

Pension Savings: The Real Return

2014 Edition



A Research Report by

BETTER FINANCE for all

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Private Pensions: The Real Returns

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Foreword

One can supervise only what one can measure:

Why is this pension savings performance report (unfortunately) unique?

The worst European retail services market

Investment and private pension products are persistently the worst performing retail services market of all throughout the European Union according to the European Commission's consumer scorecards¹.

The Commission also points out that "*other reasons for not saving long-term are the often poor performance of financial intermediaries to deliver reasonable return and costs of intermediation*"².

Pension savings also appears to be one of the few retail services where neither the customers nor the public supervisors are properly informed about the real net performance for customers of the services rendered. These features of the pension savings markets may well be connected of course.

The actual performance of this market is unknown to clients and to regulators

Indeed, apart from the 2012 OECD (the Organisation for Economic Co-operation and Development) publication of the real return of certain "pension funds"³, the contributors to this research report could not find any other more complete or more recent published comprehensive series of net real pension savings returns for EU countries. Even the recent report produced for the European Commission on

¹ ec.europa.eu/consumers/consumer_research/editions/docs/8th_edition_scoreboard_en.pdf.

² European Commission - Staff Working Document on long term financing of the EU economy (2013).

³ <http://www.oecd.org/finance/private-pensions/oecd-pensions-outlook-2012.htm>.

“the position of savers in private pension products”⁴ relies only on the above-mentioned OECD report as far as returns and performance are concerned.

Moreover, as analysed in the first edition of Better Finance’s research on the real return of pension savings, the extremely useful data reported by OECD are unfortunately quite incomplete:

- Certain EU countries are missing, including France and other Eastern European Member States,
- Probably a large part – if not most – of personal pension products are missing as well,
- It is doubtful whether OECD could capture all expenses borne by pension savers, entry fees for example, because OECD relies mostly on national authorities reporting, and typically, this is not something those do capture,
- Finally, OECD figures are all before tax only.

This means the European financial supervisors – the European Commission and the European financial supervision authorities (Securities & Markets, Insurance and Pensions, and Banking) – do not know the actual performance of the services they are supposed to regulate and supervise.

The failure of European supervisors to report “consumer” performance data

The European Supervisory Authorities (ESAs) have a legal duty to collect, analyse and report data on “consumer trends” in their respective field (article 9(1) of the European Regulations establishing the three ESAs).

To our knowledge, neither the Banking⁵ nor the Insurance and Pensions⁶ ones provide any reporting on the performance of the retail savings products in their field of competence (respectively bank savings products, and life insurance and pension saving products). The Securities & Markets one does include “retail investor” performance data in its “Trends, Risks and Vulnerabilities” report⁷, but

⁴ Study on the position of savers in private pension products – prepared for the DG Internal Market of the European Commission and the Financial Services User Group (published in August 2013).

⁵ EBA – EBA Consumer Trends Report 2014.

⁶ EIOPA – Consumer Trends Report – 15 December 2013.

⁷ ESMA – Trends, Risks, Vulnerabilities Report Nr. 1, March 2014.





these data actually regard capital market performance data: the 5 year average monthly returns on a portfolio composed of:

- 47% stocks (Stoxx600),
- 42% deposits (1Y Euribor),
- and 11% bonds (Barclays Euro Aggregate 7-10Y).

Such a portfolio has unfortunately little in common with the retail investors' average portfolio, which – according to ESMA (the European Securities and Markets Authority) itself in the next page of its Report – is composed of:

- 35% deposits (but for the vast majority certainly not returning the one year “interbank” rate [Euribor] and not even benchmarked to it),
- 32% insurance and pension funds,
- 17% stocks,
- 7% mutual funds,
- and 5% bonds.

Performance: capital markets are not a proxy for retail investments

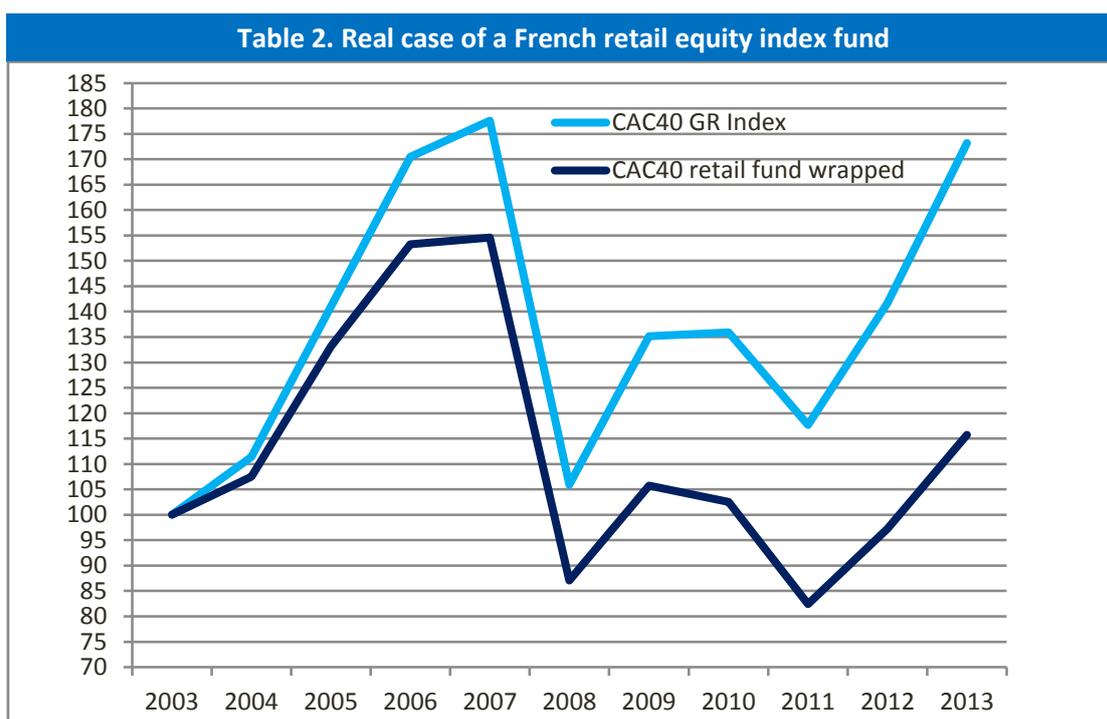
Our experience and findings clearly confirm that capital market performances have unfortunately very little to do with the performances of the actual savings products distributed to the EU citizens. And this is particularly true for long term and pension savings. The main reason is indeed that most EU citizens do not invest the majority of their savings into capital market products (such as equities and bonds), but into “packaged products” (such as investment funds, life insurance contracts and pension savings products).

One could then argue that insurance and pension products have similar returns to a mixed portfolio of equities and bonds, as those are indeed the main underlying components investments of insurance and pension “packaged” products. This is nothing else than a “leap of faith” ignoring such realities as the fees and commissions charged on retail products, portfolio turnover rates, manager’s risks, etc. Charges alone totally invalidate this theory.

The tables below show two striking – but unfortunately not uncommon – real examples of this largely ignored reality: capital market performance is not a valid proxy for retail investment performance, and a key reason is the fees and

commissions charged directly or indirectly to customers. The European Commission itself publicly acknowledges this reality (see footnote² above).

Table 1. Real case of a Belgian occupational pension fund	
Capital markets vs. Belgian occupational pension fund 2000-2012 performance	
Capital markets (benchmark index*) performance	
Nominal performance	+48%
Real performance (before tax)	+11%
Pension fund performance (same benchmark)	
Nominal performance	+10%
Real performance (before tax)	- 25%
* 50% Equity / 50% bonds (MSCI World equity index and JPM Euro Bond Index)	
Sources: Better Finance, provider	



Source: Better Finance research

In that case, a retail so called “index” fund actually under-performed the relevant equity index by 5700 basis points after ten years (+16% instead of +73% for the benchmark), the performance gap all attributable to fees.





The approach inappropriately chosen by ESMA to use capital market returns as a proxy for retail investment ones is unfortunately widespread in available public research. This is for example the case of the latest research report published by the European Commission on this topic (see footnote⁴ above).

Unfortunately, it is not by chance that the European regulator required the Supervisory Authorities to collect, analyse and report on European savers “trends”. We learn in business schools that one can manage and supervise only what one can measure. And one major legal responsibility assigned to the European supervisory authorities is to *“take a leading role in promoting transparency, simplicity and fairness in the market for consumer financial products or services across the internal market, including by... collecting, analysing and reporting on consumer trends...”*

A customer-based approach to pension savings returns

This is the ambition and challenge of this research initiated by Better Finance and its partners: to collect, analyse and report on the actual past performance of pension savings products for the customer.

Our first report in 2013 established the methodology that is also used for this 2014 much expanded edition, now covering 75% of the EU population.

The net real return of pension saving products should be:

- the long-term return (at least ten years and at least covering two full economic and financial cycles, as even long-term returns are very sensitive to the entry and exit dates);
- net of all fees, commissions and charges borne directly or indirectly by the customer;
- net of taxes borne by the customer (in the USA, it has been mandatory for decades to disclose the past performance of mutual funds after tax in the summary of the prospectus);
- net of inflation (as, for long term products, only the real return matters; that is the right approach taken by OECD as mentioned above).

The following general report and country reports show that this is not an impossible but a very challenging task for an independent expert centre such as Better Finance, as quite a lot of data are simply not available at an aggregate and country level,

especially for earlier years. The complexity of pension savings taxation in EU countries makes it also extremely difficult to compute after tax returns. So much for the *“transparency, simplicity and fairness in the market for consumer financial products”* engraved in EU Law.





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Executive Summary

As stated by the European Commission in a 2013 staff working document, “*the crisis has increased savers’ distrust in financial institutions and markets*”⁸. Similarly, the latest EU Consumer Markets Scorecard⁹ again ranks pensions and investments as the worst consumer markets of all.

The present report documents a potential component of such distrust, namely the poor performance of private pension products, when inflation, charges and taxes are deducted from nominal returns. It extends the geographical coverage of an initial research by Better Finance entitled “*Private Pensions: the Real Return*” published in June 2013. Belgium, Germany, Italy, Poland and the United Kingdom were added to the initial group composed of Spain, France and Denmark. It also extends the period of time covered in order to measure performance from 2000 to 2013, as far as data was available. Thus, the Better Finance research now covers 75% of the EU population.

The countries under review can be divided into three categories:

- countries like Denmark and the United Kingdom at one end, where pension funds and life insurance assets represent far more than the annual GDP (Gross Domestic Product) and where the real returns of private pensions is of crucial importance;
- at the opposite end, countries like Italy and Spain, where pensions mainly depend on the quality and sustainability of pay-as-you-go (PAYG) schemes;
- and the other countries in an intermediate position, where the standard of life of retirees depends both on the sustainability of pay-as-you-go systems and the returns of private savings.

⁸Commission Staff Working Document “Long-Term Financing of the European Economy” accompanying the Green Paper on Long Investment, European Commission, 25 March 2013, page 10. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2013:0076:FIN:EN:PDF>.

