EVOLUTION IN THE EUROPEAN PENSIONS MARKET

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Overview

- Pension reform options not yet widely grasped despite coming difficulties of social security
- Pension fund growth in Europe strong but unevenly distributed
- Some regulatory problems for EU pension fund investments remain unresolved
- Funding and EMU are combining to revolutionise EU financial markets, with important implications for pension fund managers
- Looking ahead, financial stability risks arise for retirement systems, particularly where reform absent – suggesting a painful denoument for the laggards

The ageing problem

- Increase in life expectancy, projected to rise another 5 years by 2050….
- ….decline in the birth rate….
- ….giving rise to an ageing population…
- ….and financial difficulties for generous pay-as-you-go systems….
- ….generally in countries where funding is not developed
- Aggravated by fall in average age of retirement in EU – often stimulated by tax/pension policy…
- …and more general adverse effects of PAYG on economic performance

Projected pension costs

Percent of GDP	2000	2020	2040	Change to peak	Replace-ment rate at $20,000 earnings*	Replace-ment rate at $50,000 earnings*
Belgium	9.3	10.4	13.0	3.7	59	40
Denmark	10.2	14.0	13.9	4.5	87	35
Germany	10.3	10.6	14.4	4.3	45	40
Greece	na	na	na	Na	69	40
Spain	9.4	10.2	16.3	8.3	97	56
France	12.1	15.0	15.8	3.9	61	41
Ireland	4.6	6.7	8.3	4.4	56	23
Italy	14.2	14.9	15.7	1.7	76	72
Luxembourg	na	na	na	na	86	76
Netherlands	7.9	11.1	14.1	6.2	76	30
Austria	14.5	15.7	17.0	3.1	71	68
Portugal	9.8	14.4	15.8	6.2	76	76
Finland	11.3	140	16.0	4.7	60	60
Sweden	9.0	10.2	10.7	1.7	67	45
UK	5.1	4.4	4.4	0.0	49	20

*Social security pension/earnings for married man, source Watson Wyatt (2000)

Projections of elderly dependency ratio

Population 65+ as percentage of 15-64	2000	2050	Over 80 as percent of over 65 2050
Belgium	26	45	37
Denmark	22	36	35
Germany	24	49	39
Greece	26	54	33
Spain	25	60	33
France	24	46	38
Ireland	17	40	27
Italy	27	61	39
Luxembourg	21	38	38
Netherlands	20	41	37
Austria	23	54	42
Portugal	23	46	31
Finland	22	44	36
Sweden	27	42	36
UK	24	42	37

The logic of pension reform

1970-95	Pension fund returns/ Risk	50–50 Bond Equity	Global Portfolio	Real Average Earnings
Australia	1.8	3.5	6.1	1.0
	(11.4)	(17.5)	(18.2)	(3.4)
Canada	4.8	4.0	7.1	1.3
	(10.0)	(12.1)	(14.7)	(2.4)
Denmark	5.0	6.1	3.7	2.4
	(11.1)	(19.0)	(18.5)	(3.5)
Germany	6.0	6.4	3.9	2.7
	(5.9)	(17.7)	(18.4)	(2.7)
Japan	4.4	6.1	6.9	2.4
	(10.2)	(16.9)	(16.0)	(3.0)
Netherlands	4.6	5.5	4.8	1.4
	(6.0)	(18.3)	(14.7)	(2.6)
Sweden	2.0	8.0	6.3	1.4
	(13.1)	(20.1)	(14.8)	(3.5)
Switzerland	1.7	2.4	3.7	1.5
	(7.5)	(18.1)	(17.0)	(2.1)
UK	5.9	4.7	5.9	2.8
	(12.8)	(15.4)	(15.0)	(2.3)
US	4.5	4.4	7.5	–0.2
	(11.8)	(13.3)	(15.2)	(1.9)

Some key issues in pension reform

- What is the effect on overall economic performance?
- What is the effect on public finances?, e.g. What is the fiscal burden of tax privileges?
- Does a generation have to “pay twice”?
  - A tax on low fertility?
  - Economic performance better with funding?
- Should a funded component be mandatory?
- Is there an *“Achilles heel”*?
- How willing are politicians to push through unpopular measures, not least promoting funding in a bear market?

