

Technical fiche¹

Pension funds in the context of the FTT proposal

1. Methodological considerations and interpretation of the legal provisions

The reference to pension funds in the context of the proposal for a directive for a common system of FTT is to Institutions for occupational retirement provision (IORPs) regulated by the Directive 2003/41/EC (see Article 2.1(7)(f)). The quoted article also covers their specialised managers, especially for the case in which these institutions – which are usually the funds itself – are not legal persons. Such institutions are private and are completely separate from the public (government-managed) schemes (under public law), so in this context we will actually discuss only about the **private** pension funds (under private law).

Directive 2003/41/EC defines the 'institution for occupational retirement provision' 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 retirement benefits in the context of an occupational activity on the basis of an agreement or a contract agreed:*

- *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.*"

This IORP directive specifically excludes in Article 2.2 institutions operating social-security schemes, institutions which operate on a pay-as-you-go basis etc. If one refers to the old methodology developed by the World Bank in the 1990s², only what is usually known as the second and third pillars would be covered by the provisions of the FTT directive, so the potential impact on pensioners of the FTT could be limited with regard to the first pillar.

¹ This technical fiche should be considered as a non-paper that commits only the Commission's services involved in its preparation.

² The model of the World Bank, intended as a blueprint for developing/transition countries, consists of (I) public pay-as-you-go (PAYG) pensions, (II) mandatory, privately managed pensions (occupational schemes), and (III) voluntary (private) individual accounts (without any link to the employment status).

While pillar I is currently indeed the most important part in many Member States (though not in all), the trend towards pillars II and III is rather strong due to the pressure of demographic changes on pillar I³. Notably, the Netherlands, Ireland, United Kingdom, Sweden, Denmark, Germany and Belgium are the Member States which have a significant funded occupational pension sector (often called pillar II pensions) today. Additionally, Finland is running a statutory funded scheme (other funded pensions are not yet all that significant for most of those retiring today). For the future, the mandatory funded schemes in the Member States from CEE will grow and mature and become more significant. Existing pillar II schemes are expected to expand; notably, in the UK next year they are launching a new national occupational pension scheme and automatic enrolment into schemes which is eventually expected to result in an extra 5 million people being covered by pillar II pensions.

Pillar III pensions (individual voluntary contracts normally between individuals and insurance companies and incentivized by governments normally via tax breaks) are only significant in a few Member States and even there they are not as important as occupational pensions for most of the people. Germany, with its "Riester Rente", is the most obvious case; one can also refer to the Czech Republic, the United Kingdom and Ireland. Nevertheless, there is a somewhat "grey area" between long-term savings products and individual private pensions⁴. Another issue to bear in mind is that in many cases⁵, pillar III is more addressed to higher income groups as a top up to other pensions, rather than something utilized across all income groups because (a) it requires spare income in order to make the voluntary savings in the first place and (b) incentives often come in the form of tax breaks and as tax systems are progressive, tax incentives are often regressive.

2. The size, asset structure and investment strategies of private pension funds

2.1 Size and importance

The relative importance of (private) pension funds (pillar II pensions) is very different across the European Union. It is the highest in the Netherlands (135% of its GDP or around EUR

³ PAYG pillar I pensions are perceived to become less "generous" (as they are reformed to enhance their sustainability/react to the economic crisis) and hence less significant proportionately in the overall pension income of individuals.

⁴ There is a good case for arguing that the the Czech Republic has in place long term savings products, not individual pensions.