⁹http://ec.europa.eu/consumers/consumer_evidence/consumer_scoreboards/10_edition/docs/cms_10_factsheet_en.pdf.

Inflation has declined in recent years in a majority of countries, thus reducing the gap between nominal and real performance. The main differences in net real returns across countries are partially caused by the asset mix of pension products, by the performance of investment markets, by the asset managers' skills in terms of stock picking and market timing. However, net real returns of private pensions are most affected and influenced by asset managers and other intermediaries as well as, ultimately, the tax burden.

There are striking differences between pension funds' asset allocation across countries. Mutual funds are the main component of investments in Belgium and in Germany. This is also the case for the United Kingdom, although to a lesser extent, where mutual funds tend to replace direct holdings of shares, whose weight fell from 57% to 21% between 2001 and 2012. Conversely, the preponderance of corporate securities in Denmark explains the good performance of pension products in this country. Bonds dominate in Poland, Spain and Italy, chiefly consisting of government bonds in Italy and Spain, while in Poland there is a balance between government and corporate bonds that has pushed returns upwards. Overall, the period 2001-2012 shows a decline of equities and an increase of public debt in pension funds allocation, a trend that is unfavourable to savers because it diminishes return prospects.

As far as market performances are concerned, all equity indices had recovered their pre-crisis level by the end of 2013, but the real return over a 14-years period, from the end of 2000 to the end of 2013, was still negative in Belgium, France, Italy, Spain and the United Kingdom. We have chosen the 14 years period because it includes two market upturns and two downturns (post dot com bubble and the 2008 financial crisis), on which we base our analysis in as far as data are available. The choice of the time reference actually has a very material impact on real returns: in order to keep our research objective, we paid special attention to our choice of period to cover.

The decrease in government bonds interest rates since 2012 had a positive impact on outstanding assets, especially in countries where this asset class dominates, but it reduces the capacity to offer a good remuneration on new investment flows.

Charges substantially reduce performances of pension products, especially personal "packaged" pension products. Charges are often complex, opaque and far from being harmonised for different pension providers.



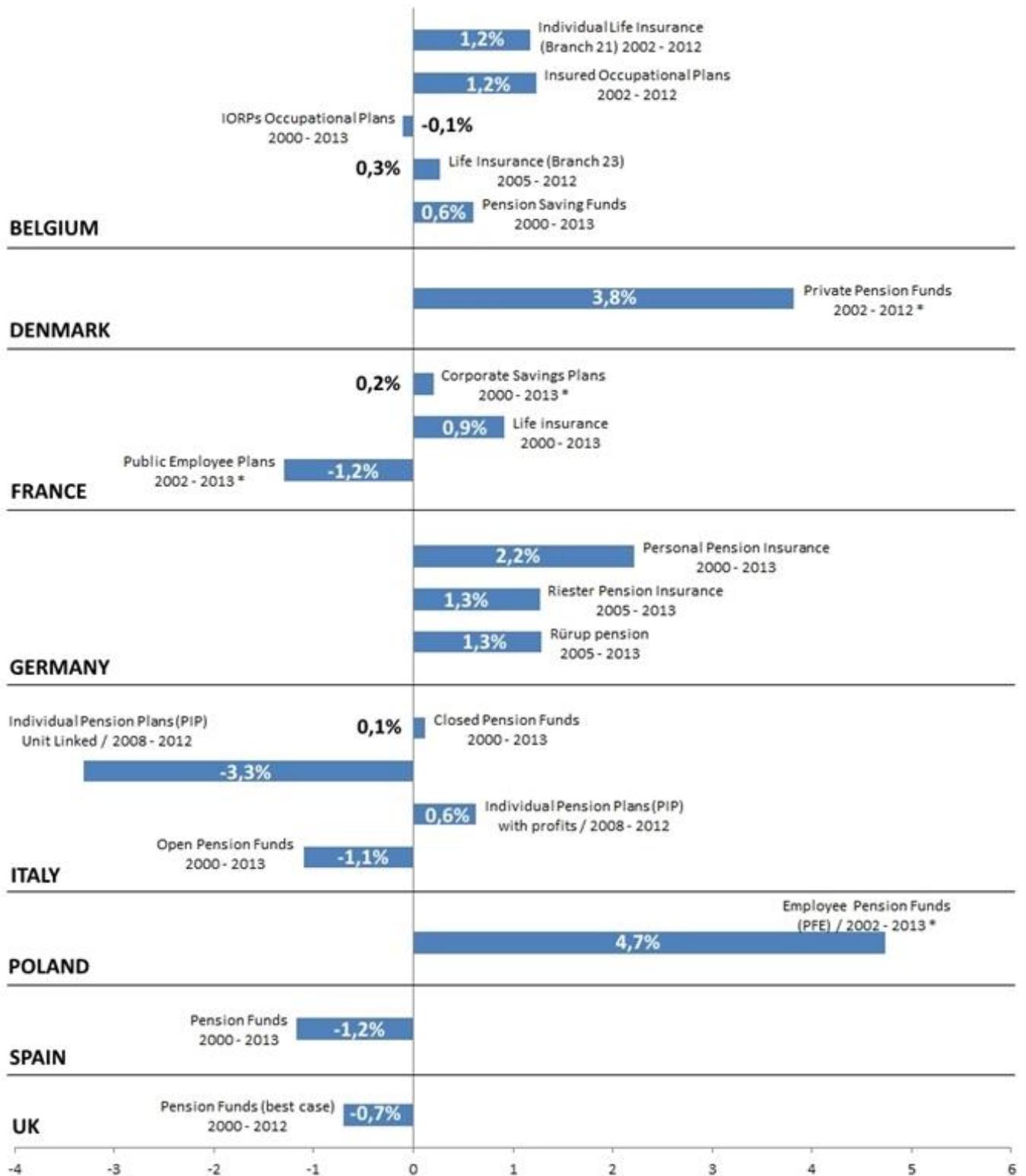


Finally, taxes reduce the performance of investment. The general model applied to pension products is deferred taxation, with contributions being deducted from the taxable income while pensions are taxed. The accumulated capital can be withdrawn at least partially at retirement as a lump sum, which is often not taxable. Our calculations of net returns are based on the most favourable case, i.e. assuming that the saver withdraws the maximum lump sum possible.

The average yearly real returns after charges and taxation of pension funds have exceeded 4.7% in Denmark over the period 2002-2012 and in Poland over the period 2002-2013. Conversely we found negative returns in Belgium (Pension funds – IORP 2000-2013), in France (unit-linked life insurance contracts 2000-2013), in Italy (Open funds 2003-2012 and PIP II 2008-2012), in Spain (unit-linked 2000-2013) and in the United Kingdom (2000-2012). Indeed, these negative returns have led public authorities in some Member States to take measures in order to add transparency and to limit the fees charged by pension providers. The issue is crucial, especially in countries like the United Kingdom where the standard of life of retirees depends heavily on pre-funded pension schemes.

Annualised real net returns of pension savings

After charges, inflation and tax (except * = before tax)





Private Pensions: The Real Returns

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General Report

Introduction

In June 2013, Better Finance published a research report entitled: “*Private Pensions: The Real Return*”. This study evaluates the real return of private pension products after charges, after inflation (“real” returns) and – whenever possible – after taxation; and identifies the contributing factors for these returns in Denmark, France and Spain. Moreover, the study includes an in-depth description of the pension saving vehicles available in each country and the charges and taxes that apply to them.

The study showed that real returns of savings for retirement in Denmark, France and Spain had been very low over the 10-year period from 2002 to 2011 when charges, inflation and taxes are taken into account. Measuring all elements (inflation, charges and taxes) reducing investment performances is especially important when interest rates are low and equity trends uncertain because the real return for savers can be substantially negative.

In order to get a more complete picture of the pension return experience across the EU, the present study aims at:

- Updating the initial study of Better Finance with data relating to the years 2012 and 2013 when available at the time of print;
- Expanding the number of EU Member States covered by the research methodology developed in the initial report. New countries studied include Belgium, Germany, Italy, Poland and the United Kingdom.

Thus, the Better Finance pension savings research now covers 75 % of the EU population.

The comparison of the effectiveness of national private pension systems is even more important now that the European Commission has:

- issued a proposal to amend the Occupational Pensions Directive including enhancements of disclosures to pension participants¹⁰,
- and decided “to start a new project to develop the Single Market for Personal Pensions”¹¹. The present study may help to define the best model to be generalised and applied to the whole EU.

Country profiles

Table 3 includes some key characteristics of the pension systems in the covered countries.

A useful indicator of the pressure on pension systems is the old-age-dependency ratio, defined as the ratio between the total number of elderly persons of an age when they are generally economically inactive (aged 65 and over) and the number of persons of working age¹². This ratio is low in Spain (13%) and Poland (19%). It is the highest, around 31%, in Italy and Germany. This means that the pressure on the pay-as-you-go system is at the maximum level in these two countries. Belgium, the United Kingdom, France and Denmark are in intermediate positions, with ratios of around 25%.

Pension schemes, life insurance contracts and pay-as-you-go systems combine differently in each country to build the overall income of retirees¹³. The replacement rates for median earners are the highest in Denmark (95%), Spain (85%) and Italy (76%) and this output mainly results from the pre-funded pension schemes and life insurance reserves in the first of these three countries and from the public pension system in the two other countries.

The net equity of households in pension funds reserves ranges from a minimum of 4% in Belgium to a maximum of 138% in the United Kingdom. With the exception of

¹⁰ <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014PC0167>.

¹¹ EIOPA, Towards an EU-single market for personal pensions, an EIOPA Preliminary to COM », EIOPA-BoS-14/029, 2014.

¹² Eurostat definition.

¹³ Looking only at financial sources of pension income; property-related income is not in the scope of this study.





the United Kingdom and Denmark (61%), this ratio is inferior to 25% in all countries. This reflects that only those two countries have been building pre-funded pension schemes for a long time, whereas other countries have widely relied on a publicly-managed pay-as-you-go scheme.

However, one should also take into account a second indicator to have a correct perception of savings accumulated for retirement: the ratio of the net equity of households in life insurance reserves as a percentage of GDP. Indeed, many pension arrangements are organised in the legal framework of life insurance contracts, both in the pillar 2 (occupational and company schemes) and pillar 3 (individual private contracts) of the pension systems. Hence, the net equity of households in life insurance reserves represents 59% of GDP in Belgium, 49% in the UK, 65% in France and 76% in Denmark.

Moreover, in countries like France, life insurance is widely used by households as a means to obtain additional resources at retirement age, even though most products offered by insurance companies are not specifically designed for retirement, i.e. subscribers can withdraw their savings at any moment even when they are not retired. It is not possible to know ex-ante which percentage of life insurance contracts will actually be used during the retirement period, but many polls confirm that this objective is a major motivation for subscribing to a life insurance contract.

The weight of life insurance is smaller in Germany (36%), Italy (27%), Spain (13%) and Poland (5%).