Models for major pension reforms – mainly non-EU

- Mandatory personal defined contribution funds managed on decentralised basis (Latin America, Eastern Europe) – *commission costs?*
- Mandatory personal defined contribution funds invested centrally by public bodies (Hong Kong, Singapore) – *political interference?*
- Mandatory occupational defined contribution funds (Australia, Switzerland) – *employer incentives to optimise risk and return?*
- Defined contribution pay-as-you-go (Sweden, Italy, Poland) with pension indexed to life expectancy – a major alternative to funding?

Parametric reform – can it be sufficient?

- Pay as you go
  - Raise retirement age (e.g. in Italy)
  - Change indexation rules (Germany)
  - Cut replacement ratio (UK)
  - Increase contribution period (France)
  - Lower incentive for early retirement (Finland)
  - Cutting privileges for public employees (France), disabled (Netherlands)
  - Lower credits for higher education (Germany)
  - Reserve fund for pay-as-you-go (In what assets? Managed by whom?) (France, Ireland)

Parametric reform – can it be sufficient? (cont)

- Funding
  - Easing of portfolio regulations (EU Pensions Directive)
  - Development of funding from current severance payment system (Italy)
  - New funded tier of pensions supported by enhanced tax privileges (Germany)
  - Allow opting out of earnings related social security (UK)
  - "Monopsony" of public sector buying asset management services on behalf of private individuals (Sweden)

Ongoing pressures for reform

- EMU effects
  - Stability pact and rating agency focus on social security deficits and implicit debts
  - Transparency in costs leading firms to focus on cost of social security contributions – and either shifting production or cutting employment to maintain competitiveness
  - Reduction in book-reserves to help credit rating (S and P view as debt)
  - Also via Lisbon process – targets for employment and calculation of projected pension expenditure on common basis
- EU entrants with reformed systems, enhancing their competitive challenge

European pension fund market

- Growth still in prospect: assets Euro 2500 bn in 2000, forecast Euro 3500 bn in 2005
- Underlying shift from bonds to equities underway – albeit set back by bear market
- Improving conditions for existing funds
  - Better risk return trade-off due to EMU, financial innovations (e.g. hedge funds, risk management via derivatives)
  - Easing of regulations
  - Increased competition among asset managers

European pension fund market (cont)

- But despite reforms in a number of countries, assets and growth remain concentrated in the UK, Sweden, Netherlands and Denmark
- Reforms themselves e.g. in Germany are modest and will not generate a rapid build-up of assets, while elsewhere (e.g. France) reform very slow
- Many countries retain restrictive portfolio regulations, hampering performance, although EMU and the Pension Funds Directive will mitigate their effects (see below)

European pension fund market (cont)

- Investment dominated by domestic banks, which charge relatively high fees owing to lack of competition (also some hidden fees and lack of independent performance measurement)
- Insurance companies’ role in pension provision
- Bear market has generated underfunding problems

Pension funds and other institutional sectors, 2000

Percent of GDP	Pension funds	Investment funds	Insurance
Belgium	6	30	42
Denmark	24	20	78
Germany	16	12	43
Greece	4	25	1
Spain	7	30	13
France	7	55	61
Ireland	51	144	45
Italy	3	39	21
Luxembourg	1	3867	117
Netherlands	111	25	65
Austria	12	40	24
Portugal	12	16	20
Finland	9	10	57
Sweden	57	34	90
UK	81	27	107

Portfolio restrictions on EU and Swiss pension funds

BE	>15% in government bonds
DK	rules of the EU's 3rd life insurance directive, 80% currency matching
FR	>50% EU government bonds
DE	<30% EU equities, <25% EU property, <6% non-EU equities, <6% non-EU bonds, <20% overall foreign assets, >80% currency matching
IT	<20% liquid assets, <50% non-listed OECD securities, <5% non-OECD securities, >30% currency matching
PT	<40% in foreign equity
CH	<50% real estate, <30% Swiss equities, <30% foreign loans, <25% foreign equities

European asset manager performance

	Operating profits	Net revenues	Total costs	Memo: % retail funds	Memo: equity fund management costs (bp)
Benelux	19	32	13	53	4.6
France	19	32	13	40	5.7
Germany	9	23	14	31	5.7
Iberia	42	53	11	74	3.7
Italy	35	48	13	94	5.8
UK	11	28	17	21	5.8

