currently fixed at 50% should, therefore, be abolished.

Lithuania

1. The rules regulating switching between funds (1st pillar bis) should be eased.

Poland

1. All existing investment restrictions should be abolished, in the mandatory and voluntary systems, particularly the restrictions on foreign assets, which are harmful to a healthy diversification of the portfolios.
2. Specific rules with regard to payment of pensions under the first pillar bis should be enacted as soon as possible and annuities should be earmarked as best practice.
3. It should be possible for both employers and employees to contribute to the first pillar bis rather than this being the sole responsibility of employees.
4. The authorities should abolish the so-called “dead accounts”, which are open accounts to which no contribution has been paid. These are unproductive and cost-inefficient for the whole industry.

5. The legal framework and taxation of all supplementary pension plans should be simplified and improved with the objective to achieve greater stability than currently experienced.
6. The minimum required return should be abolished considering its negative effects on portfolio diversification, return, risk and costs.
7. Since 2005, it is possible in the first pillar bis to offer two types of funds. There is doubt whether this is enough and the authorities should review this.

Hungary

1. Regulation to set up closed pension funds for employers and other sponsors should be simplified and should avoid putting an excessive administrative burden on these.
2. The payment of the contributions to the mandatory pension funds (first pillar bis) should be centralised, as is the case in other countries.
3. The minimum required return should be abolished considering its negative effects on portfolio diversification, return, risk and costs and the internal reserve accumulation, which pension plans must constitute to ensure this minimum guaranteed return, should be abolished as well.

Slovak Republic

1. Both employers and employees should be permitted to contribute to the mandatory individual accounts (1st pillar bis).
2. The minimum required return should be abolished considering its negative effects on portfolio diversification, return, risk and costs.

Czech Republic

1. There should be no preferential treatment with regard to contribution rates to the PAYG first pillar between all categories of gainfully occupied people.
2. The pension assets of the voluntary pension funds should be legally separated from the assets of the managing institutions.

3. The role of each of the currently existing supervisory authorities should be clearly defined and it would be better to merge these into one single institution.

4. A long-term investment approach ought to be encouraged and therefore the obligation for voluntary pension funds to achieve a positive return each year should be abolished.

5. The voluntary pension fund providers should be authorised to offer several funds with different investment and risk profiles to better meet individual demand.

6. Because individual plans offered by financial institutions are generally expensive, a second pillar, based on collectivity and risk sharing, set up by collective labour agreements should be established despite the fact that a large part of the population is already covered by a third pillar pension scheme, to which employers contribute.

7. The third pillar (i.e. pension funds "under the Act n°42/1994 Coll. on the pension co-insurance with a state contribution") should be subject to the Pension Fund Directive.

Slovenia

1. All supplementary pension provision should be subject to the same regulation and accountable to a single Supervisory Authority, irrespective the type of pension fund provider.

2. The minimum required return should be abolished considering its negative effects on portfolio diversification, return, risk and costs

3. The requirement for a voluntary pension fund that at least 51% of employees of a company must contribute before benefiting from tax relief, should be abolished.

Cyprus

1. The provident funds should be subject to the Pension Fund Directive.

2. The members of provident funds should have choice between annuities and lump sums with, however, a better tax treatment for annuities and should not be constrained to lump sums payments only.

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Annex 1: List of respondents

	last name	first name	country
1	Adolphsen	Erik	Denmark
2	APFIPP Associação Portuguesa de Fundos de Investimento, Pensões e Patrimónios		Portugal
3	Arlman	Paul	Belgium
4	Benes	Petr	Czech Republic
5	Bergström	Folke	Finland
6	Bester	Helena	Slovenia
7	Bizjak-Mlakar	Julijana	Slovenia
8	Böhm	Lucka	Slovenia
9	Borgdorff	Peter J.C.	The Netherlands
10	Borza	Gabor	Hungary
11	Braeuninger	Dieter	Germany
12	Chlon-Dominczak	Agnieszka	Poland
13	Cleff	Eberhard	Germany
14	Clemeur	Hugo	Belgium
15	Damgaard Jensen	Peter	Denmark
16	Dannberg	Björn	Sweden
17	De Boeck	Edwin	Belgium
18	Delbecque	Bernard	Belgium
19	Dencik	Peter	United Kingdom
20	Doetsch	Peter	Germany
21	Fornero	Elsa	Italy
22	Gatt	Edward G.	Malta
23	Gidhagen	Hans	Sweden
24	Góra	Marek	Poland
25	Gustafson	Eva	Sweden
26	Gustsons	Viktors	Latvia
27	Haenen	Paul	Germany
28	Hlavnovà	Mária	Slovak Republic
29	Horvath	Andras	Hungary
30	Judickaitè	Irmina	Lithuania
31	Kidric	Dusan	Slovenia
32	Klugger	Gerhard	Germany
33	Krassnig	Peter	Slovenia

34	Langejan	T.W	The Netherlands
35	Lepp	Evelin	Estonia
36	Lewicka	Ewa	Poland
37	Lillead (together with Vilija Kuzmin, Siiri Toniste and Thomas Auvaart)	Tonu	Estonia
38	Lindblad	Peter	Sweden
39	Maassen	J.F.	The Netherlands
40	Marczell	Zsofia	Hungary
41	Matits	Agnes	Hungary
42	McPherson	Neil	United Kingdom
43	Mendinhos	Jose	Portugal
44	Messori	Marcello	Italy
45	Mihaly (together with Csaba Nagy and HFSA)	Erdos	Hungary
46	Mikelsons	Kristians	Latvia
47	Nalevanko	Michal	Slovak Republic
48	Nausedaite	Vilija	Lithuania
49	Noël	Hervé	Belgium
50	Ose	Ieva	Latvia
51	Ozereljeva	Julija	Latvia
52	Parniczky	Tibor	Hungary
53	Pedersen	Torben Möger	Denmark
54	Peraita	Manuel	Spain
55	Pina Pereira	João	Portugal
56	Pinto	Alice	Portugal
57	Pipan (together with Uros Ornik)	Boris	Slovenia
58	Poldoja	Priit	Estonia
59	Psaras	George M.	Cyprus
60	Rinaldi	Ambrogio	Italy
61	Roels	Paul	Belgium
62	Rusnok	Jiri	Czech Republic
63	Saar	Silja	Estonia
64	Samek	Vit	Czech Republic
65	Sciclune (together with Robert Higgans)	Marianne	Malta
66	Sforza	Leonardo	Belgium
67	Skuciene	Daiva	Lithuania
68	Snippe	Jan	The Netherlands