Overall, countries under review can be divided into three categories:

- In a first group of countries the sum of pension and life insurance assets (and liabilities) represents huge amounts, equivalent to 187% in the United Kingdom at the end of 2012 and 137% in Denmark. In these countries, the issue of the real returns of private pensions is a crucial one for future retirees, especially for those who are members of defined contribution schemes.
- In a grouping at the other end, citizens have little pre-funded assets available for retirement. The sum of life insurance contracts and pension funds' assets represented 23% of the GDP in Poland and 24% in Spain at the end of 2012. In these countries, citizens will predominantly depend on the quality and sustainability of arrangements within the framework of pay-as-you-go systems.

- The third group of countries is in an intermediate position. Pension funds and life insurance contracts represent 72% of GDP in France, 63 % in Belgium, 61% in Germany and 42% in Italy. In these countries, citizens depend equally on the sustainability of pay-as-you-go systems and on the returns of pension savings. Governments focus on strengthening the Public Pension System (as is the case in Italy) and/or on the rise of savings in private pension products (as is the case in Germany). However, when private pension products deliver poor benefits, the legitimacy of such efforts is questioned in the public debate. Controversy about “*Riester*” products illustrates this risk.

A limitation of the present report is that it does not take into account housing as an asset for retirement. The proportion of households owning their residences varies greatly from one country to another. For example, it is especially low in Germany, where a majority of households rent their residences. In this country, the stake of the returns of pension savings is all the more important since a majority of retirees cannot rely on their home-ownership to ensure a decent minimum standard of life.

However, home-ownership is not necessarily the best asset for retirement: indeed it is an illiquid asset and it often does not fit the needs of the elder in the absence of a broad use of reverse mortgages. The house might become too large or unsuitable in case of dependency. In that case, financial assets might be preferable, under the condition that they provide a good performance.

Table 3. Country profiles (at the end of 2012)

Belgium			
Net equity of households in pension funds reserves	€15.1bn	Net equity of households in pension funds reserves as % of GDP	4.0%
Net equity of households in life insurance reserves	€222.1bn	Net equity of households in life insurance reserves as % of GDP	59.1%
Working population	4.9m	Elderly dependency ratio	26.0%
Net pension replacement rates: median earners			66.0%
Net Pension replacement rate from Public Pension Systems for average earners, 2011			52.1%
Denmark			
Net equity of households in pension funds reserves	€150.4bn	Net equity of households in pension funds reserves as % of GDP	61.3%





Net equity of households in life insurance reserves	€186.7bn	Net equity of households in life insurance reserves as % of GDP	76.1%
Working population	2.9m	Elderly dependency ratio	25.5%
Net pension replacement rates: median earners			94.5%
Net Pension replacement rate from Public Pension Systems for average earners, 2011			32.6%

France			
Net equity of households in pension funds reserves	€163bn	Net equity of households in pension funds reserves as % of GDP	8.0%
Net equity of households in life insurance reserves	€1.306.1bn	Net equity of households in life insurance reserves as % of GDP	64.3%
Working population	28.8m	Elderly dependency ratio	25.9%
Net pension replacement rates: median earners			60.8%
Net Pension replacement rate from Public Pension Systems for average earners, 2011			60.4%

Germany*			
Pension assets	€665.4bn	Pension assets as % of GDP	25.0%
Life insurance assets	€958bn	Life insurance assets as % of GDP	35.9%
Working population	42.4m	Elderly dependency ratio	31.6%
Net pension replacement rates: median earners			58.4%
Net Pension Replacement Rates from Public Pension Systems for average earners, 2011			56.0%

Italy			
Net equity of households in pension funds reserves	€227.7bn	Net equity of households in pension funds reserves as % of GDP	14.5%
Net equity of households in life insurance reserves	€958bn	Net equity of households in life insurance reserves as % of GDP	27.3%
Working population	42.4m	Elderly dependency ratio	30.9%
Net pension replacement rates: median earners			76.2%
Net Pension replacement rate from Public Pension Systems for average earners, 2011			71.7%

Poland			
Net equity of households in pension funds reserves	€68.7bn	Net equity of households in pension funds reserves as % of GDP	18.0%
Net equity of households in life insurance reserves	€18.2bn	Net equity of households in life insurance reserves as % of GDP	4.8%
Working population	17.3m	Elderly dependency ratio	18.9%

Net pension replacement rates: median earners		68.2%
Net Pension replacement rate from Public Pension Systems for average earners, 2011		33.2%

Spain			
Net equity of households in pension funds reserves	€109.2bn	Net equity of households in pension funds reserves as % of GDP	10.6%
Net equity of households in life insurance reserves	€134bn	Net equity of households in life insurance reserves as % of GDP	13.0%
Working population	23.1m	Elderly dependency ratio	25.2%
Net pension replacement rates: median earners			84.5%
Net Pension replacement rate from Public Pension Systems for average earners, 2011			84.9%

United Kingdom**			
Pension assets, 2011	€2.450bn	Pension assets as % of GDP	138.3%
Life insurance assets, 2011	€858.4bn	Life insurance assets as % of GDP	48.5%
Working population	31.9m	Elderly dependency ratio	25.2%
Net pension replacement rates: median earners			58.4%
Net Pension replacement rate from Public Pension Systems for average earners, 2011			37.4%

* For Germany, the life insurance assets correspond to the total assets held by life insurance corporations. The pension assets are the sum of assets held by pension funds and pension funds reserves of non-financial corporations.

** For UK, the life insurance assets and pension assets correspond respectively to the assets held by life insurance corporations and funded pensions in 2011.

Source: OECD, Eurostat and ONS





Return attribution

Inflation

The countries newly covered by the present study experienced varying inflation profiles in the last ten years.

Over the observed period, Poland showed the highest average inflation rate, translating into a large negative impact on real returns of savings.

Average price inflation was considerably lower in Germany with an especially sharp decrease in 2009 where the inflation rate dropped to almost zero. This was in accordance with the low rates witnessed in all other countries except for Poland and the United Kingdom.

In the United Kingdom, inflation reached a maximum of 4.5% in 2011, before returning to the European average in 2012 and diverging again in 2013 as the sharp decline observed in the Euro area did not happen in the UK. During the entire period, the levy on the returns of pension savings has been strong.

Belgium and Italy showed similar trends over the same period, with historical lows in 2009, then a sharp increase in 2011 and convergence with other countries in 2012 and 2013.

In total, inflation rates somewhat decreased in a majority of countries. There is a debate among economists on the implication of current price trends. Some economists fear that the euro area may fall victim to deflation. They urge political and monetary authorities to take measures to combat the risk of a deepening recession. Other economists and most Central Banks consider, on the contrary, that the current price moderation is due to import trends, especially for energy. One should in any case take into account that the low level of interest rates exposes savers to the risk of negative returns if inflation was to rise again.

Table 4. Inflation [in %]

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Belgium	1.5	1.9	2.5	2.3	1.8	4.5	0.0	2.3	3.4	2.6	1.2
Denmark	2.0	0.9	1.7	1.9	1.7	3.6	1.1	2.2	2.7	2.4	0.4
France	2.2	2.3	1.9	1.9	1.6	3.2	0.1	1.7	2.3	2.2	1.0
Germany	1.0	1.8	1.9	1.8	2.3	2.8	0.2	1.2	2.5	2.1	1.6
Italy	2.8	2.3	2.2	2.2	2.0	3.5	0.8	1.6	2.9	3.3	1.3
Poland	0.7	3.6	2.2	1.3	2.6	4.2	4.0	2.7	3.9	3.7	0.8
Spain	3.1	3.1	3.4	3.6	2.8	4.1	<u>-0.2</u>	2.0	3.1	2.4	1.5
United Kingdom	1.4	1.3	2.1	2.3	2.3	3.6	2.2	3.3	4.5	2.8	2.6

Source: Eurostat (HICP)

The decline of inflation is correlated with a reduction in public sector deficits in all countries, and even a surplus in Germany.

However, the outstanding level of public debt is still high and above the theoretical 60% ceiling of the Maastricht Treaty in all countries except Poland with the maximum being recorded in Italy. Since savings are also decreasing rapidly in the latter country, there is a risk that its deficit would be covered by monetary creation and price inflation.

Table 5. Public sector deficit and debt¹⁴ [in %]

	Public Sector Deficit as a % of GDP		Public Debt as a % of GDP	
	2009	2012	2009	2012
	EU (27)	<u>-6.9</u>	<u>-3.9</u>	96.6
Belgium	<u>-5.6</u>	<u>-4.0</u>	74.6	81.0
Denmark	<u>-2.7</u>	<u>-3.8</u>	40.7	45.4
France	<u>-7.5</u>	<u>-4.9</u>	79.2	90.6
Germany	<u>-3.1</u>	0.1	74.6	81.0
Italy	<u>-5.5</u>	<u>-3.0</u>	116.4	127.0
Poland	<u>-7.5</u>	<u>-3.9</u>	50.9	55.6
Spain	<u>-11.1</u>	<u>-10.6</u>	54.0	86.0
United Kingdom	<u>-11.4</u>	<u>-6.1</u>	67.1	88.6

Source: Eurostat

¹⁴ Central Government gross debt, so-called "Maastricht debt".





Asset Mix

There are striking differences between pension funds' asset allocations across European countries.

In Belgium, mutual funds represent the main component of investments (71% in 2012). However, this figure provides very little information on the type of exposure of pension funds, as the composition of the portfolio of investment funds held by pension funds is unknown. Moreover, mutual funds are one of the modalities of delegated portfolio management, the other being the mandate given to professional portfolio managers.

The specificity of Denmark is the predominance of corporate securities, both shares and bonds. Public bonds are marginal, because public deficits are small, as explained in the initial study. However, in 2012 the relative weight of public bonds doubled from 24% in 2007 to 49%.

In Germany, mutual funds have become the predominant share of pension funds' assets. An additional feature of German pension funds is the importance of loans in their assets. Most of these loans are attributed to employees in companies.

In Italy, public bonds and bills represent almost half of the pension funds' assets. Households are traditionally strong investors in Italian government bonds, but they have progressively diminished their exposure to these types of products and institutional investors, pension funds among others, have been compensating for their withdrawal.

In Poland, public debt accounted for 66% of the assets, but their weight decreased and in 2012 their share was equal (44%) to the share of corporate securities.

In Spain, the weight of public debt increased sharply after the financial crisis, from 28% of assets in 2007 to 40% in 2012. This trend is mirrored by the decrease of corporate bonds and shares in the portfolios.

The United Kingdom is traditionally the country where shares are the major asset allocation of pension funds. It decreased from 57% to 21% between 2001 and 2012, but this trend is offset by a growing recourse to investment funds, which might have simply replaced mandates as a legal framework for outsourced portfolio management.

Overall, the period 2001-2012 shows a decline of equities and an increase of public debt in pension funds' asset allocation. These phenomena are partially due to unrealised capital losses on the equity portfolio and partly due to a re-allocation of assets. This trend is unfavourable to pension savers because it decreased the perspective of returns. However, the good performance of equity markets in 2013 compared to bonds and the end of the sovereign debt crisis recently led numerous asset managers to re-allocate a higher proportion of their investments to equities, especially Euro area equities.