Fees for a $100 mn balanced mandate

	Fees (basis points)
Ireland	18
Netherlands	18
Germany	27
UK	27
France	32
Switzerland	40
Memo: US	46

Asset manager competition – barriers to entry of markets

Answers Ranked from 1 (Unimportant) to 5 (Very Important)	**Foreign**	**Domestic**
Reputation of existing firms	3.63	3.52
Existing firms' relationships with clients	3.69	3.61
Existing firms' distribution channels/selling networks	3.93	3.8
Existing firms' expertise/technical capabilities	3.07	3.39
Existing firms' lower unit costs	2.48	2.82
Capital or marketing costs	2.98	2.95
Existing firms' local information	3.36	2.8
Established investor preferences	3.34	3.22
Regulatory barriers	3.07	2.38

Regulatory issues for pension fund investment

- Directive on Occupational Retirement Provision
  - Some good points, enshrines prudent person investment (necessary for optimal investment), sets minimum limit of 70% equity and 30% non-matching currencies
  - But also allows quantitative restrictions, which could constitute a loophole
  - And sets out a minimum funding aspect, which will be particularly strict for cross-border funds and may discourage their development
  - No attempt to address vesting or taxation

Regulatory issues (cont)

- Tax barriers to cross border occupational pensions
  - Common basis for taxation (EET) needed for pan-European pension schemes, being sought by Commission
  - Danner ECJ case gives hope for progress in removal of tax discrimination for cross border sales of financial services such as life insurance
- Directive on Takeovers
  - Wholly undesirable that this has been emasculated, thus giving poor protection to minority shareholders and undue protection for incumbent management

Regulatory issues (cont)

- Barriers to competition in domestic legislation
  – German “Riester” pensions and others insist on use of investment funds based in home market or with unique features hindering cross border sales
- Proposed introduction of Basel 2 to European law
  – Major issue of “operational risk” capital requirement on asset managers; could drive some index managers out of the EU

Pension fund growth and EU financial markets

- Important to see pension fund growth in combination with EMU
- Both have effects of:
  - Increasing role of securities markets
  - Boosting cross border investment
  - Increasing contestability of asset management
  - Putting pressure on bank profitability
  - Leading to concentration of trading activity
  - Shift in corporate governance to Anglo-Saxon
- …*benefiting funds themselves*

Evidence of pension fund and EMU effects?

- Securities markets:
  - Massive growth in corporate bond issuance and securitisation, stimulated by institutional investor demand and the euro – and low government deficits - providing *higher yielding matching assets* for EU pension funds
  - Some expansion of index linked bonds (e.g. France)
- Cross border investment
  - Pension fund sectors raising cross border investment, particularly in the euro zone, where currency risk ceases to hold, thus *lowering asset risk* – although bear market showed limitations
  - "Sectoral investment" and indexation becoming key strategies therein, *reducing competitive advantage of domestic managers*

Pension fund and EMU (cont)

- Domestic equity mandates fell 60% over 1999-2001, and domestic bond mandates by 92%.
- In 1999-2000 41 of top asset managers operated in 5 or more countries, in 1996 17

- Banks’ profits
  - Continuing squeeze on profitability of banks in many EU countries, with narrowing interest margins, linked inter alia to competition from institutional saving, leading to *downward pressure on fees*

Pension funds and EMU (cont)

- Trading activity
  - Privatisation, mergers and prospective mergers of bourses, with growth of alternative trading systems, due to “footloose” nature of pension funds and other institutional investors’ trading seeking *lower commissions and improved liquidity*
- Corporate governance
  - Massive growth in merger activity in Continental Europe (Mannesmann, Olivetti, Soc Gen-Paribas) where pension funds are major players
  - Direct corporate governance pressures on Continental firms (performance, shareholder rights, management structure)

Pension funds and EMU (cont)

  - Universal banks such as Deutsche Bank shifting to investment bank and asset management focus, and disposing of equity holdings
  - *Overall benefit to pension funds in terms of orientation of firms to shareholder value, where my research suggests that growth of institutional investors' share of equity leads to higher dividends and productivity and lower (low return?) fixed investment*
- Book-reserve funding in decline
  - firms seek to shift to external funding, owing to pressure on credit ratings, and facilitated by German tax reform. Particular issue of S and P judging unfunded liabilities to be debt

Pension funds and EMU (cont)

- Meanwhile strong effect on EU financial markets (e.g. in corporate governance) generated by US funds, whose foreign assets are $800 bn
- Given ageing of the population, the effects set out above can only intensify in the future, subject to progress of pension reforms and an appropriate regulatory framework

Convergence of EU financial structure on the US?