69	Sokka	Jari	Finland
70	Solarz	Slawomir	Poland
71	Stankovic	Jasna	Slovenia
72	Staszewski	Lucjan	Poland
73	Steflikova	Julia	Slovak Republic
74	Tomlinson	Lindsay	United Kingdom
75	Valero Carreras	Diego	Spain
76	Van Dalen	G.A.W.	The Netherlands
77	Van Eykelenburg	Carel	The Netherlands
78	van Zelst	Willem A.	The Netherlands
79	Vandier	Vincent	France
80	Vanheste (for Wilfried Neven)	Bjorn	Belgium
81	Vanovska	Inta	Latvia
82	Verhaegen	Chris	Belgium
83	Voborsky - Czech Insurance Association	Rudolf	Czech Republic
84	Werle	Franz-Josef	France
85	Wunderlich	Herbert	Germany
86	Wynne-Griffith	Huw	United Kingdom

Annex 2: Statistics of the respondents

Per country response statistics

	name of the country	number of responses	percentage
1	Austria	0	0,0%
2	Belgium	9	10,5%
3	Cyprus	1	1,2%
4	Czech Republic	4	4,7%
5	Denmark	3	3,5%
6	Estonia	4	4,7%
7	Finland	2	2,3%
8	France	2	2,3%
9	Germany	6	7,0%
10	Greece	0	0,0%
11	Hungary	6	7,0%
12	Ireland	0	0,0%
13	Italy	3	3,5%
14	Latvia	5	5,8%
15	Lithuania	3	3,5%
16	Luxembourg	0	0,0%
17	Malta	2	2,3%
18	Poland	5	5,8%
19	Portugal	4	4,7%
20	Slovak Republic	3	3,5%
21	Slovenia	7	8,1%
22	Spain	2	2,3%
23	Sweden	4	4,7%
24	The Netherlands	7	8,1%
25	United Kingdom	4	4,7%
	Total	**86**	**100,0%**

Per sector response statistics

sector	number of responses	percentage
Actuaries	2	2,3%
Asset Managers / Financial Institutions	10	11,6%
Consultants/ Academics	9	10,5%
Employees' Associations	3	3,5%
Insurance Companies	10	11,6%
Pension Funds	18	20,9%
Pension Funds Associations	4	4,7%
Public Local or International Authorities	10	11,6%
Stock Exchanges	2	2,3%
Supervisory Authorities	9	10,5%
Other	9	10,5%
Total	**86**	**100,0%**

Annex 3: Financing methods in the private sector first pillar in the EU-15

First pillar (private sector employees)	
High promises	Financing method
France	PAYG + demographic reserve
Italy	PAYG
Spain	PAYG + demographic reserve
Portugal	PAYG + demographic reserve
Greece	PAYG
Austria	PAYG
Luxembourg	PAYG+ demographic reserve
Germany	PAYG
Belgium	PAYG + demographic reserve
Finland	PAYG + funding
Denmark	Tax-financed + funding
Sweden	PAYG + funding + individual accounts
Reasonable Promises	
The Netherlands	PAYG + demographic reserve
Low Promises	
Ireland	PAYG + demographic reserve
United Kingdom	PAYG

Source: Pragma Consulting

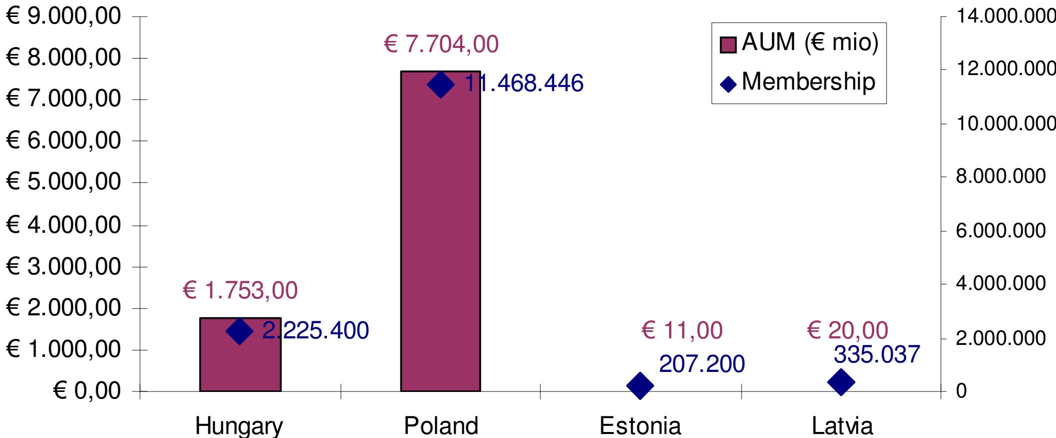
Annex 4: Pensions contribution sharing in the NMS between employers, employees and the State, where applicable, and between the first and the mandatory first pillar bis, where applicable, 2002 (as a percentage of insured wages)

	Year	Total	Employers	Employees	State	PAYG (1st pillar)			Funded (1st pillar bis)
						Total	Employer	Employee	
Estonia	2002	22.00[1]	20.00	2.00[2]		16.00	16.00		4.00 +2.00[2]
Latvia	2002	20.00	24.00[3]	9.00[3]		18.00			2.00[4]
Lithuania[5]	2004	25.9	22.9	2.50		23.4%			2.5%
Hungary	2004	26.00	18.00	8.5[6]		20.00	18.00	0.5	8.00
Poland		19.52[7]	9.76	9.76		12.22	9.76	2.46	7.30
Slovak Republic[8]		22.75	18.75	4.00		9.00	5.00	4.00	9.00
Czech Republic		26.00	19.50	6.50					
Slovenia		24.35	8.85	15.50					
Malta		30.00	10.00	10.00	10.00				
Cyprus		16.60[9]	6.30	6.30	4.00				

[1] For those who have not joined the second tier, the total contribution rate for pensions is 20%.
[2] 2% employee contribution for the funded second tier is compulsory for new entrants to the labour market (persons born in 1983 or later) and optional for the current work force.
[3] The total contributions paid by employers and employees amounts to 33% and represent the overall social insurance contribution rate. There is no further distinction of contribution sharing for the pension system
[4] Contribution to the second tier is scheduled to rise to 4% in 2007, 8% in 2008, 9% in 2009, and 10% in 2010.
[5] The social security contributions are aggregated and redistributed by the State Social Insurance Fund between the different items and pillars so that it is not possible to determine the contribution sharing between employers and employees to the second pillar. Nevertheless, both contribute to the system. The contribution to the funded tier will gradually increase by 1% point in each subsequent year until it reaches 5.5 in 2007, hand in hand with a decrease of the contribution to the PAYG tier.
[6] For members in the old system, the employees' contributions of 8.5% exclusively finance the PAYG-tier.
[7] Excluding disability and survivor's pensions. No distinction between payments to funded and PAYG because all is deducted from the old-age contribution. The split is here only for illustrative purpose.
[8] The legislation establishing a mandatory second pension pillar come into force on January 1, 2004 and will (probably) be effective in 2005. For this reason, figures of the contribution sharing between the first and second pillar may change. An employer' contribution of 4.75% to a so-called reserve solidarity fund is also foreseen.
[9] This figure covers all contingencies. There is no legal allocation of contributions between short- and long-term benefits except for unemployment benefits, for which 0.996% (6% of 16.6%) is allocated