Table 6. Pension funds ¹⁵ asset allocation, excluding unallocated contracts [in % of total assets]							
		Cash & Deposits	Bills & Bonds	Equities	Mutual Funds	Other Investment	Total
Belgium	2001	3.8	15.5	17.7	55.1	7.9	100
	2007	2.5	7.6	9.3	75.5	5.1	100
	2012	3.0	11.4	8.2	71.4	6.0	100
Denmark	2001	0.3	47.1	39.7	10.0	2.9	100
	2007	0.3	50.8	30.7	11.6	6.6	100
	2012	0.4	66.1	13.0	2.3	18.2	100
Germany	2001	1.6	28.4	39.1	0.0	30.8	100
	2007	2.3	23.5	0.1	38.5	35.6	100
	2012	1.4	35.7	0.2	39.2	23.6	100
Italy	2001	3.8	12.9	17.7	55.1	10.5	100
	2007	2.5	6.4	9.3	75.5	6.4	100
	2012	3.0	9.5	8.2	71.4	7.9	100
Poland	2001	3.8	11.9	17.7	55.1	11.5	100
	2007	2.5	5.8	9.3	75.5	6.9	100
	2012	3.0	8.8	8.2	71.4	8.6	100
Spain	2001	4.7	58.1	19.6	4.3	13.3	100
	2007	5.6	59.6	17.4	8.5	8.9	100
	2012	14.6	55.7	9.1	9.7	11.0	100
United Kingdom	2001	2.6	19.2	53.8	11.4	13.1	100
	2007	2.9	21.9	29.6	23.3	22.3	100
	2012	na	26.8	21.3	34.4	17.6	100

Source: OECD Global Pension Statistics, UK Office of National Statistics (United Kingdom, 2012)

¹⁵ According to the OECD official definition of pension funds. For more information please go to "Private Pensions: OECD Classification and Glossary", available at www.oecd.org/daf/pensions.





Asset performance

Equity markets

European equity markets recovered in 2012 and 2013. The MSCI total return index, “*Developed Europe*”, rose by 17.3% (2012) and 19.8% (2013) in nominal terms and 14.3% (2012) and 18% (2013) in real terms (after -10.8% in 2011), as seen below in Table 7. In 2012, real returns turned positive on all country markets composing the MSCI index except the Spanish one (-1%) which eventually turned positive in 2013 (23.8%). By the end of 2013 all indices had recovered their pre-crisis level (2000), however, the real average annual return of equity investments over a 14-year period, from the end of 2000 to the end of 2013, was still negative in Belgium, France, Italy, Spain and the United Kingdom. The German market neither gained nor lost in real terms while Denmark (5.9%) and Poland (1.5%) showed positive results. This 14-year period reference includes two market upturns and two downturns. The choice of the time reference actually has a very material impact on real returns, even a relatively long term one. Ideally, one should look at the average length (or duration) of an individual’s pension savings, which is most probably longer than 14 years.

Looking at 2013 only, the best performers were the Spanish exchange (+23.8% in real terms) and the German one (+23.7%) followed by the Belgian one (+20.7%), the French one (+19.7%) and the Danish one (+19.3%). Italy and the United Kingdom lagged behind (+13.8% and +12.6% respectively) while the Polish exchange was even negative (-2.6%).

Over the 14-year period, the worst performance was recorded on the Milan-based Italian stock exchange with a real annual average return of -4.6%. The Italian stock exchange suffered from the predominant weight of the financial sector in the total market capitalisation. The Belgium exchange also performed poorly (-1.6% per year on average) because this concentrated market went through the sharpest decline in 2008 (-66.3% in real terms). The best performance was recorded in Denmark, with an exceptional real annual average return of 5.9% which does not seem sustainable, given the growth rate of the real economy.

Table 7. Historical Real Returns Equity Markets 2000-2013, yearly average

Developed Europe*	Belgium	Denmark	France	Germany	Italy	Poland	Spain	UK
<u>-1.0%</u>	<u>-1.6%</u>	5.9%	<u>-1.3%</u>	0.0%	<u>-4.6%</u>	1.5%	<u>-0.2%</u>	<u>-0.8%</u>

* MSCI Europe NR Index consists of the following 15 developed market country indices: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

Government Bond markets

In 2012, interest rates on new government bond issues fell sharply in most euro area countries and generated significant unrealised capital gains on the existing holdings of pension funds. The Barclays index of Government Bonds in the euro area rose by 10.9% in nominal terms and 8.3% after deduction of the inflation rate.

The best performance in 2012 was recorded in Italy, where interest rates of 10-year new government bond issues fell from around 7% at the end of 2011 to around 4.5% at the end of 2012, and generated a nominal return of 20.8%, representing a real return of 16.9%. However, this upward trend followed two years of tension with negative returns. Over a 14-year period (from end 2000 to end 2013), the Italian bond market generated a 3% annual average real return. Political uncertainty in 2013 prevented Italy to benefit from a further decrease of interest rates like in Spain despite reassurance from the European Central Bank that any measure would be taken to preserve the euro. The Italian authorities had to wait until the beginning of 2014 to get full confidence from market participants.

The second best performance in 2012 was recorded in Belgium (+13.3% in real terms).

Throughout 2012 and in the early 2013, German and French long-term rates were continuously going down. Over the 14-year period, the real return of the German bond market was among the highest thanks to low inflation (3.4% on average).

Results in the United Kingdom are not synchronised with those of the Euro area: in 2011, an exceptional 16.6% return was recorded, although a higher inflation (4.5%) than in the euro area (2.7%) reduced the real return to 11.6%. On the contrary, in 2012, the interest rates remained stable and the real return was almost zero.

It is important to note that the decrease in interest rates has a positive impact on outstanding assets of pension funds, but it reduces the capability to offer a good remuneration to new investment flows.



Table 8. Historical Equity Market Returns

	Q4 1999	Q4 2000	Q4 2001	Q4 2002	Q4 2003	Q4 2004	Q4 2005	Q4 2006	Q4 2007	Q4 2008	Q4 2009	Q4 2010	Q4 2011	Q4 2012	Q4 2013	Ann/Avg
Developed Europe*	135.77	132.79	112.15	77.67	89.53	100.43	126.63	151.46	155.54	87.65	115.35	128.15	117.79	138.16	165.54	
Total Return (Net)																
%Δ	-2.2%	-15.5%	-30.7%	-30.7%	15.3%	12.2%	26.1%	19.6%	2.7%	-43.6%	31.6%	11.1%	-8.1%	17.3%	19.8%	1.43%
%Δ HICP	3.5%	3.2%	3.2%	2.5%	2.1%	2.3%	2.3%	2.3%	2.4%	3.7%	1.0%	2.1%	3.1%	2.6%	1.5%	2.46%
Real Return	-5.5%	-18.2%	-32.4%	-32.4%	12.8%	9.7%	23.3%	16.9%	0.3%	-45.6%	30.3%	8.8%	-10.8%	14.3%	18.0%	-1.01%
Belgium	100.45	89.17	83.78	60.45	68.06	90.65	113.91	139.24	122.16	43.06	65.71	69.98	64.64	88.83	108.46	
Total Return (Net)																
%Δ	-11.2%	-6.0%	-27.9%	-27.9%	12.6%	33.2%	25.7%	22.2%	-12.3%	-64.7%	52.6%	6.5%	-7.6%	37.4%	22.1%	0.5%
%Δ HICP	2.7%	2.4%	2.4%	1.6%	1.5%	1.9%	2.5%	2.3%	1.8%	4.5%	0.0%	2.3%	3.4%	2.6%	1.2%	2.2%
Real Return	-13.5%	-8.3%	-29.0%	-29.0%	10.9%	30.8%	22.6%	19.5%	-13.8%	-66.3%	52.6%	4.1%	-10.6%	33.9%	20.7%	-1.6%
Denmark	131.28	144.99	130.24	92.80	115.23	139.88	200.69	249.11	282.18	155.64	205.94	287.93	249.89	322.99	387.06	
Total Return (Net)																
%Δ	10.4%	-10.2%	-28.7%	-28.7%	24.2%	21.4%	43.5%	24.1%	13.3%	-44.8%	32.3%	39.8%	-13.2%	29.3%	19.8%	8.0%
%Δ HICP	2.7%	2.3%	2.3%	2.5%	2.0%	0.8%	1.7%	1.8%	1.7%	3.7%	1.0%	2.2%	2.7%	2.4%	0.4%	2.0%
Real Return	7.5%	-12.2%	-30.5%	-30.5%	21.8%	20.4%	41.0%	21.9%	11.4%	-46.8%	31.0%	36.8%	-15.5%	26.3%	19.3%	5.9%
France	151.44	154.71	126.65	84.70	98.81	108.64	137.56	165.48	169.00	100.84	128.80	132.08	113.47	135.52	163.80	
Total Return (Net)																
%Δ	2.2%	-18.1%	-33.1%	-33.1%	16.7%	9.9%	26.6%	20.3%	2.1%	-40.3%	27.7%	2.6%	-14.1%	19.4%	20.9%	0.6%
%Δ HICP	1.8%	1.8%	1.9%	1.9%	2.2%	2.3%	1.9%	1.9%	1.6%	3.2%	0.1%	1.7%	2.3%	2.2%	1.0%	1.9%
Real Return	0.3%	-19.6%	-34.4%	-34.4%	14.2%	7.4%	24.3%	18.0%	0.5%	-42.2%	27.6%	0.8%	-16.0%	16.8%	19.7%	-1.3%
Germany	140.63	126.74	103.72	58.80	80.14	86.39	109.42	133.11	162.32	92.42	112.06	129.96	110.01	141.80	178.23	
Total Return (Net)																
%Δ	-9.9%	-18.2%	-43.3%	-43.3%	36.3%	7.8%	26.7%	21.6%	21.9%	-43.1%	21.3%	16.0%	-15.3%	28.9%	25.7%	1.7%
%Δ HICP	1.4%	1.8%	1.4%	1.4%	1.0%	1.8%	1.9%	1.8%	2.3%	2.8%	0.2%	1.1%	2.5%	2.2%	1.6%	1.7%
Real Return	-11.1%	-19.6%	-44.1%	-44.1%	34.9%	5.9%	24.3%	19.5%	19.3%	-44.6%	21.0%	14.7%	-17.4%	26.2%	23.7%	0.0%
Italy	116.84	123.09	95.27	74.92	85.91	105.61	124.01	146.97	140.59	73.97	90.71	82.45	65.46	72.49	83.53	
Total Return (Net)																
%Δ	5.3%	-22.6%	-21.4%	-21.4%	14.7%	22.9%	17.4%	18.5%	-4.3%	-47.4%	22.6%	-9.1%	-20.6%	10.7%	15.2%	-2.4%
%Δ HICP	2.5%	2.4%	2.6%	2.6%	2.8%	2.2%	2.2%	2.2%	2.1%	3.5%	0.7%	1.7%	2.9%	3.3%	1.3%	2.3%
Real Return	2.7%	-24.4%	-23.4%	-23.4%	11.6%	20.3%	14.8%	16.0%	-6.3%	-49.2%	21.7%	-10.6%	-22.8%	7.3%	13.8%	-4.6%
Poland	100.00	76.28	65.36	73.48	109.83	157.18	195.75	223.32	223.32	106.12	145.47	179.29	129.48	177.52	174.24	
Total Return (Net)																
%Δ	-23.7%	-14.3%	-14.3%	-14.3%	12.4%	49.5%	43.1%	24.5%	14.1%	-52.5%	37.1%	23.2%	-27.8%	37.1%	-1.8%	4.4%
%Δ HICP	5.3%	2.0%	0.7%	0.7%	3.6%	3.6%	2.1%	1.3%	2.6%	4.2%	4.0%	2.7%	3.9%	3.7%	0.8%	2.8%
Real Return	-27.5%	-16.0%	-16.0%	-16.0%	11.6%	44.3%	40.1%	22.9%	11.2%	-54.4%	31.9%	20.1%	-30.5%	32.3%	-2.6%	1.5%
Spain	122.81	110.32	103.11	74.11	97.71	116.90	140.65	187.90	210.07	131.25	182.46	152.30	138.07	140.03	175.94	
Total Return (Net)																
%Δ	-10.2%	-6.5%	-28.1%	-28.1%	31.8%	19.6%	20.3%	33.6%	11.8%	-37.5%	39.0%	-16.5%	-9.3%	1.4%	25.6%	2.6%
%Δ HICP	3.5%	2.8%	3.6%	3.6%	3.1%	3.1%	3.4%	3.6%	2.8%	4.1%	-0.2%	2.0%	3.1%	2.4%	1.5%	2.8%
Real Return	-13.2%	-9.1%	-30.6%	-30.6%	27.9%	16.1%	16.4%	29.0%	8.7%	-40.0%	39.4%	-18.2%	-12.0%	-1.0%	23.8%	-0.2%
United Kingdom	131.74	124.43	112.77	81.10	89.11	98.87	122.31	142.90	139.66	75.88	105.35	122.54	123.39	140.03	161.67	
Total Return (Net)																
%Δ	-5.5%	-9.4%	-28.1%	-28.1%	9.9%	11.0%	23.7%	16.8%	-2.3%	-45.7%	38.8%	16.3%	0.7%	13.5%	15.5%	1.5%
%Δ HICP	0.9%	1.2%	1.3%	1.3%	1.4%	1.3%	2.0%	2.3%	2.3%	3.6%	2.1%	3.3%	4.5%	2.8%	2.5%	2.3%
Real Return	-6.4%	-10.4%	-29.0%	-29.0%	8.4%	9.5%	21.2%	14.2%	-4.5%	-47.6%	36.0%	12.6%	-3.6%	10.3%	12.6%	-0.8%