% of GDP	**Equities**	**Government bonds**	**Private bonds**	**Bank assets**	**Total**	**Institutional investors**
E.U.-15	62	40	24	–134	–14	71
E.U.-11	82	41	26	–133	0	86
Belgium	69	–17	6	–253	–201	87
Denmark	75	27	–43	–36	18	78
Germany	88	57	14	–127	19	99
Greece	95	6	60	–12	143	N.A.
Spain	80	53	53	–99	57	107
France	80	51	24	–132	16	70
Ireland	63	53	57	–156	13	N.A.
Italy	93	–23	23	–96	4	125
Luxembourg	–64	90	–1	–3552	–3566	–1797
Netherlands	14	40	42	–131	–45	–13
Austria	102	61	27	–160	17	110
Portugal	89	45	40	–139	38	111
Finland	64	50	28	–37	98	95
Sweden	20	36	–5	–32	–1	29
United Kingdom	–29	60	42	–180	–111	–17

EU financial markets and pensions systems during ageing

- Ageing – which is most acute in Europe - will generate sharp changes in quantities and prices in financial markets
- Effects can be traced for the “general case” of ageing, for countries where pay-as-you remains dominant and where funding is introduced
- No system is likely to be unscathed, but issues far more serious for pay-as-you-go. Hence this section indicates dangers for countries unwilling to reform

General case of ageing

- Fall in economic growth and rise in capital-labour ratio as labour force shrinks, putting returns on capital under downward pressure
- If saving initially rises – possible external surplus and loss of competitiveness with currency appreciation, aggravated by home bias due to uncertainty on part of pension funds
- May generate excess liquidity and loose macro policies (structural mistaken for cyclical) – generating financial bubble (cf Japan)
- Later balance of payments deficits – currency crises accompanying banking crises
- Spillovers to EMEs

Risks in pay-as-you-go

- Trace extreme case of no-reform
- Case of tax finance
  - major economic difficulties - decline in inward investment, slower economic growth and growing evasion of contributions as tax rates rise
  - ultimately capital and labour would leave country
  - generating credit losses and falls in asset prices, which are unlikely to be accurately anticipated
- Case of bond finance
  - sharp rise in long term interest rates, loss of credit rating, crowding-out, recession
  - Hence major credit losses for lenders (most past fiscal crises were with unliberalised banking systems)

Risks in pay-as-you-go (cont)

  - Government's ability to recapitalise banks declines
  - Ultimately fiscal-solvency crises, which could be contagious, "snowball" and temptation to monetise – hitting holders of non-indexed bonds (and threat to EMU)
- Precautionary saving
  - Likely to increase as confidence in social security declines
  - If directed to banks, may lead to underpricing of risk in domestic credit or international interbank markets
  - Life insurers could invest in high yield bonds, property, vulnerable to credit cycle

Risks arising from institutional investors

- Financial structure with sizeable institutional sector should have strong stabilising properties:
  - Accuracy of asset pricing
  - Liquidity
  - Transparency/marking to market
  - Distance from safety net
  - “Multiple avenues of intermediation”

Institutional investors (cont)