Sources: Fultz, Elaine. "Recent Trends in Pension Reform and Implementation in the EU Accession Countries". May 2003. pp.10-11; adapted by Pragma Consulting

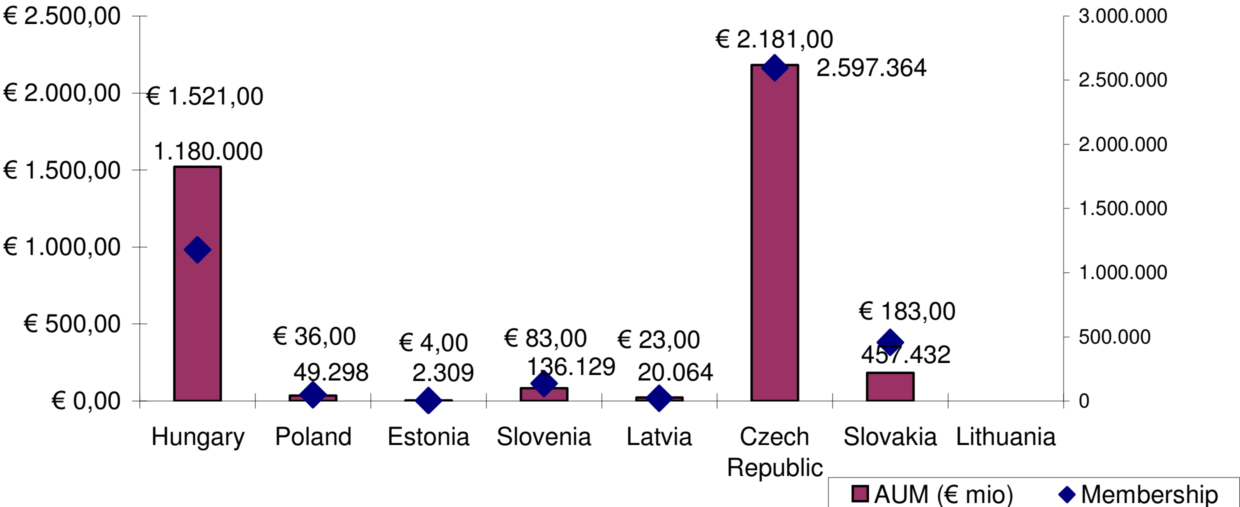
Annex 5: Size of the funded mandatory pillar in 4 new Member States (first pillar bis, end 2002)



Estonia as at 21-06-2003: € 33.5 mio

Source: Pragma Consulting

Annex 6: Size and structure of the third pillar in the new Member States (end 2002)



Source: Pragma Consulting

Annex 7: Investment restrictions in the new Member States

Countries	% equities	% real estate	Self-investment	% foreign assets
Estonia				
Mandatory funded first pillar bis	Max. 50% of the total assets or a lower percentage if in the fund's rules (+ max.5% in a single issuer)	Max. 10% of the market value of the assets (+ max.2% in a single piece of real estate)	If authorised by the pension fund rules but max.30% of the total assets in shares and units issued by the same group as the pension management company	Max. 30% of the total assets in foreign currency. The limitation does not apply to the Euro
Voluntary individual funds	As set out in the fund rules (the investments in the units of other investment funds which may, directly or through other investment funds invests in shares are also considered as investments in shares) (max.10% single issuer)	Max 20% of the market value of the assets (max 5% in one undivided immovable property)	Max 50% of the market value of the assets in securities issued by the company that manages the pension fund	Assets can exclusively be invested in the European Economic Area and IOSCO[1] member countries
Latvia				
Mandatory funded first pillar bis	Max. 30% of the total assets (+ max. 5% in a single issuer)	Not allowed	Not allowed	Assets can exclusively be invested in the EU, EFTA, OECD or Baltic countries Max. 30% of the total assets in foreign currency and max. 10% limit for each non-matching currency[2]

Voluntary individual funds	No limit (max.10% single issuer)	Max 15% of the total assets (10% in one undivided immovable property)	Max 5% of the total assets in securities issued by the same group as the pension management company	Max. 30% of the total assets in foreign currency and max. 10% limit for each non-matching currency Assets can exclusively be invested in EU, European Economic Area and Baltic markets
Lithuania *Funded first pillar bis*	No limit except specific rules ref. single issuer (max. 5% but exceptions exist)	Not allowed	Max. 20% of the total assets in shares and units issued by the same group as the pension management company	No limit except that assets must be invested in regulated markets
Voluntary individual funds	Max. 5% single issuer	Not allowed	Max. 20% of the total assets in shares and units issued by the same group as the pension management company	No restrictions
Hungary *Mandatory funded first pillar bis*	Max. 50% of the total assets (+ max. 10% in a single issuer)	Since January 2004: Max. 10% of the total assets among which max. 5% in direct real estate	Max. 10% of the total assets	Since January 2004: Max. 30% of assets invested in instruments denominated in currencies other than the currency of liabilities; investments in non-OECD and non-EEA country issuers shall not exceed 20% of the total foreign investments.

Voluntary individual funds	Max 60% of the total assets (max.10% single issuer)	Max 10% of the total assets	Max 10% of the total assets	Max. 30% of assets invested in instruments denominated in currencies other than the currency of liabilities; investments in non-OECD and non-EEA country issuers shall not exceed 20% of the total foreign investments
Poland				
Mandatory funded first pillar bis	Max. 60% of the total assets i.e. max. 40% directly on regulated markets (+ max.10% in a single issuer), max.10% on non regulated markets and max. 10% indirectly by means of mutual funds (+ max.5% in a single issuer)	Not allowed	Not allowed	Max. 5% of the total assets. The limitation is applied to the Euro as well.
Voluntary individual funds[3]	No limit (max.10% single issuer)	Not allowed	Max 12.5% of the total assets if traded on organised markets; if not, max.5%	Max 5% of the total assets
Slovak Republic				
Mandatory funded first pillar bis	In function of the type of portfolio (see p. 50) + max. 3% in a single issuer	Max. 3% of total portfolio in a single issuer. Direct investment in real estate is prohibited	Not allowed	Max. 50% in foreign investments with a limit of 20% per country.
Voluntary individual funds	Max. 20% of the total assets (max.10% single issuer)	Max.10% of the total assets		Max 15% of the total assets