850 bn. in 2010) followed by Finland (82% of the Finnish GDP). In Denmark and Ireland it corresponds to around 50% of GDP, while in countries like Germany, Austria and Italy it reaches around 5% of GDP. In some of EU10 Member States, such as Poland or Hungary, these pension funds have accumulated assets corresponding to around 15% of GDP. However, in some other Member States, such as Belgium, Slovenia, France or Greece the accumulated assets of such funds are significantly below 5% of GDP.⁶

2.2 Portfolio structures and investment strategies

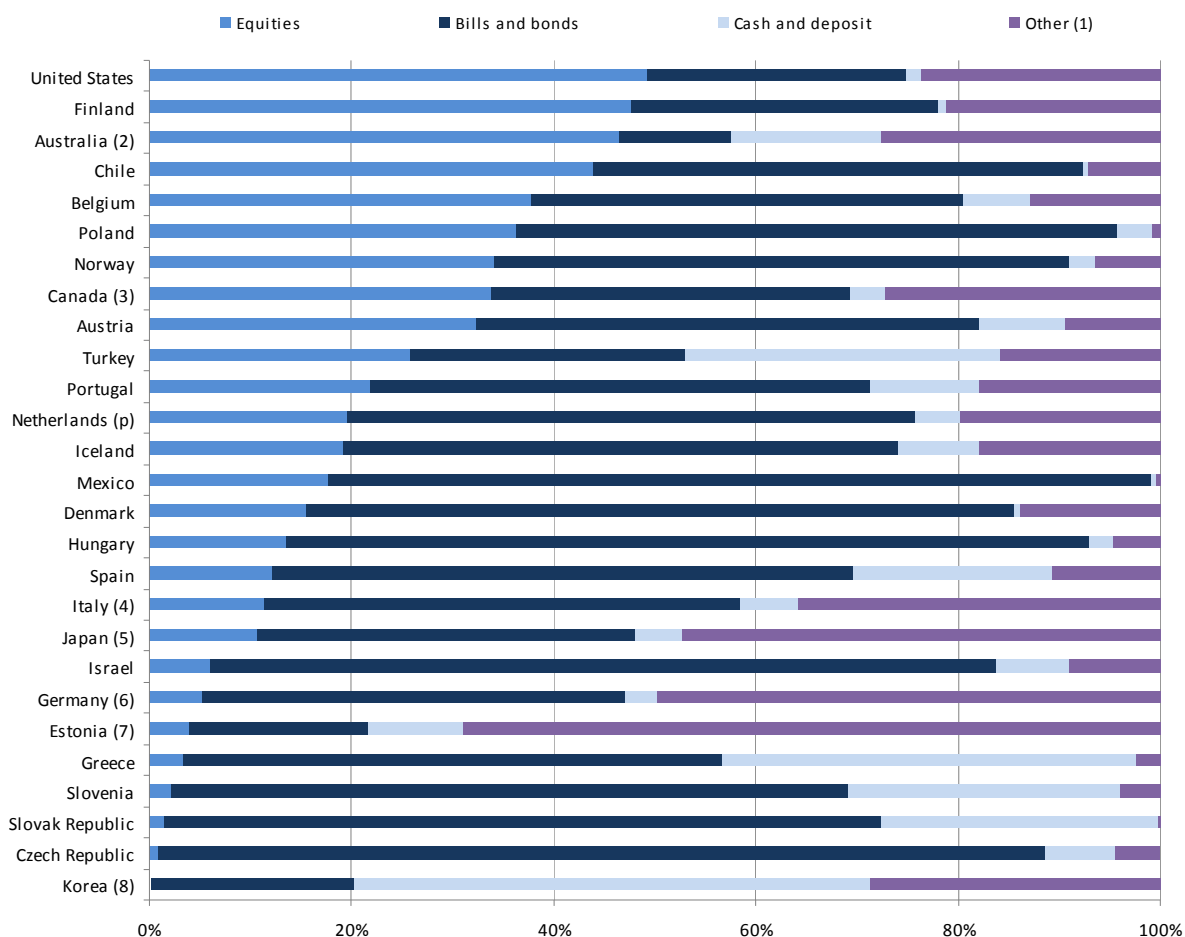
The impact of an FTT on pension funds will depend on both the asset allocation (portfolio) and on the investment strategy (more frequent trading vs. less frequent trading, for example). If one looks at the asset allocation in selected pension funds (see figure 1), **not all these assets represent taxable financial instruments as defined in the proposal**, neither do all the transactions. As an illustration, cash and deposits and other assets (including derivatives, but also investment in real estate and others) make up for 22% (or almost EUR 190bn) in the Netherlands (over 4% in cash and deposits) and 34% in Bulgaria (over 28% in cash and deposits).