* MSCI Europe NR Index consists of the following 15 developed market country indices: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

Source: MSCI, Eurostat, IODS Research

Table 9. Government Bond Market Returns

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Annual average
Eurozone															
Annual re	7.1%	5.9%	9.7%	4.0%	7.6%	5.3%	-0.2%	1.7%	9.4%	4.3%	1.3%	3.4%	10.9%	2.2%	5.1%
HICP	2.1%	2.4%	2.2%	2.1%	2.1%	2.2%	2.2%	2.1%	3.3%	0.3%	1.6%	2.7%	2.5%	1.3%	2.1%
Real retur	4.9%	3.4%	7.3%	1.9%	5.4%	3.1%	-2.4%	-0.5%	5.9%	4.0%	-0.4%	0.7%	8.3%	0.9%	3.0%
Belgium															
Annual re	7.3%	6.3%	10.5%	4.3%	7.5%	5.0%	-0.2%	1.4%	9.4%	5.1%	2.0%	4.1%	16.3%	-0.5%	5.5%
HICP	2.7%	2.4%	1.6%	1.5%	1.9%	2.5%	2.3%	1.8%	4.5%	0.0%	2.3%	3.4%	2.6%	1.2%	2.2%
Real retur	4.5%	3.8%	8.8%	2.8%	5.5%	2.4%	-2.5%	-0.4%	4.7%	5.1%	-0.3%	0.7%	13.3%	-1.6%	3.3%
France															
Annual re	7.2%	5.4%	9.6%	3.9%	7.4%	5.3%	-0.3%	1.5%	11.9%	2.9%	5.4%	4.5%	10.1%	-0.5%	5.3%
HICP	1.8%	1.8%	1.9%	2.2%	2.3%	1.9%	1.9%	1.6%	3.2%	0.1%	1.7%	2.3%	2.2%	1.0%	1.9%
Real retur	5.3%	3.6%	7.5%	1.7%	4.9%	3.4%	-2.1%	-0.1%	8.4%	2.8%	3.6%	2.2%	7.7%	-1.5%	3.3%
Germany															
Annual re	7.3%	5.2%	9.3%	3.8%	7.4%	5.2%	-0.2%	1.8%	12.4%	1.8%	6.3%	9.7%	4.6%	-2.3%	5.1%
HICP	1.4%	1.8%	1.4%	1.0%	1.8%	1.9%	1.8%	2.3%	2.8%	0.2%	1.1%	2.5%	2.2%	1.6%	1.7%
Real retur	5.8%	3.3%	7.9%	2.7%	5.5%	3.2%	-1.9%	-0.4%	9.4%	1.6%	5.1%	7.0%	2.4%	-3.8%	3.4%
Italy															
Annual re	6.8%	6.7%	9.5%	3.9%	8.3%	5.8%	-0.4%	1.5%	5.9%	8.1%	-0.7%	-5.5%	20.8%	7.2%	5.4%
HICP	2.5%	2.4%	2.6%	2.8%	2.2%	2.2%	2.2%	2.1%	3.5%	0.7%	1.7%	2.9%	3.3%	1.3%	2.3%
Real retur	4.1%	4.2%	6.6%	1.1%	6.0%	3.4%	-2.5%	-0.6%	2.3%	7.3%	-2.3%	-8.2%	16.9%	5.9%	3.0%
Spain															
Annual re	7.1%	6.2%	10.3%	4.2%	7.8%	5.7%	-0.5%	1.6%	9.1%	3.8%	-4.4%	7.3%	5.5%	11.0%	5.3%
HICP	3.5%	2.8%	3.6%	3.1%	3.1%	3.4%	3.6%	2.8%	4.1%	-0.2%	2.0%	3.1%	2.4%	1.5%	2.8%
Real retur	3.5%	3.3%	6.5%	1.0%	4.6%	2.2%	-3.9%	-1.2%	4.7%	4.1%	-6.3%	4.1%	3.0%	9.3%	2.4%
United Kingdom															
Annual re	8.9%	3.2%	9.1%	2.3%	6.3%	8.2%	0.6%	5.3%	12.9%	-1.2%	7.5%	16.6%	2.9%	-4.2%	5.5%
HICP	0.9%	1.2%	1.3%	1.4%	1.3%	2.0%	2.3%	2.3%	3.6%	2.1%	3.3%	4.5%	2.8%	2.5%	2.3%
Real retur	8.0%	2.0%	7.8%	0.9%	4.9%	6.0%	-1.7%	2.8%	9.0%	-3.2%	4.0%	11.6%	0.1%	-6.6%	3.1%

Sources: Barclays, Eurostat





Portfolio Manager / Advisor Competence

The original Better Finance study highlighted that in almost all categories of investment funds, a majority of funds under-performed their benchmarks.

Looking at the evolution since the publication of this previous study, we computed the returns of equity funds and bond funds in 2011, 2012, on a 3-year period (2009-2012) and a 10-year period (2002-2012) basis. We compared those returns to a broad European stock index, the STOXX Europe TMI. We find that the proportion of equity funds that over-performed the European index dramatically dropped in 2012 (30%) as compared to 2011 (74%). One cannot conclude that the competence of portfolio managers collapsed in just one year. Indeed, most equity funds are not invested in equity only. In 2011, the market was downward, while it was upward in 2012. Funds did not catch the whole performance of the market because of the mixed composition of most equity funds. However, using the same argument, the fact that 26% of funds underperformed the index raises questions.

Table 10. Beating the benchmark – European equity funds*

Benchmark	1-year (2013)	3-year (2011-2013)	10-year (2004-2013)
Stoxx TMI (Net return)	44%	30%	41%
Stoxx Global 1800 (Net return)	44%	23%	48%

Source : Lipper FMI, Stoxx, Own Research

* Actively managed funds; only funds existing during the whole period have been used

Table 11. Beating the benchmark – European bond funds*

Benchmark	1-year (2013)	3-year (2011-2013)	10-year (2004-2013)
Barclays Pan-European Aggregate TR	48%	24%	27%
Barclays Global Aggregate TR	72%	62%	26%

Source : Lipper FMI, Barclays, Own Research

* Actively managed funds; only funds existing during the whole period have been used

Investment charges

Findings of the initial study by Better Finance on the opacity and weight of charges did not change dramatically in 2012. Charges are often very complex and far from being harmonised for different pension providers. Generally speaking, they are heavier on personal pension products than on occupational pension funds, as

employers are in better position to negotiate with competing providers than individuals.

To tackle this complexity, some pension providers - for example, some auto-enrolment schemes in the United Kingdom – set up fixed costs per member; but this penalises low paid workers. A recent report of the Office of Fair Trading highlighted the lack of transparency and comparability on fees charged to members of UK pension funds: various fees are added to the Annual Management Charges (AMC) on the basis of which pension funds providers usually promote their services. The dispersion of charges has also been found to be very significant, depending amongst others on the type (personal plans are more heavily charged than occupational ones) and the size of the funds. There is currently a project for new regulation by the UK Department for Work and Pensions to impose a cap of 1% or 0.75% to annual management charges.

Taxation

The general model applied to pension products is usually deferred taxation: contributions are deducted from the taxable income and pensions are taxed within the framework of income tax or at a usually more favourable rate. However, the reverse rule is applied in Poland: contributions are paid from the taxable income while pensions are tax-free.

In general, the accumulated capital can be withdrawn by the saver at least partially as a lump sum, which is often not taxable. Our calculation of returns net of taxation has been based on the most favourable case, i.e. assuming that the saver withdraws the maximum lump sum possible.

Savings products used as retirement preparation but which are not strictly pension products might benefit from a favourable tax treatment. This is the case of life insurance in France but successive increases of the rate of “social contributions” on the nominal income tend to diminish the returns of the investment.