Czech Republic	Max.25% of the total assets (max.10% single issuer)	Max. single investment: 5%	No specific regulations	Assets can exclusively be invested in OECD markets
Slovenia	Max. 30% of the total technical provisions with max. 5% in shares traded on non-regulated markets (+ max. 5% in a single issuer and max. 1% in case of non-regulated markets)	Max. 30% of the total technical provisions (+ max.10% in a single issuer)	Max. 5% of the total technical provisions in shares and units issued by the same fund as the pension management company	Assets can exclusively be invested in EU and OECD countries
Malta[4]	Max. 60% of the total assets	Max. 30% of the total assets	No restrictions	Max. 10 OR 30% of the total assets
Cyprus *Provident and pension funds*	No restrictions	No restrictions	No restrictions	Max. 30% of the total assets

[1] IOSCO stands for International Organisation of Securities Commissions.
[2] Latvia plans to shift to the Euro as matching currency (instead of the Lat) by 2008.
[3] In the case of Employees Pension Programmes, restrictions differ according to the insurance or investment fund or employee pension fund's regulation. In general, these are less strict than in the case of mandatory pension funds.
[4] These figures are only for indicative purpose. They come from the welfare reform internal consultations currently underway between all social partners in Malta.

Source: Pragma Consulting

Annex 8: Taxation systems in the new Member States

Countries	Contributions	Investment income/capital gains	Pensions or lump sums
Estonia *Mandatory funded first pillar bis*	Exempt (no ceiling)	Exempt	Taxed according to the following formula: [(sum of the benefits paid from the first and second pillars – 3x the tax free minimum income[1]) x26%]
Voluntary individual funds	Individual contributions: Exempt up to a ceiling of 15% of gross salary	Exempt	Lump sums are taxed at 10% Annuities are not taxed
Latvia *Mandatory funded first pillar bis*	Exempt up to a ceiling of 10% of gross salary	Exempt	Taxable if the sum of the benefits paid from the first and second pillars exceed the free tax minimum income
Voluntary individual funds	Exempt from personal income tax up to a ceiling of 10% of gross salary	Exempt	Taxed
Lithuania *Funded first pillar bis*	Taxed[2]	Exempt	Exempt

Hungary *Mandatory funded first pillar bis* *Voluntary individual funds*	As from 2004: taxed Employees' contributions: partially Exempt (30%) from personal income tax to a ceiling of HUF 100,000/year Employers' contributions: Exempt up to the amount of national minimum wage	Exempt Exempt	Fully exempt Exempt if paid at retirement
Poland *Mandatory funded first pillar bis* *Employees Pension Programmes*	Exempt[3] up to a ceiling of 30x the average monthly salary predicted for the coming year, published in the State Budget Act Taxed	Exempt Exempt	Taxed Exempt
Slovak Republic *Mandatory funded first pillar bis*	Exempt	Exempt	Taxed at 19%
Czech Republic	Tax exempt between CZK 6.000/ year and CZK 18.000/year Employer's contributions are tax exempt up to a ceiling of 3% of gross salary	15% on investment income from equities only	15% on capital gains In case of earlier payment, tax of 25% on the employer's contributions whereas the state's subsidies have to be reimbursed

Slovenia	Employer and individual contributions are exempt together up to a ceiling of 5.8% of gross salary Employee contributions are deductible from income tax but remain subject to social security contributions	Exempt	Taxable[4]
Malta	Exempt	Exempt	Taxed
Cyprus	Exempt up to a ceiling (1/6 of chargeable income (including social insurance contributions)	Exempt	Exempt (lump sums of provident funds or occupational pension schemes) Taxed (annuities paid by occupational pension schemes)

[1] The current free tax minimum income amounts to EEK 12.000/year (equivalent to € 767).
[2] The 3% employees' contributions are calculated before taxes (gross salary) but are subject to income tax because income tax is calculated on gross salary; therefore social contributions form part of this.
[3] The sum of contributions to first and second pillar is taking into account. To be noticed that above the ceiling, no contributions are paid to the system.
[4] The government has not yet amended the Act on personal income tax ref. taxation of benefits, as the first payment of pension benefits of second pillar will not occur before 2010. In the third pillar, tax relief is available only if 51% of employees are enrolled in the scheme.

Source: Pragma Consulting

Annex 9: Pension benefits in the new Member States

Countries	Lump sum	Annuity	Other
Estonia *Mandatory funded first pillar bis*	√	√	3 eligibility criteria for a funded second-tier pension: - minimum retirement age, which is the same as for the PAYG first tier of the social security pension - the PAYG first tier of the social security pension must be payable - minimum of 5 years participation in the funded second-tier pension scheme Lump sums are available if the accumulated assets are smaller than twice the (monthly) national pension i.e. lower than ± 125 euro for the time being.
Voluntary pension plans	√	√	
Latvia *Mandatory funded first pillar bis*	X	√	2 options: - the accrued funded pension capital is added to the PAYG first-tier of the social security pension and the pension is calculated from the total amount - the participants may, for the accrued funded pension capital, purchase a life annuity from an insurance company (in which case the amounts are not added up)
Voluntary pension plans	√	√	Choice between lump sum and regular draw downs of fixed amounts
Lithuania *Funded first pillar bis*	√	√	Lump sum is available if the accumulated assets under the funded second tier pension are lower than 50% or 3X greater than/of the basic first tier pension paid under the first pillar (flat rate amount[86])

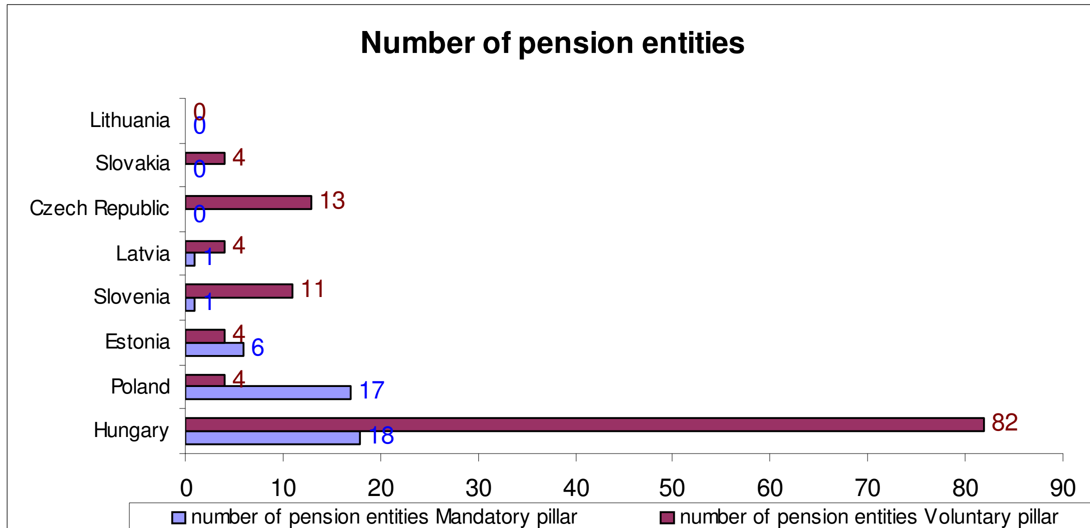
[86] The PAYG first tier of the social security pension is composed of 2 parts: a flat rate and a earnings-related pension. Solely the flat rate pension is taken into account in the formula.