Also, a distinction between defined-benefit schemes (DB) and defined-contribution schemes (DC) looks meaningful, as both will have to hedge different risks differently. According to EIOPA data, loan deposits and other assets have a lower weight in the total portfolio in the case of defined-benefit (DB) schemes, whilst these types of assets are better represented in the total portfolio of defined-contribution (DC) schemes, with around 40% in Spain, Italy, Bulgaria and Latvia.

Figure 1: Pension fund asset allocation for selected investment categories
in selected OECD countries, 2010 (% of total investment)

⁵ The "Riester Rente" in Germany should be seen as an exception due to the progressive nature of the incentives.

⁶ See OECD(2011) Pension market in focus.



¹This category includes loans, land and buildings, unallocated insurance contracts, private investment funds, other mutual funds.

Source: OECD (2011) Pension markets in focus

The OECD has observed that although most pension funds have performed positively in 2010, investment returns were lower than in 2009. In the OECD countries that have submitted data, in the 2008-2010 period, the average net returns (i.e. returns on savings minus operating cost) reached 2.6% in real terms (4.4% in nominal terms). It was noted that the **funds with conservative investment portfolios and strategies were still ahead in terms of performance for that period.**

The potential impact of liquidity risk on pension funds underlines the need for a suitable risk management and control framework that takes into consideration various elements. This has become more evident especially during the financial crisis because of contagion and counterparty risk exposures. To a certain extent, the common view that pension funds are typical long term investors may need revision. **When assessing the investment horizon, careful consideration needs to be given to factors that may shorten the effective horizon**

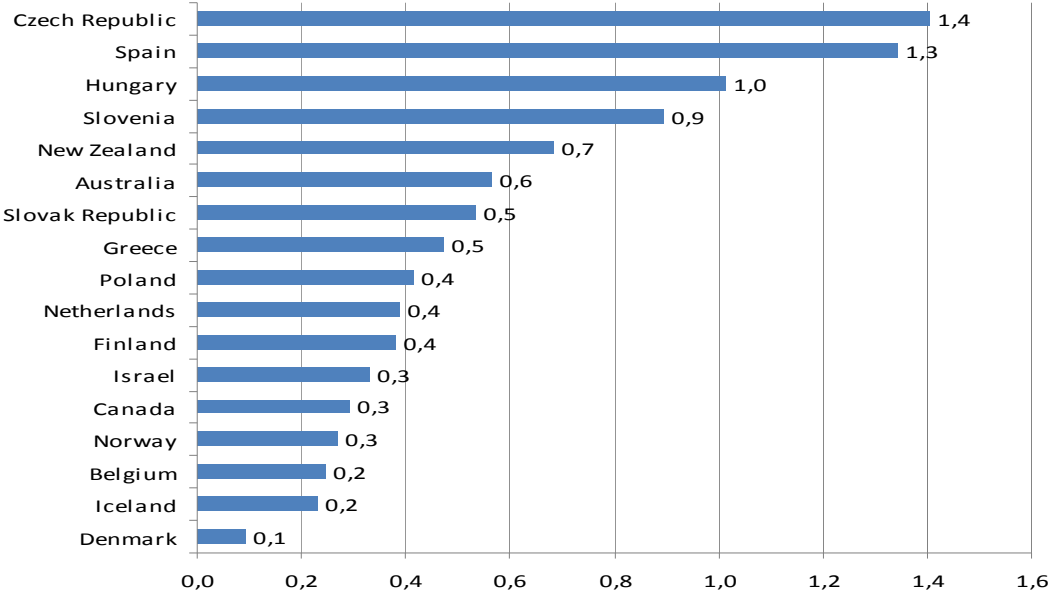
of investments, such as periodic rebalancing transactions, active management, (cash) collateral calls or other unexpected liquidity needs. **Such factors may lead to higher turnover levels and shorter effective holding periods**⁷.