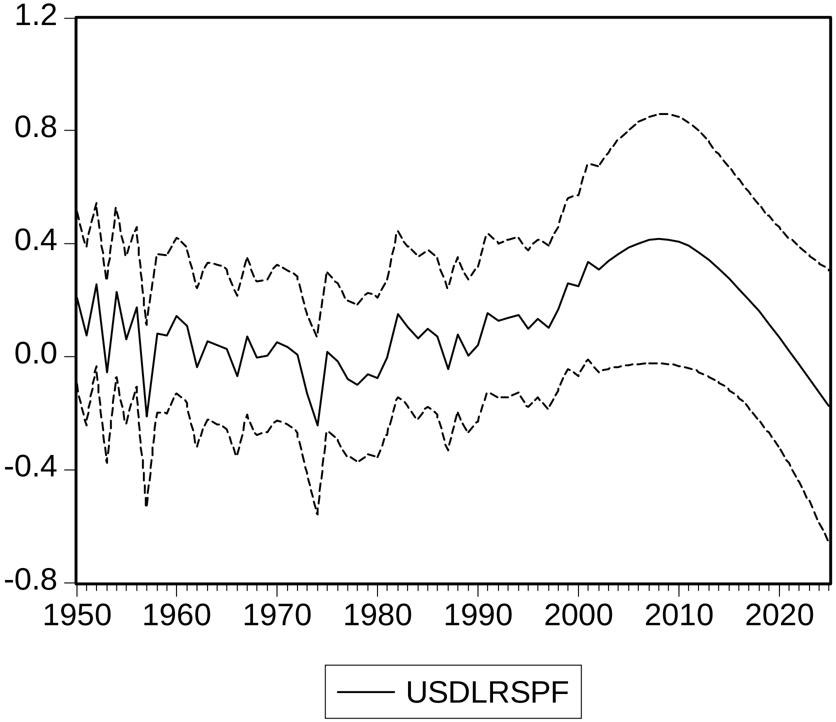
- But some unfamiliar risks arise about which both asset managers and regulators need to learn:
  - Extreme price volatility after a shift in expectations and asset allocations
  - Protracted collapse of market liquidity and issuance after similar portfolio shifts
- Threat to EMEs, banks and non financial sector…
- …and possibly to institutions themselves given e.g. exposure to credit risk in real estate cycles

Risks from asset accumulation during funding

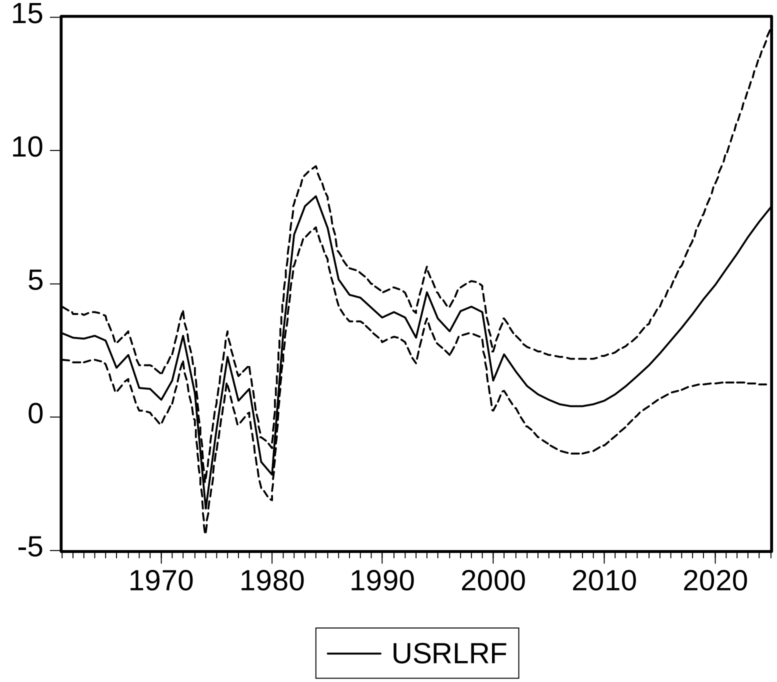
- Possible effects of institutional flows on equity market in 1990s
- Bubbles in debt and property feasible
- Vulnerability of EMEs to institutional flows
- Falls in asset prices during ageing (see charts):
  - Lower real returns on capital
  - Switch from equities to bonds
  - Lower saving (“baby bust”) affecting real interest rates or risk premium, ultimately raising bond yields as well as cutting share prices

Expected asset prices

Projected US real equity prices



Projected US real bond yields



Conclusions

- Major reform effort still needed at national level – and also regulatory reforms needed at EU level to facilitate funding
- Pension fund growth still focused on subset of countries
- Pension fund growth and EMU having major effect on EU markets, in virtuous circle
- Upcoming financial risks linked to ageing underline need to scale down pay-as-you-go, but be conscious of risks to funding
- It is underlined that reforms should hence focus on creating a diversified system.

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