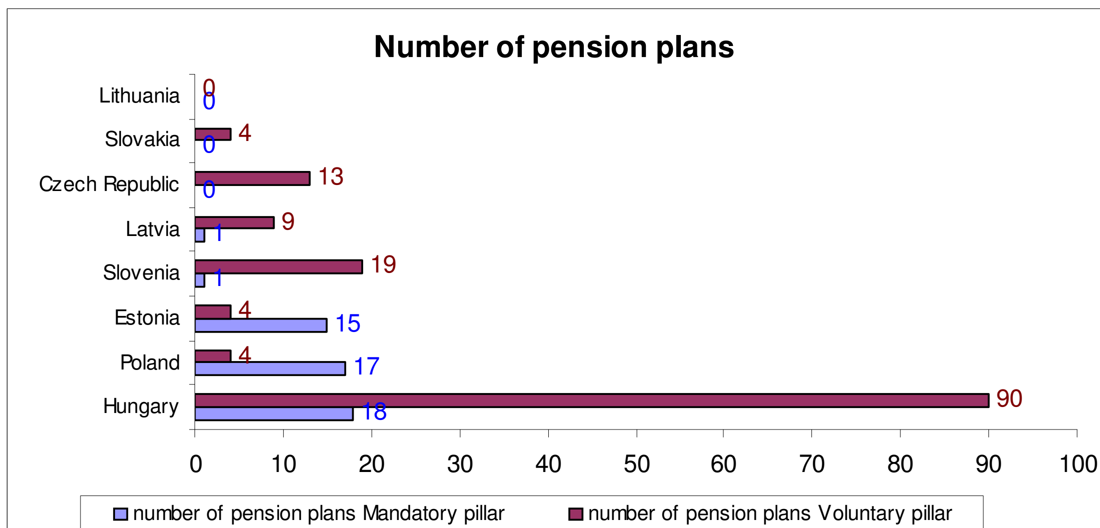
Hungary[87] *Mandatory funded first pillar bis* *Voluntary pension plans*	√ √	√ √	Every fund member who has participated at least 15 years receives an annuity. Those with a shorter participation period can opt for a lump sum or an annuity Both options are available without any restrictions.
Poland *Mandatory funded first pillar bis*	Not yet regulated by law. This should be determined before 2009, year of the first payments of pension benefits. Probably exclusively annuities.		
Employees Pension Programmes	√	√	
Czech Republic	√	√	According to the individual contracts/agreements
Slovak Republic	√	√	Individual choice
Slovenia	√	√	Lump sum is available under some restrictions
Malta			
Cyprus	√	√	Annuities are available from occupational pension schemes but not from provident funds

Source: Pragma Consulting

[87] Benefits are very modest. In Hungary, which has the oldest existing system the average funded second tier account (mandatory funds) currently amounts to the equivalent of € 840 whereas the average third pillar account (voluntary funds) amounts to some € 1.275.

Annex 10: Number of pension entities and plans in the mandatory first pillar bis and the voluntary funded pension schemes (at the end of 2002) in the new Member States





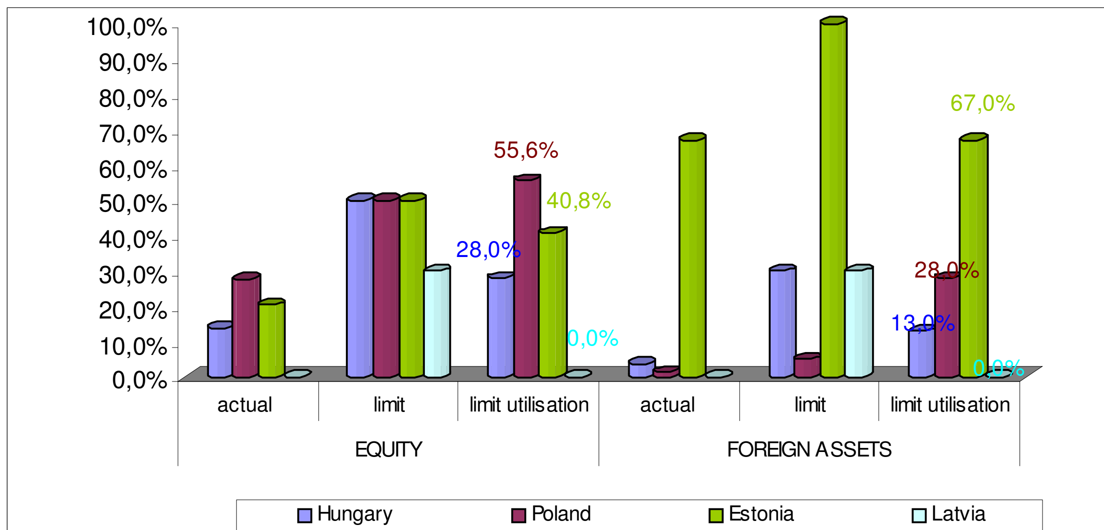
In Latvia, the State Treasury acted as sole asset manager until the beginning of 2003, when the market was opened to competition. In mid 2003, there were 6 providers (excluding the State Treasury) offering 15 investment plans.

In Lithuania, licences have been granted to 4 management companies. Figures are not yet available, as the funding has started in January 2004.

For the Slovak Republic, figures will not be available before 2005-2006.
Source: FI-AD Financial Advisory Ltd.