However, the higher a fund's portfolio turnover rate in a year, the greater the trading costs payable by the fund during the year. A 2011 study⁸ by SCM Private in the UK found that, with a 128% turnover rate for the average portfolio, estimated in 2011 this adds 0.7% of total assets in costs per year to an average UK pension fund. For an average 25 years membership in a pension scheme, this additional cost would translate in a 17.5% loss in the real net return for the scheme member.

2.3 Operating costs

The ratio of total operating costs against assets managed is a measure of the efficiency of private pension systems. The total operating costs include all the costs of administration and investment management; they include costs for marketing the plan, collecting contributions, sending contributions to investment fund managers, record keeping, reporting to scheme members, investing the assets etc.⁹

Figure 2: Operating costs in selected OECD countries (% of total assets)



Source: OECD (2011) Pension markets in focus

⁷ OECD/IOPS (2011), Good practices on pension funds' use of alternative investment and derivatives, p.29.

⁸ Give source

⁹ Tapia, W. and Yermo, J. (2008), Fees in individual account pension systems, OECD Working papers.

The **structure of the fees** that pension funds charge their clients **is quite diverse** and usually covers more of the following at the same time:

- fixed commission;
- fees on contributions;
- fees on assets;
- fees on returns;
- switching/exit fee;
- death and disability insurance.

The magnitude of the fees varies across countries and depends mainly on the concentration in the market (the level of competition between pension funds), but also on the investment strategy. Very actively managed pension funds and investment vehicles come with significantly higher handling fees passed on to the saver than passively managed ones. The operating costs shown in figure 2 relate to total assets and not to annual contributions. If one reflects on the time horizon for which a member is present in a pension scheme, and assuming an average of 25 years¹⁰, the net average return a member will get from its pension scheme could be affected by 35% in case the operating costs amounted to 1.4% of total assets, while they would remain limited to 2.5% in case the operating costs were only 0.1% of total assets.

2.4 The use of derivatives and alternative investments by pension funds

The recent agreement on the regulation on OTC derivatives (EMIR) contains a clause temporarily exempting pension funds from abiding to the rules on the mandatory use of central clearing. The non-use of central clearing triggers additional posting of cash as collateral (mainly, for the variation margin). Nevertheless, national capital requirements should provide a guarantee similar to cleared contracts. The regulation will also be reviewed in order to see whether high-liquid non-cash assets could be used as collateral.

Derivatives can be used for various purposes by long-term investors such as pension funds – most notably as a substitute for direct investment in the underlying asset (because of liquidity, market timing, tax or other reasons) and risk control. Derivatives can also be used to change the characteristics of their portfolio investments (such as the duration of their fixed income

¹⁰ Pitt-Watson, D. (2010) – Tomorrow's investor: Building the consensus for a People's pension in Britain, FRSA, p.17.

portfolio). They can also be used for risk control or hedging, duration control and general portfolio management. However, **derivatives can also be used for other purposes, including speculation and leveraging of portfolios, which can come into conflict with the basic objectives of a pension fund¹¹.**

The IORP directive also contains some general rules on investment (in Article 18), including on the use of derivatives: *"investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued on a prudent basis, taking into account the underlying asset, and included in the valuation of the institution's assets. The institution shall also avoid excessive risk exposure to a single counterparty and to other derivative operations."*

Usually, **the use of derivatives is limited in the national legislation**, where ceilings for certain types of assets may be defined (there are no such rules in the IORP directive). In general, the use of derivatives is more spread in pension funds operating in Member States such as the UK, Netherlands or Sweden, compared to those from Member States in CEE.

a) Qualitative limits

For example, Romania authorizes the use of derivatives only in cases where pension funds have the underlying assets in their portfolio. In Germany, derivative transactions are only permitted if derivatives are used for the purposes of hedging, acquisition preparation and yield-enhancing operations under specific conditions and in a limited way. The use of derivatives in short selling, however, is not permitted. In Slovakia, mandatory funds considered to have the most risky portfolios, that is, investment in overseas securities, must hedge at least 20% of the net asset value of the fund against currency risk, with this limit rising to 50% in a balanced pension fund (zero currency exposure is allowed in conservative funds). There are, sometimes, also countries with specific rules on the use of OTC derivatives; for example, in Germany, Bulgaria and Poland the use of OTC derivatives which involve certain types of charges is restricted.