Table 12. Overview of Main Taxation Rules Applied in the Country Reports

Belgium	<ul style="list-style-type: none"> · Up to 30% of contributions are tax deductible; · No taxation in the capital accumulation phase; · Pillar 2: Taxation in pay-out phase depending on origin of contribution (employee: 10%, employer: 16.5%) + 7% of local taxes; · Pillar 3: Taxation in pay-out phase at 10% rate at the age of 60 + 7% of local taxes.
Denmark	<ul style="list-style-type: none"> · Contributions are usually tax deductible (exception lump sum contributions); · Interest, dividends, earnings and losses are taxed at 15.3% in the capital accumulation phase; · Taxation at the personal income rate in the pay-out phase (lump sum pay-outs are tax free).
France	<ul style="list-style-type: none"> · Complex taxation regimes; · Contributions to some DC pension plans (PERCO and PERP) are income tax deductible but no general deductibility from social levies. No tax deductibility for life insurance contracts; · Taxation in the retirement phase (sometimes with tax reductions).
Germany	<ul style="list-style-type: none"> · At the moment: transitional phase to the point of deferred taxation; · Contributions are tax deductible for sponsored retirement products up to prescribed limits; · No taxation in the capital accumulation phase; · Taxation at the personal income rate in the pay-out phase for sponsored retirement products.
Italy	<ul style="list-style-type: none"> · Contributions are tax deductible up to prescribed limits; · Accruals are taxed at 11% in the capital accumulation phase; · Taxation in the pay-out phase varies from 9-15%.
Poland	<ul style="list-style-type: none"> · Contributions to Employees Pension Programs (PPE) and Individual Retirement Accounts (IKE) have to be made from taxed income, Individual Retirement Savings Accounts (IKZE) are tax deductible up to prescribed limits; · PPE and IKZE are not subject to taxation in the accumulation phase and tax relief applies for capital gains on IKE; · PPE and IKE are not taxed in the retirement phase, IKZE are subject to a reduced flat-rate income tax of 10%.
Spain	<ul style="list-style-type: none"> · Contributions are tax deductible up to prescribed limits; · No taxation in the capital accumulation phase; · Pay-outs are taxed differently depending whether they take the form of personal income or the form of a lump sum payment.
United Kingdom	<ul style="list-style-type: none"> · Tax relief and allowances on contributions; · No taxation in the capital accumulation phase; · Pay-outs are taxed as income, there are three marginal rates in the UK at the moment.

Conclusion

Table 13. Yearly Real Returns of Private Pension Products	
Belgium	<u>Pension Funds (IORP ¹⁶), 2000-2013: -0.10%</u>
	<i>“Assurance Groupe” (Branch 21), 2002-2012 :+ 1.24%</i>
	Pension Savings Funds, 2000-2013: +0.60%
	Life Insurance, Guaranteed, 2002-2012: +1.17%
	Life Insurance, Unit-linked, 2005-2012: +0.30%
Denmark	Pension funds, 2002-2012: +4.79%*
France	Life Insurance, Guaranteed, 2000-2013: +1.30%
	<u>Life Insurance, Unit-linked, 2000-2013: -1.10%</u>
	<u>Public Employee Plans, 2003-2013: -1.16%</u>
	Corporate Plans, 2000-2013: +0.20%
Germany	<i>Pensionskassen and Pension Funds, 2002-2012: +1.87%</i>
	<i>Riester and Rürup Pension Insurance, 2005-2013: +1.3%</i>
	Personal Pension Insurance, 2000-2013 : +2.20%
Italy	Closed Pension Funds, 2000-2013: +0.12%
	<u>Open Funds, 2003-2012: -1.10%</u>
	PIP I, 2008-2012: +0.63%
	<u>PIP II, 2008-2012: -3.31%</u>
Poland	Employee Pension Funds, 2002-2013: +4.74%*
Spain	<u>Unit-Linked, 2000-2013: -1.17%</u>
United Kingdom	<u>Pension Funds, 2000-2012, -0.7%</u>
*Before tax	
Source: IODS Research, Better Finance Research	

The update of the original study by Better Finance highlights an improvement of the real returns of pension savings over the ten year period 2003-2012 as compared to 2002-2011, in the context of upwards equity markets and declining inflation rates. We also tried to extend calculations to a longer period of time, from 2000 to 2013, when data were available. Since stock markets were at a historical high at the beginning of this period, estimated performances are worsened. After deduction of inflation, charges and taxes, returns were negative for Belgian occupational pension funds, for French and Spanish unit-linked life insurance contracts and for Pension funds in the United Kingdom.

In France, the improvement in returns in 2012 and 2013 was largely offset by higher taxes on life insurance.

¹⁶ Occupational pension funds as per the definition and scope of the EU “Institutions for Occupational Retirement Provision Directive” (IORP).





Among the new countries covered by the present study, Italy and the United Kingdom are two opposite examples of policy options chosen by governments to tackle the imbalances of pension systems. In Italy, an ambitious reform was implemented by the minister Elsa Fornero under the Monti government in order to secure the public pay-as-you-go system despite very unfavourable demographic trends. Hence, the poor returns of the personal pension plans will have a limited impact on the replacement rates of retirees' income.

By contrast, pensions in the UK are more heavily dependent on pre-funded schemes. The government has implemented "auto-enrolment" to extend the benefits of pension funds to most employees. Here, the negative returns of pension funds after deduction of charges, inflation and taxation have led public authorities to take measures in order to add transparency and to limit the fees charged by pension providers.

Like in Italy, demographic trends in Germany are very unfavourable and the government ran several reforms to promote private pension savings. Since 2002, employees have the right to receive part of their earnings as contributions to a pension plan under a deferred compensation arrangement and significant subsidies and tax incentives have fostered personal pension plans ("*Riester*" and "*Rürup*" pensions). An average real net return of 2.2% was achieved by occupational funds over the 11-year period from 2002 to 2012 and 1.3% by promoted personal pension plans over 9 years. However, one should mention that beyond the returns of investment, the unfavourable determination of the annuity for a given capital has been challenged in the public debate.

In Spain, the promotion of occupational and personal pension schemes has only recently been established. Personal pension provisions and pension funds are taxed according to the beneficial EET formula; however, pension disclosures to individuals are broadly inadequate. The 14-year period states a significant negative real return of -1.2%.

Finally, only a small minority of Poles participates in employee pension schemes and personal pension products because they have only recently been set up. Those who participated in employees' pension funds benefitted from a very substantial annual real rate of return of almost 4.7%. However, the disclosure policy of pension providers is far from being satisfactory, especially as there is no guarantee: a market downturn would severely impact the wealth of pension funds participants,

a risk that few of them may be aware of. Similar returns on pension funds could be witnessed for Denmark with 4.8% on average over the 11-year period from 2002 to 2012. Both real returns, however, are calculated before taxation.

Recommendations

Based on these research findings, we recommend the following ten policy measures to urgently address this issue of inadequate pension savings returns:

1. Improve and harmonize disclosures for all long term and retirement savings products;
 - “PRIIPs”: the EU proposed Regulation for a Key Information Document (KID) must be extended to all retail long-term and pension investment products, or, at least, a summary of pension saving product information should be required and be as comparable as possible to this KID;
 - Disclosure of full costs and commissions, and long term historical returns must be provided:
 - After inflation;
 - After all charges borne directly or indirectly by the investor; and
 - After taxes (as required in the US for investment funds).
 - Disclosure of funding status (assets/liabilities coverage);
 - Disclosure of transfer/exit possibilities.
2. For EIOPA to comply with ESAs Regulations article 9(1)¹⁷: to actually report on pension saver trends, including on the actual performance of all pension products – one can manage or supervise only what one can measure. It is indeed quite surprising that the actual net performance of pension saving products is not really known, nor by clients nor by supervisors.

¹⁷ “The Authority shall take a leading role in promoting transparency, simplicity and fairness in the market for consumer financial products or services across the internal market, including by: (a) collecting, analysing and reporting on consumer trends”.





3. Design a simple retirement savings vehicle:
 - that protects the long-term purchasing power of savings (could be used as a default option in other pension saving products):
 - readily accessible, without need for advice and its associated commissions;
 - supervised by public bodies.

A pan-European Personal Pension Plan would definitely be welcomed by EU savers if it matches these requirements and if it is not disadvantaged in terms of taxation.

4. Simplify and standardize the range of product offerings; forbid non UCITs funds (“AIFs”¹⁸) in all retail packaged long-term and pension products (except for qualified investors who can access packaged products with choice of investment units), and find ways to thoroughly streamline the excessive number of UCITs offered in the EU (about 35,000 versus 9,000 in the US, and that for a smaller market).
5. Establish transparent, competitive and easy-to-use (standardised) retail annuities markets throughout the EU, and give more freedom to pension savers to choose between annuities and withdrawals when and after they reach retirement age.
6. For those individually subscribed to collective pension products, improve the governance of the collective scheme by having at least half of the scheme’s supervisory body directly designated by the pension scheme participants.
7. Ensure the end of biased advice at the point of sale and guarantee competent advice on long term investments, including going back to basics in order to explain what the building blocks of LT saving products are: equities and bonds.

¹⁸ AIFs stand for Alternative Investment Funds. They are subject to fewer investor protection rules than UCITs, however AIFs are up to now very widely used by personal pensions providers.

8. Ensure special treatment by prudential regulation of all pension products (insurance and non-insurance regulated): the long duration of the liabilities allow for higher portfolio allocation to long term investments such as equities.
9. Taxation to incentivize long term retirement savings and investment over consumption and short term savings, or at least not penalise this virtuous behaviour.
10. Basic financial mathematics to be part of school curricula, as this is a crucial tool in selecting suitable investment products for pension savers.





Private Pensions: The Real Returns

2014 Edition

Country Case: Belgium

Introduction

The Belgian pension system is divided into three pillars:

- **Pillar 1:** Pay-as-you-go pension system consisting of three regimes; one for employees in the private sector, one for the self-employed and one for civil servants. The legal age of retirement is 65 for both women and men. It used to be 60 for women until 1993, but was progressively increased to reach 65 in 2010. The replacement rate from the PAYG system for average earners was 62.1% in 2012 but was much higher for low earners, at around 80.7%¹⁹.
- **Pillar 2:** Occupational pension plans are private and voluntary. This pillar exists for both employees and self-employed. Employees can subscribe to occupational pension plans provided either through their employer (company pension plans) or through their activity sector (sector pension plans). Conversely, the self-employed decide for themselves to take part in a supplementary pension scheme.

An employer can set up a company pension plan for all its employees, for a group of employees or even for an individual employee. In the case of sector pension plans, collective bargaining agreements establish the terms and conditions of pension coverage. Employers must join sector pension plans, unless agreements allow them to opt out. Employers who decide to opt out have the obligation to implement another plan providing benefits at least equal to those offered by the sector.

Company and sector pension plans can be considered as “social pension plans” when they include a solidarity clause that provides additional coverage for periods of inactivity (e.g. unemployment, maternity leave, illness). Notably, social pension

¹⁹ Theoretical net replacement rates at different earnings levels for full-career workers entering the labour market in 2012, OECD Pension at Glance 2013.

plans are becoming less and less prevalent, possibly as a result of the relatively high charges associated with these plans in comparison to pension plans without a solidarity clause.

Company pension plans are traditionally dominant in pillar 2 in comparison to sector pension plans.

Pension schemes in pillar 2 can be managed by either an Institution for Occupational Retirement Provision (IORP) or by an insurance company. Occupational pension funds are predominantly managed by insurance companies.