Annex 11: The margins between the quantitative investment restrictions and the actual investments in equities and foreign assets

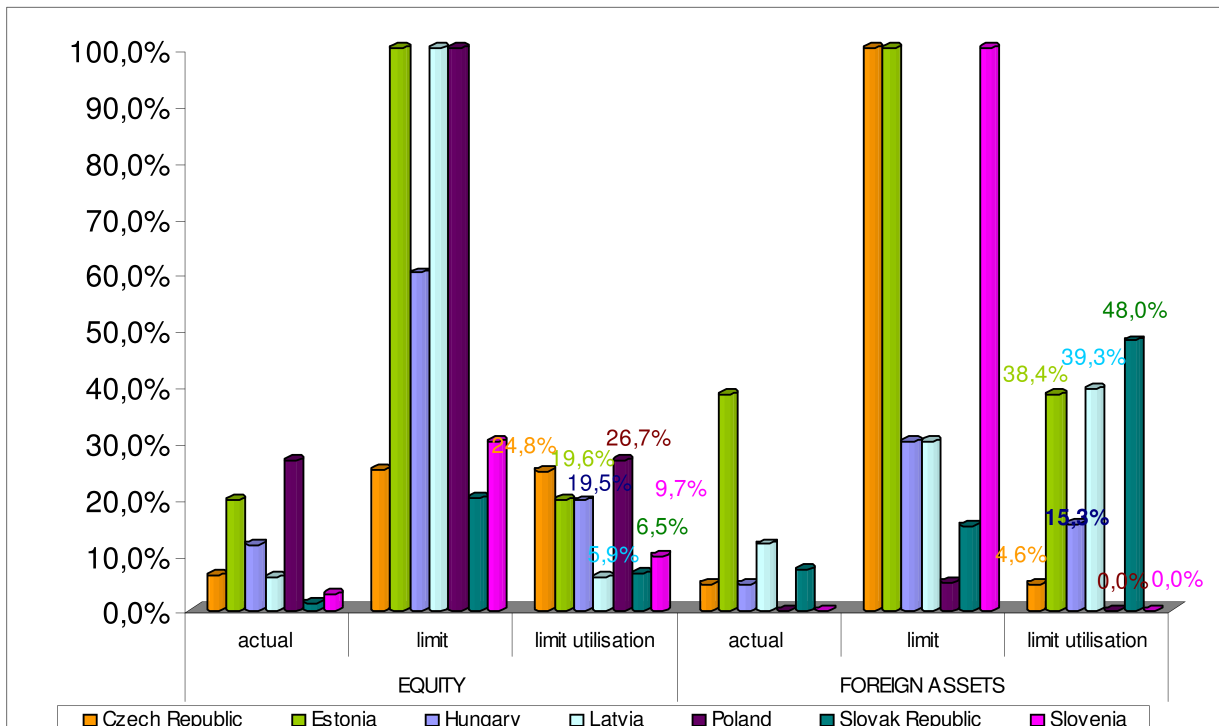
In the Mandatory funded first pillar bis



The figures show the percentages of the existing limit used in the actual portfolio (as at the end of 2002)

For example, the maximal use of the limit on equity was 55.6% of that allowed in Poland in 2002 and 67% in Estonia for foreign assets.

In the voluntary pension plans (second and third pillars)



For the voluntary pension funds, the picture is similar with less than 25% of the limit of percentage on equity investments used (in the Czech Republic for example) and less than 50% on foreign assets (in the Slovak Republic for example).

Source: FI-AD Financial Advisory Ltd.

Annex 12: The supervisory authorities of funded pension schemes in the new Member States

	Name of the supervisory authority	Accountable to
Estonia		
First pillar bis	The Financial Supervisory Authority	Bank of Estonia
Second pillar	Not applicable	
Third pillar	The Financial Supervisory Authority	Bank of Estonia
Latvia		
First pillar bis	The Ministry of Finance for the Treasury The Financial and Capital Market Commission	Parliament
Second pillar	The Financial and Capital Market Commission	Parliament
Third pillar		
Lithuania		
First pillar bis	The Insurance Supervisory Commission[1] The Lithuanian Securities Commission	Government Parliament
Second pillar	Not applicable	
Third pillar	The Lithuanian Securities Commission	Parliament
Poland		
First pillar bis		Prime Minister and representatives of the interest boards of the institutions
Second pillar	KNUiFE	
Third pillar		
Hungary		
First pillar bis	Hungarian Financial Supervisory Authority (HFSA)	Parliament
Second pillar		
Third pillar		
The Slovak Republic		
First pillar bis	The Financial Market Authority	Government
Second pillar	The Ministry of Labour, Social Affairs and Family The Ministry of Finance	Government
Third pillar	N.A.	

The Czech Republic		
First pillar bis	Not applicable	
Second pillar	Not applicable	
Third pillar	The Office of the State Supervision in Insurance and Pension Funds	Government
Slovenia		
First pillar bis	Not applicable	
Second pillar	2 different authorities in function of the providers: Pension companies and insurance companies: the Insurance Supervision Agency Mutual pension funds: the Security Market Agency	The Ministry of Labour, family and social affairs The Ministry of Finance
Third pillar	The Insurance Supervision Agency	The Ministry of Labour, family and social affairs
Malta[2]		
First pillar bis	Not applicable	Parliament
Second pillar	Malta Financial Services Authority (MFSA)	
Third pillar		
Cyprus		
First pillar bis	Not applicable	
Second pillar	Provident Funds Superintendent	Government (Ministry of Labour and Social Insurance)
Third pillar	Insurance Superintendent	The Ministry of Finance

[1] The Insurance Supervisory Commission is responsible for regulation and supervision of first pillar bis pension funds managed by life insurance companies whereas the Securities Commission supervises pension funds managed by management companies. Actually both institutions do the same type of work.
[2] Although Malta has currently a mono-pillar pension scheme, the supervisory authorities have been already designated to take care of a possible first pillar bis. It is expected that the second pillar pension schemes, once set up, will be run by the Government, following the enactment of ad-hoc legislation regulated by again the MFSA.

Source: Pragma Consulting

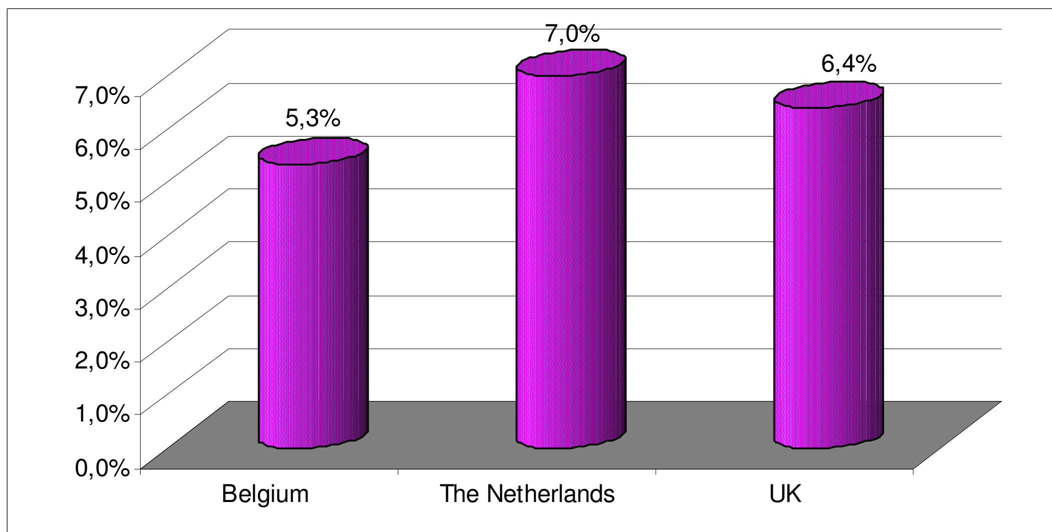
Annex 13: Summary of current risk bearing in the United Kingdom: who bears which categories of risk?