(b) Quantitative limits

In Germany, for both Pensionsfonds and Pensionskassen, derivative use is limited to 7.5% of the total assets of the portfolio at the last balance sheet date. This limit applies to acquisition-

¹¹ OECD/IOPS (2011), Good practices on pension funds' use of alternative investment and derivatives.

preparation operations and yield-enhancing operations. Yield-enhancing operations occur when the securities actually held in a portfolio are used in order to increase returns via financial derivatives. Generally, acquisition-preparation operations and yield-enhancing operations only use certain derivative instruments which are assigned to this specific purpose and are thus permissible. For hedging operations, the volume of balance sheet items hedged by these instruments may not exceed 100% of the portfolio of assets at the latest balance-sheet date. If derivatives are used for the purpose of a pre-emptive purchase taking place within one year or the purpose of an increase in profit, each instrument has to follow a limit of a maximum 7.5%.

In Austria, the supervisory authority applies minimum standards for risk management, and where a Pensionskasse is assessed as not meeting these requirements, investments in derivatives are restricted to a maximum of 5% of the portfolio. In Estonia, up to 10% of the value of the assets of a pension fund can be invested in derivatives, with the exception of foreign exchange hedging

The use of alternative investments (in hedge funds, private equity, structured products, securitised real estate investments, etc.) has also taken off during the last ten years. In the Netherlands, for example, the use of alternative investments (% of total assets) is around 6.2% (3.4% in hedge funds and 2.8% in private equity)¹². With relatively higher returns, alternative investments also tend to be more expensive than traditional investments (compared to UCITS, for example¹³), with fees of 1.5-2% of the assets under management, plus a performance-related fee of 10-20% of the return on investment.

3. The impact of the proposed FTT on pension funds

3.1 Interaction with regulation

The FTT proposal does not primarily aim at dealing with the behavior of financial institutions; this is a rather secondary objective. These are issues best being dealt by

¹² IOPS (2011), Pension funds use of alternative investments and derivatives - regulation, industry practice and implementation issues, p. 18.

¹³ Nevertheless, also for UCITS, in the case of use of funds of funds (pooling amounts together) there are extra-fees.

regulation, and the Commission considers publishing a proposal to review the so-called IORP directive (2003/41/EC) mainly with respect to capital and solvency requirements, including in the light of the financial and economic crisis developments and of the implementation of the framework directive Solvency II (for the insurance sector).

The management of risk and the increased use of alternative investments and derivatives by pension funds have also come to the attention of supervisory authorities. In the OECD/IOPS paper on 'Good practices on pension funds' use of alternative investments and derivatives it was noted: *"Though suffering less of a direct impact from the financial crisis in general and from such instruments in particular than other financial sectors, pension fund regulators and supervisors raised concerns that the pension funds which they oversee did not understand the products they were investing in, or have the necessary risk management systems to cope with them."*

The Commission has already issued in 2011 a Green paper – 'Towards adequate, sustainable and safe European pension systems' – which highlights that *"increasing reliance on private schemes has fiscal costs, given the widespread practice of providing tax incentives during the accumulation phase. The costs of tax relief can be considerable and its effectiveness and redistributive impacts questionable"*¹⁴.

However, the approach taken by the FTT directive is without prejudice to the discussions around striking the right balance between the need for sustainable social security systems achieving adequate pensions and social inclusion objectives and the need for structural reforms, including of the pensions systems, especially in the light of attaining a fair and inter-generationally sustainable way of funding these systems.