Table 14: Percentage of employees covered by an occupational pension plan (%)									
	2003	2004	2005	2006	2007	2008	2009	2010	2011
IORP	9.45	8.87	8.81	9.22	13.48	18.46	17.68	16.85	16.50
Insurance companies	33.50	37.49	41.49	41.83	44.07	45.65	51.37	52.22	54.65
Total	42.95	46.35	50.30	51.05	57.55	64.11	69.05	69.07	71.15

Source: Assuralia

The coverage of employees in pillar 2 increased with the effects of changes in the law in 2004, which encouraged the development of sector pension plans. The number of employees covered by an occupational pension plan has become increasingly important. In 2013, the growth of the pillar 2 continued, with 2.8 million Belgians covered by a pillar 2 pension scheme: 2.5 million employees were covered by a pension scheme through their employer or sector and 307,000 self-employed are covered by pillar 2 supplementary pensions²⁰.

- Pillar 3:** There are also personal pension plans that are private and voluntary. These types of pension schemes are administrated by either licensed life insurance companies or by asset management companies. Compared to other EU member states, this pillar has been very pronounced in Belgium. The law of April 28, 2003, provides users of voluntary individual private pension products with tax deductions on contributions, though with a quite low ceiling limit.

²⁰ Sigedis and Financial Services and Markets Authority (FSMA).





Pension Vehicles

Pillar 2: Occupational pension schemes

The pillar 2 refers to occupational pension schemes that are designed to foster the replacement rate. Savings in these schemes are encouraged by tax benefits. Unlike the first pension pillar, pillar 2 is based on the capitalisation principle; pension amounts result from capitalisation of the contributions paid by the employer and/or employee in the scheme or by the self-employed.

There exist three types of occupational pension plans:

- Company pension schemes;
- Sector pension schemes;
- Supplementary pension schemes for the self-employed.

Management of occupational pension schemes

The management of occupational pension schemes can be entrusted to an Institution for Occupational Retirement Provision (IORP) or to an insurance company.

In 2012, 203 occupational pension schemes were managed by an IORP. The number of affiliates to an IORP has increased since 2004 from 367,897 to 1,394,936 in 2012. This increase was due to a doubling of affiliates in sector pension schemes between 2011 and 2012 from 510,105 to 1,026,533.

In 2012, the sector pension plans represented almost three quarters of affiliates in IORP but only 15% of total reserves (2.47 billion), whereas company pension schemes represented three quarters of total reserves (12.27 billion) with only 15% of affiliates. Three supplementary pension schemes for the self-employed (€1.57 billion of reserves) were managed by IORP.

Occupational pension schemes in pillar 2 are predominantly managed by insurance companies. Such pension schemes are called “*Assurance Groupe*” and can be divided into two different types of contracts:

- Branch 21 contracts offer guaranteed capital. All sector pension schemes and supplementary pension schemes for the self-employed are managed through this type of contracts. Most of company pension schemes are managed through Branch 21 contracts rather than Branch 23 contracts.
- Branch 23 contracts are unit-linked contracts and are invested mainly in investment funds and equity markets. Returns depend on the composition of the portfolio. In pillar 2, only company pension schemes are managed through Branch 23 contracts. However, €1.73 billion were managed through these contracts and only represented 3.5% of the total reserves managed by “Assurance Groupe” (see Table 15).

The FSMA provided detailed information on IORP. Information on Branch 21 contract insurance groups was provided by “Assuralia” and on Branch 23 contract insurance groups by the National Bank of Belgium (BNB).

Table 15. Total reserves managed in pillar 2 (€bn) ²¹										
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
IORP⁽¹⁾	10.90	11.70	13.40	14.30	14.90	11.1	11.20	13.90	14.00	16.40
“Assurance Groupe”: Branch 21 contracts⁽²⁾	26.10	29.90	30.60	33.50	35.60	38.00	40.30	42.80	45.60	48.20
“Assurance Groupe”: Branch 23 contracts⁽³⁾	na	na	1.62	1.71	1.72	1.43	1.79	1.81	1.62	1.73
Total “Assurance Groupe”⁽²⁾⁺⁽³⁾	na	na	32.20	35.2	37.30	39.50	42.10	44.60	47.20	49.90
Total⁽¹⁾⁺⁽²⁾⁺⁽³⁾	37.00	41.60	45.60	49.50	52.20	50.60	53.30	58.50	61.20	66.30

Source: “Assuralia”, BNB, own research, FSMA

The Financial Services and Markets Authority (FSMA) provides detailed information on both sector pension schemes and supplementary pensions for the self-employed.

²¹ Data does not include the insurance dedicated to managing directors that represented around €3.3 billion of assets under management in 2012. Table 15 represents reserves managed only in pillar 2 (either IORP or “Assurance Groupe”). Table 20 represents all reserves managed in individual life-insurance contracts (excluding “Assurance Groupe”). Some of these reserves are managed in pillar 3.





Description of the different types of occupational pension schemes

Sector pension schemes²²

The sector pension schemes are supplementary pension commitments that are established on the basis of a collective bargaining agreement and concluded by a joint committee or joint sub-committee. Inside the joint committee/sub-committee, a sectorial organiser responsible for the pension commitment is appointed.

Sector pension plans are managed by insurance companies exclusively through Branch 21 contracts. In 2011, €1.05 billion of reserves were managed through these contracts which represented 2.3% of the total reserves managed in pillar 2 Branch 21 contracts.

However, two thirds of sector pension scheme reserves (€2.47 billion) are managed by IORP, which represented 15% of the total reserves managed by IORP in 2012.

Table 16. Total reserves in sector pension schemes (€bn)²³

	2005	2007	2009	2010	2011	2012
IORP	0.42	1.43	1.48	1.62	2.04	2.47
"Assurance Groupe" (Branch 21)	0.14	0.67	0.81	0.93	1.05	na
Total	0.56	2.10	2.29	2.55	3.10	na

Source: FSMA

Occupational Pensions for the Self-Employed

In 2004, "*Pension Complémentaire Libre des Indépendants*" (PLCI) – Private Supplementary Pensions for the Self-employed – were integrated into the law on supplementary pensions. The purpose of PLCI is to save in order to obtain a supplementary and/or a survival pension at retirement.

Since 2004, the self-employed have the choice to contribute to a supplementary pension. Moreover, they can henceforth choose the pension provider, either an

²² Only plans for which information is available. Data on company pension plans can be partially found (source Belgian FSMA).

²³ Data for 2006 and 2008 was not available. FSMA publishes reports on sector pensions and self-employed pensions every two years.

IORP or an insurance company. They can switch from one provider to another during the accumulation period. In 2011, the self-employed had the choice between 26 pension funds (3 IORPs and 23 pension schemes managed through Branch 21 contracts).

Like employees, the self-employed can supplement their PLCI with several solidarity benefits, called social conventions. These conventions offer benefits such as the funding of the PLCI in the case of inactivity and compensation in the form of an annuity in the case of loss of income.

The self-employed can save up to 8.17% of their income, without exceeding a maximum amount indexed annually (in 2014, it was up to €3,027.09). These ceilings can be increased to 9.40% and €3,482.82 if a social convention is included.

Table 17. Total reserves managed in PLPCI conventions (€bn)

	2006	2007	2008	2009	2010	2011	2012
IORP	na	na	na	1.63	1.66	1.39	1.57
“Assurance Groupe” (Branch 21)	na	na	na	2.40	2.82	3.71	na
Total	2.89	3.27	3.50	4.03	4.48	5.10	na

Source: FSMA

Company pension schemes

Company pension schemes are the predominant type of scheme within pillar 2. However, aggregated and public information on this type of scheme is not available.

From data in table 17 and information on sector pension and supplementary pension for self-employed, we can estimate for the company pension schemes the amount of reserves managed by IORP and “Assurance Groupe” in pillar 2.





Table 18. Total reserves managed in company pension schemes (€bn)

	2009	2010	2011	2012
IORP ⁽¹⁾	9.97	10.74	10.50	12.27
“Assurance Groupe”: Branch 21 contracts ⁽²⁾	37.09	39.05	40.83	na
“Assurance Groupe”: Branch 23 contracts ⁽³⁾	1.79	1.81	1.62	1.73
Total “Assurance Groupe” (2) +(3)	38.88	40.86	42.45	na
Total ⁽¹⁾⁺⁽²⁾⁺⁽³⁾	48.85	51.60	52.95	na

Source: “Assuralia”, BNB, own research, FSMA

Pillar 3

Pillar 3 refers to private pension schemes that are contracted on an individual and voluntary basis. The Belgian market of personal pension schemes is divided into two types of products:

1. Pension savings products, which can take two different statuses:
 - A pension savings fund;
 - A pension savings insurance (through individual Branch 21 contracts).

60% of Belgian taxpayers are covered by a pension savings product of pillar 3 (either a pension savings fund or pension savings insurance).

2. Long-term savings products corresponding mainly to a combination of Branch 23 and Branch 21 contracts²⁴.

Pension savings funds

The size of personal pension savings funds is close to the size of funds managed by IORP in pillar 2. At the end of 2013, €14.35 billion of net assets were managed by pension savings funds. The Belgian market of pension savings funds has remained relatively concentrated since the launch of the first funds in 1987. The market has grown significantly in the past few years. 16 products were available for

²⁴ Indeed, the Belgian tax system provides tax incentives for investing in Branch 21 and Branch 23 life insurances as “*épargne de long terme*” (long-term savings).

subscription at the end of 2013 and the net assets under management doubled over 10 years.

Table 19. Net assets under management in pension savings funds (€bn)

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
7.42	8.69	10.32	11.48	11.78	8.98	11.12	12.04	11.16	12.63	14.35

Source: BEAMA

Prudential rules/quantitative limits apply to the investments of pension savings funds:

- A maximum of 75% in equity;
- A maximum of 75% in bonds;
- A maximum of 10% in cash deposited in euros or any currency of a country of the European Economic Area;
- A maximum of 20% in foreign currency deposits.

In practice, the majority of funds are predominantly exposed to the equity market. Their return is entirely variable and depends on the returns of the underlying assets and on the fees.

Pension savings insurance / Long-term savings products

The net equity of households in life insurance reserves represents 59% of GDP in Belgium.

Belgians can benefit from tax relief when they subscribe to insurance products that will allow them to get a supplementary pension at their retirement or a lump sum.

Belgians can save for their retirement through life insurance products within two different frameworks; a pension savings insurance (Branch 21 contracts) or a long-term savings product (Branch 21 contracts combined with Branch 23 contracts).





Table 20. Total reserves in individual life insurance products (€bn)²⁵

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Branch 21	41.65	51.59	63.18	75.57	85.92	95.60	103.20	111.39	117.66	120.93
Branch 23	na	na	20.27	19.72	22.75	19.19	16.42	16.86	16.55	18.49
Total	41.65	51.59	83.45	95.28	108.67	114.79	119.62	128.24	134.21	139.41

Source: "Assuralia"

"Assuralia" provided information on the reserves managed through individual life insurance products in the framework of pillar 3, either through Pensions savings insurance (Branch 21 contracts) or Long term savings products (Branch 21 and Branch 23 contracts combined).

In 2012, reserves managed in the framework of pillar 3 represented 18.6% of total individual life insurance reserves. However, historical data are not available and there is no available information on the breakdown between Branch 21 and Branch 23 contracts.