Risk category	Classic DB	Classic DC
Investment pre-retirement	Employer	Individual[1]
Investment post-retirement	Employer	Annuity provider or individual
Specific longevity post-retirement	Employer	Annuity provider or individual
Average cohort longevity post-retirement	Employer	Annuity provider or individual
Long-term average cohort longevity pre-retirement	Employer[2]	Individual
Default/political	Individual (in future partly covered by Pension Protection Fund (PPF))	Individual[3]
Earnings progression	Employer	Individual

[1] May be partially absorbed through with-profit funds. When investment return is very poor, however, this risk is partially absorbed by the state if there is a means-tested element in the state pension system.
[2] Employer absorbs this risk if (as in most DB schemes) the age of retirement is contractually stipulated in advance
[3] Partly recovered by Financial Services Compensation Scheme

Source: Turner Report. “Pensions: Challenges and Choices. The first report of the Pensions Commission”. UK. 2004. p.107

Annex 14: Performance of some European pension funds over the long-term (10-years annualised) in local currency at the end of 2003



Sources: ABIP, VB Vereniging, WM Company and Pragma Consulting

This graph shows that over 10 years, the average Belgian pension fund for example, achieved at the end of 2003 an annualised 5.3% return to be compared with a minimum guaranteed return of 3.25% for DC plans. This difference is substantial because plus 1% return difference over 40 years gives a 15% higher pension or for the same pension, 15% reduction of contributions. We believe that it is possible to achieve a 3-4% higher return than the above 3.25% at acceptable risk; therefore a 45% higher pension or for the same pension 45% less contributions ought to be possible.

Risks need to be defined, quantified and traded against return and protection. In this model a fair deal for sponsors and members should prevail and paternalism should be banned. Risk sharing is not, after all, out of date, because sufficient and secure pensions are still important for everyone.

GLOSSARY

Active management: A style of investment management, which seeks out-performance of a relevant benchmark through either asset allocation, market timing, security selection or a combination thereof.

Annuity: A regular (e.g. monthly) income receivable for a specified period or for life of the annuitant (i.e. person receiving the annuity). Annuity rates normally depend on going market interest rates at the time they are applied.

Asset allocation: The apportionment of a fund's assets between asset classes and/or markets.

Asset class: A category of investment with common characteristics, such as stocks, bonds, property etc. in which the investment manager may invest.

Biometric risks: These are death and/or disability risks/benefits.

Board of Directors: The term used throughout the report is meant to embrace the different national models. For example Board of Trustees is the Anglo-Saxon term, whereas on the European Continent the term Board of Directors is more common.

Book reserve schemes: Occupational pension scheme that is accounted for by means of a provision on the balance sheet of the employer.

Closed funds: Funds that are established on the level of companies, sectors of industry, professional groups or regions and that are only accessible to members thereof.

Currency matching: Requirement by which the assets have to be invested in the same currency in which the liabilities are expressed.

Custodian: A financial institution, usually a bank, entrusted with settlement of trades and safekeeping of the assets on behalf of third parties (in this case pension funds); with interest and dividend collection, tax reclamation and a whole series of other possible activities. Also called a "Depository" ("Dépositaire" in French).

Defined Benefit pension scheme (DB): A scheme whereby the benefits are defined in advance by the sponsor(s) of the scheme (for example in percentage of final pay), independently of the contribution rate and the return on assets.

Defined Contribution pension scheme (DC): A pension scheme, where only contributions are fixed and benefits therefore vary (are uncertain), depending on the level of these contributions and on the return on assets.

Directive (Proposal for a): An initiative for regulation or deregulation initiated by the European Commission and to be adopted by the European Council (of Ministers) and the European Parliament whereafter it needs to be implemented in national regulation by the Member States.

Downside risk: In this meaning risk is not referred to as the variability of return but as the possibility of having insufficient assets to meet the obligations as they become due. There is a certain level of return that must be earned at minimum in order to meet future liabilities; this is called the Minimal Acceptable Return (MAR). Only those returns that fall below the MAR incur this type of risk.

Dynamic Minimum Funding Requirement (DMFR): A flexible Minimum Funding Requirement, which takes into account the asset structure/risk profile, the liability structure/age profile of the group as well as the quality/financial strength of the sponsor.

EET: Stands for Exempt-Exempt-Taxed and applies to the tax regime of pension funds or group insured plans, whereby contributions into the scheme and investment income/capital gains are tax deferred (temporarily exempt) and the pensions or lump sums when payable are taxed.

EFRP: European Federation for Retirement Provision, the organisation, which represents the interests of the national associations of pension funds on the EU-level. Its counterpart from the insurance sector is the Comité Européen des Assurances (CEA) (The European Federation of national insurance associations).

EMU: European Monetary Union.

EPC: Economic Policy Committee of the European Commission.

EU-15: The 15 Member States, which were members of the European Union before May 1st 2004.

EU-25: The EU-15 and the 10 new Member States that joined the European Union on May 1st, 2004

European Commission (EC): Executive body on the level of the EU institutions, which proposes EU regulation and administers EU policies.

Euro-zone: Those 12 Member States that are part of the EMU, also called "Euroland". These are the EU-15 minus the United Kingdom, Sweden and Denmark.

Expense ratio: Information on all directly incurred charges to an investment fund (mutual fund), including entrance and/or exit commissions; management fees and charges for reporting, advice and education. In this definition, transaction costs are not included.

First pillar: Public pillar, usually social security pensions for private sector employees and the self-employed, which is mostly totally or partially financed on a PAYG basis (i.e. unfunded) and the other part being funded. It is usually but not always subsidised through the general or specific public budgets. Pensions for civil servants, which are usually budgetary expenses are also first pillar pensions.