3.2 Impact on transaction costs

One could now argue that the introduction of an FTT would affect (private) pension funds involved in more frequent trading much more than those that trade less frequently in financial instruments, i.e. those funds pursuing a "buy and hold" strategy would be much less affected than those following an "active" strategy with significant and frequent turning over of assets. This difference is illustrated in the below box.

¹⁴ See also the Social Protection Committee's report "Privately managed funded pension provision and their contribution to adequate and sustainable pensions" published by DG EMPL in 2008.

"Buy and hold" versus "active management" strategies

Example 1:

A Dutch pension fund has invested its assets of EUR 10 bn the following way: 10% in shares, 10% in real-estate funds, 70% in bills and bonds, and 10% in other (such as cash or deposits or real estate). The Fund follows a passive “buy and hold” strategy, i.e. it shadows the relevant indices for shares, it purchases bills and bonds when they are issued and holds them until maturity. Pay-outs (to pensioners) and pay-ins (from contributors) are balanced. Due to changes in the composition of the stock-market indices, it has to turn over (buy and sell) on average 10% of its shares and real-estate funds each year. None of the new purchases are purchases on primary markets.

- Transactions in 80% (primary markets for bills and bonds, cash and deposit and other such as real estate) are out of scope of the FTT directive. The turning over of the shares and real-estate funds carries Dutch FTT.
- The pension fund has to pay EUR 400.000 Dutch FTT annually for the turning over of its shares in case the Netherlands applied the minimum tax rates. This corresponds to 0.004% of its assets.
- If these assets represented 20 years of savings / asset accumulation the annual figure of 0.004% of total assets translated into 0.08% of annual savings, i.e. a pensioner who has invested EUR 100/month would receive returns (after FTT) as if he had invested only EUR 99.92/month in case the fund managers passed these costs on fully to the pensioners and not to the borrowers of capital.

Example 2:

Same asset structure etc. as in the previous case, but this time the pension fund follows an “active” strategy, and turns over all its assets except cash and deposits and other (such as real estate), i.e. 90% twice a year. It does not intervene on primary markets for bonds and bills and shares. Also, as it is more exposed to market volatility, it is assumed to hedge 90% of all its assets four times a year against diverse risks.

- The turning over of assets carries Dutch FTT, so do the hedging operations;
- The pension fund has to pay EUR 36 mn Dutch FTT annually for the turning over of its assets. Annual Dutch FTT for hedging 3.6 mn. This corresponds to 0.396% of its assets.
- If these assets represented 20 years of savings / asset accumulation the annual figure of

0.396% of total assets translated into 7.92 % of annual savings, i.e. a pensioner who has invested EUR 100/month would receive returns (after FTT) as if he had invested only EUR 92.08/month in case the fund managers passed these costs on fully to the pensioners and not to the borrowers of capital.

As these latter would also have to cover the market risk of falling bond prices on a permanent basis, their derivatives activities might also be more important by several orders of magnitude. This impact could possibly be partly offset due to the potentially positive effect a FTT would have on volatility which would benefit the longer term investment strategy of pension funds (because of higher predictability). Evidence in the economic literature on this effect on volatility is however mixed.

Also, the investment strategy with respect to the portfolio structure could have an impact on the effects of the FTT on pension funds, as e.g. investing in government bonds and bills on primary markets would not be a taxable transaction, while buying and selling shares on secondary markets or investing in derivatives such as structured products would be taxable events.

Asking for an exemption (or special treatment) under the FTT directive for pension funds would undermine the level-playing field between various products available for savings and retirement. Moreover, pension funds (both public and private) enjoy a favorable tax treatment in numerous Member States. Despite the specifics of pension funds, there are equivalent products available on the markets, such as various types of bonds, collective investment funds and life insurance contracts (unit-linked insurance plans). While insurance premia are taxed in some Member States according to national law, bonds and collective investment funds are covered by the FTT proposal, and the insurance and reinsurance undertakings trading in financial instruments are also included in the scope.