First pillar bis: Mandatory fully funded individual defined contribution plans that are part of the first pillar and that are administered by private funds and financed by a percentage of social security contributions, as these exist in Poland, Hungary, the Baltic States and the Slovak Republic (referred as the second pillar in the World Bank terminology).

Freedom of investment: The possibility to invest in all kinds of asset classes and securities without quantitative restrictions. Freedom is not absolute but usually subject to prudent person principles (e.g. the Pension Fund Directive, article 18) and to self-imposed restrictions by any pension fund.

Full funding: The accumulation of pension reserves that equals 100% of the present value of all pension

liabilities owed to the previous members with rights, the current members and beneficiaries of a pension scheme.

Funding: The provision in advance for future liabilities by the accumulation of assets normally external to the employer's or sponsor's undertaking.

Illiquid assets: Assets that are not readily convertible into cash.

Level playing field: A term applied to the basis on which institutions should compete on equal terms. Related to pension funds and group insured plans it usually means that for the same type of "products" or "services" the same type of regulation and supervision should apply.

Liabilities: The financial obligations, both current and future, of a pension plan.

Market capitalisation: For equities, the market value of a listed stock or of all companies quoted on a stock market. Based on this, a market can, for example, be divided into large, medium-sized and small capitalisation stocks.

Minimum Funding Requirement (MFR): A requirement to fund up to a certain level, for example, the requirement that the value of a scheme's assets be no less than the amount of its accrued liabilities.

Mutual fund: A collective investment fund also called UCIT or Unit Trust (in the UK) whose units of participation are offered either to retail or institutional investors.

Notional Defined Contribution (NDC): System which mimicks individual accounts but is financed on a PAYG basis. The idea is to separate the state PAYG scheme into 2 elements: a strictly actuarial element (NDC), operating on a PAYG basis, but mimicking a funded DC scheme and a redistributive element financed from general taxation.

NMS: Stands for the new Member States i.e. the 10 countries, which entered the European Union on May 1st, 2004.

OECD: Organisation for Economic Co-operation and Development.

Occupational pension scheme/plan: Private sector pension arrangement

usually organised by an employer (or a group of employers and/or employees), or by sectors of industry on behalf of a group of employees or by a group of self-employed persons (e.g. professional plans), to provide pensions and/or other benefits on retirement, on leaving service or on death.

Open funds: Funds in which anybody can participate that are usually offered directly by insurance companies, banks and/or investment fund companies; as opposed to closed funds.

Overfunding: A situation encountered by defined benefit plans when the assets exceed the liabilities.

Pay-As-You-Go (PAYG): A pension scheme, which is unfunded i.e. whereby the active contribute for the non-active/retired scheme members.

Pension fund: A separate legal entity set up to accumulate, manage and administer pension assets.

Pension plan: The pension promise as described in the plan rules. This promise differs for DB and DC-type plans (see there).

Performance: A measure, usually expressed in percentage terms, of how well a fund has done over a particular time period, either in absolute terms or relative as measured against a market index (also called benchmark) or against the average fund or against other funds (a peer group).

Portability: Right of a member of a pension plan to transfer vested rights (see there) between plans.

PPM-system: Stands for Public Premium Pension scheme in Sweden. Pre-funded system within the first pillar organised by means of individual accounts, for which contributions are mandatory and for which individuals have a wide choice of investment funds in which they can invest.

Private equity: Shares that are not listed on a stock exchange.

Private pension schemes: Schemes that form part of the first pillar bis, the second or third pillars and that supplement the first pension pillar. Defined contribution pension plans combined with individual accounts are common for private pension schemes in several new Member States. Also called “supplementary pension provision”.

Prudent man rule (principles): Concept by which investments are to be made in such a way that they are considered as being handled "prudently" (as somebody would do in the conduct of his/her own affairs). Also called "prudent person rule".

Qualitative investment restrictions: Limits that are defined on a non-numeric basis.

Quantitative investment restrictions: Limits that are defined on a numeric basis.

Real return: Return on an asset net of inflation.

Return/risk ratio: The return obtained for the level of risk taken (in terms of standard deviation).

Risk sharing plan: These are hybrid plans also called cash balance plans (in the United States), existing in many different applications whereby the employer and the participants/beneficiaries share the investment risk. One of the most common forms is the case whereby the participants have downside protection (no negative return or a minimum interest rate) and the employer is entitled to the surplus as from a certain level of return.

Second pillar: Usually funded pension schemes that complement the first pillar, are occupational or other group-specific schemes, which implies a pension promise originating from a labour relationship or from belonging to a professional category, with emphasis on group solidarity (DB-type schemes) or on group (DC collective) or individual responsibility (DC individual)). Providers are typically pension funds that operate on a non-profit basis and group life insurance companies that operate for profit or as mutuals. Book reserve schemes and collective PAYG-financed second pillar plans also exist in the EU-15.

Shortfall: The situation that occurs when the assets do not meet the liabilities in a defined benefit scheme.

Sponsor: In a DB-type scheme the entity (e.g. company, sector by means of collective labour agreements) making the pension promise, which is entrusted to a pension fund or to an insurance company and reflected in the rules of the plan. The sponsor engages in the plan's funding; he therefore bears the shortfall risk and is entitled to the

surplus (see Risk sharing plans). In a DC-type scheme it is the entity that pays the contributions.

Stakeholder: All persons or institutions that have an interest in a pension plan/pension fund.

Standard deviation: Mathematical formula to calculate risk in terms of volatility of returns on the basis of a number of observations.

Statement of Investment Principles (SIP): A document written by the Board of Directors of a Pension Fund (art. 12 of the Pension Fund Directive) setting out their long-term attitude to risk, their return objectives and strategic asset allocation in accordance with prudential principles and taking into account the liabilities of the fund and the opportunities which the markets offer at the time of writing the statement as well as prospectively.

Surplus: Excess of assets over liabilities in a defined benefit scheme.

Third pillar: Pension scheme based on voluntary and individual contributions/premiums in addition to second pillar pensions.

Tracking error: The volatility of the over-or underperformance relevant to the benchmark.

UCITs: See also “mutual fund”. Undertakings for Collective Investments in Transferable Securities are collective investment funds that comply with the EU UCITs Directives.

Underfunding: Feature of a defined benefit plan where the liabilities exceed the assets.

Unfunded scheme: A pension scheme for which the plan sponsor does not accumulate assets in advance of the benefits becoming payable.

Vested rights:

a. For active members, benefits to which they would unconditionally be entitled on leaving the scheme;
b. For deferred members, their preserved benefits;
c. For pensioners, pensions, lump sums or other benefits to which they or their descendants/beneficiaries are entitled.

Vesting period: The minimum period of time required to be legally entitled to a vested benefit.

Volatility: The variability of returns.

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