Table 21. Contributions and reserves for life-insurance products in pillar 3 in 2012 (€bn)

	Contributions	Reserves	3 rd pillar reserves in % of total individual life insurance reserves
Pension savings insurance (Branch 21 contracts)	1.06	10.57	7.6%
Long-term savings products (Branch 21 and Branch 23 contracts combined)	1.07	15.37	11.0%
Total	2.13	25.94	18.6%

Source: "Assuralia"

²⁵ This table indicates reserves managed through individual life-insurance contracts and it excludes reserves managed through "Assurance Groupe" contracts. For pillar 2, employees can choose to redeem capital in a lump payment, but in practice few people choose annuities. Most employees redeem their product in lump sum.

Charges

Occupational pension schemes

Charges in “Assurance Groupe” (Branch 21 contracts)

The only historical information on administration and management costs as well as commissions on a yearly basis was for Branch 21 contracts, provided by “Assuralia”.

Table 22. Charges in % of reserves in “Assurance Groupe” contracts

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Administrative & management costs (% of reserves)	1.21	0.98	0.84	0.93	0.90	0.80	0.79	0.76	0.71	0.71	0.71
Commissions (% of premiums)	1.20	1.30	1.20	1.40	1.20	1.40	1.50	1.30	1.50	1.50	1.50

Source: “Assuralia”, own calculations

Moreover, many insurance companies apply entry costs. In the case of sector pension funds, the level of entry fees varies considerably, ranging from 0.5% to 5% of the premium. In 2012, half of the schemes managed by insurance companies levied charges lower than 2% of premiums and even lower to 1% for 45% of schemes. However, 30% of schemes applied charges above 5% of premiums (source: FSMA, 2013).

Charges can be higher in Branch 23 Group Insurances (“Assurance Groupe”), as shown by the case study in the annex, due to the addition of contract fees to the fees of the underlying “units” (typically investment funds).

Charges in IORP

We were unable to find any data on IORP charges. The only available information was the following, provided by the FSMA on sector pension funds; operating expenses ranged from 0.01% to 1.48% of assets, with an average of 0.17% in 2011 (0.2% in 2009). However, company pension funds managed by IORPs are smaller than sector pension funds and they are, therefore, likely to be much more costly.





Pillar 3

Pension savings funds

Historical data on charges for pension savings funds is difficult to obtain as it is often not transparent even for investors. Key Investor Information Documents must provide information on all charges related to the funds on a yearly basis, but for UCITS only, not for other investment funds. However, the only data available is for 2012 and 2013.

Using the prospectus of the 16 pension savings available on the Belgian market, the following average yearly charges were calculated:

- Entry fees: 2.2% of initial investment;
- Management fees: 1% of total assets under management;
- Total Expenses Ratio represented on average 1.24% of total assets under management;
- No exit fees.

The following table summarises the Total Expenses Ratio (TER) of 15 funds available for subscription on the Belgium market in 2013.

Table 23. Total Expense Ratio in 2013
(% of total assets under management)

Accent Pension Fund	1.31
Argenta Pensioenspaarfonds	1.35
Argenta Pensioenspaarfonds Defensive	1.38
Belfius Pension Fund High Equities Cap	1.35
Belfius Pension Fund Low Equities Cap	1.18
BNP Paribas B Pension Balanced	1.24
BNP Paribas B Pension Growth	1.24
BNP Paribas B Pension Stability F Cap	1.23
Hermes Pension funds	1.06
Interbeurs Hermes Pensioenfond	1.01
Metropolitan-Rentastro Growth	1.24
Pricos	1.25
Pricos Defensive	1.29
Record Top Pension Fund	1.35
Star Fund	1.09
Total Expenses Ratio, Average (simple)	1.24

Source: own research

Pension savings insurance (Branch 21 contracts) / Long-term savings products (Branch 21 and Branch 23 contracts combined)

“Assuralia” provided historical data on administration and management costs as well as entry fees and other commissions paid for individual life insurance contracts.

Table 24. Administrative and management costs and commissions for individual life insurance contracts

		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Branch 21	Administrative and management costs (% of reserves)	1.2	1.8	1.4	0.8	0.7	0.7	0.7	0.6	0.5	0.5	0.5
	Commissions (% of premiums)	4.8	3.7	3.6	3.3	4.7	4.6	5.4	5.8	5.7	6.0	6.6
Branch 23	Administrative and management costs (% of reserves)	na	na	na	0.8	0.8	0.8	0.8	0.7	0.6	0.6	0.6
	Commissions (% of premiums)	2.5	3.0	2.7	2.0	3.4	4.2	5.4	5.6	4.8	4.6	2.9

Source: “Assuralia”, own calculations





For Branch 23, these data most likely do not include the fees charged on the underlying units (funds); see attached case analysis.

Taxation

Occupational pension schemes

Employees pay two taxes on their benefits:

- A solidarity contribution varying up to a maximum of 2% of the benefits depending on the retiree's income.
- An INAMI ("*Institut National d'Assurance Maladie-Invalidité*") contribution of 3.55% of the benefits.

In addition, benefits from occupational pension schemes are taxed depending on how they are paid out:

- A lump sum payment;
- Periodic annuities;
- Life annuity issued from invested benefits.

Lump sum payment

In the case of a lump sum payment, the taxation of the benefits depends on the beneficiary's age and on who paid the contributions to the schemes (employer or employee). Since July 2013, the rules detailed in table 25 below are applied to taxation on benefits from occupational pension plans.

Table 25. Taxation of benefits from occupational pension schemes			
Benefits paid before the legal pension		Benefits paid at the same time as the legal pension	
Benefits from employee's contribution	Benefits from employer's contributions	Benefits from employee's contribution	Benefits from employer's contributions
10% for contributions made since 1993	60 years old: 20% 61 years old: 18%	10% for contributions made since 1993	16.50%
16.5% for contributions made before 1993	62-64 years old: 16.5%	16.5% for contributions made before 1993	10% if the employee remains employed until 65 years old
+ local tax	+ local tax	+ local tax	+ local tax

Source: "Assuralia"

Before July 2013, benefits from employer's contributions were taxed at the flat rate of 16.5% whatever the beneficiary's age at the time of the payment of the benefits.

The local tax can vary from 0% to 10%, with an average of 7%.

Periodic annuities

Periodic annuities are considered to be an income and are thus taxed at the applicable progressive personal income tax rate.

Converting the accumulated capital into a life annuity

An employee can convert the lump sum payment into a life annuity. In this case, the INAMI contribution and the solidarity contribution have to be paid according to the rules applied to the lump sum payment. Then the retiree has to pay a withholding tax of 15% on the annuity each year, which should be equal to 3% of the converted capital.





Pillar 3

Personal pension savings products (fund or life insurance contracts)

Contributions invested in pension savings products (fund or insurance) are deductible from the income tax, subject to a rather low annual ceiling (€910 in 2012, €940 in 2013). Since 2012, the tax relief is equal to 30% of the contributions, regardless of the income of the taxpayer. The tax relief of pension savings products is “stand-alone”; taxpayers can receive tax relief for only one contract even if they make contributions to several products.

The taxation on the accumulated capital depends on the age of the saver at the time of the subscription.

If the saver subscribes to the product before 55 years of age, the following rules apply:

- When the saver reaches the age of 60, 10% of the accumulated capital is levied (excluding participation to annual earnings). The taxation is based on a theoretical return of 4.75% from the fund, whatever the actual return of the fund is. For contributions made before 1993, the theoretical return of 6.25% is applied.
- If the saver quits the pension savings fund before the age of 60, the accumulated capital will be taxed under the personal income tax system. The saver can continue investing and enjoying tax relief until the age of 64. The accumulated capital is no longer taxed after the 60th birthday of the saver.

If the saver subscribes to the product at the age of 55 or after, the following rules apply:

- In order to benefit from the low final tax rate of 10% on the accumulated capital, the saver has to stay at least 10 years in the fund and at least five contributions must be made.
- If the saver quits the pension savings fund before the age of 60, the accumulated capital is taxed under the personal income tax system.
- If the saver quits the pension savings fund between the ages of 60 and 64, the accumulated capital will be taxed at the rate of 33% and the lump sum

must be declared in the annual tax declaration where it shall again be taxed (this time at the marginal tax rate according to the income level of the saver).

Long-term savings products (life insurance contracts)

The maximum amount of tax relief based on contributions invested in long-term savings products depends on the level of the saver's yearly earnings, without exceeding the ceiling of €2,280 in 2014. However, the tax relief is determined jointly for long-term savings products and mortgage deductions. If a saver already receives a tax relief for a mortgage, it may be impossible to obtain a further tax relief for life insurance products under pillar 3.

The same tax rules apply as for pension savings products. However, the taxation on the accumulated capital is calculated on the real return of the product.

Pension Returns

Occupational pension schemes

The returns of occupational pension schemes depend on the types of plans. In 2012, among the 203 pension schemes managed by an IORP, 170 had a promise of returns (DB plans) and 33 were DC plans. While newly opened schemes are always DC plans, the largest part of assets remaining are still managed in plans offering promises of returns.

In DB plans, the premium is fixed with the goal of financing target retirement replacement rates of between 60% and 75%, including state pension benefits.

Since 2004, all DC plans managed either by IORP or insurance companies through Branch 21 contracts are required to provide an annual minimum return of 3.75% on employees' contributions and 3.25% on employers' contributions.

The real returns after taxation of occupational pension plans were calculated under the following assumptions:

- Solidarity contributions corresponding to 2% of benefits and the INAMI contribution of 3.55% of benefits are levied.





- The benefits are paid as a lump sum payment.
- Only employer paid contributions and hence benefits are taxed at the flat rate of 16.5%.
- In addition, an average local tax of 7% is levied on the final benefits.

Occupational pension schemes managed by IORPs

The Belgian Association of Pension Institutions (BAPI) provides the real average weighted returns after charges of all occupational pension schemes managed by an IORP in Belgium on its website.

Table 26. Returns of occupational pension plans managed by IORPs (%) (2000-2013)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Nominal return before charges, inflation and tax	0.9	<u>-4.2</u>	<u>-11.1</u>	10.4	9.9	16.0	10.3	2.2	<u>-17.1</u>	16.6	10.3	0.4	5.3	7.5
Nominal return after charges, before inflation and tax	<u>-0.1</u>	<u>-5.1</u>	<u>-11.9</u>	9.3	8.9	15.0	9.3	1.4	<u>-17.7</u>	15.7	9.5	<u>-0.3</u>	4.6	6.7
Real return after charges and inflation and before tax	<u>-2.7</u>	<u>-7.3</u>	<u>-13.3</u>	7.7	6.9	12.2	6.8	<u>-0.4</u>	<u>-21.3</u>	15.7	7.0	<u>-3.6</u>	1.9	5.4

Sources: BAPI, own calculations

Table 27. Occupational pension plans managed by IORPs annual average return 2000-2013 (%)

Nominal return before charges, inflation and tax	3.65
Nominal return after charges, before inflation and tax	2.78
Real return after charges and inflation and before tax	0.58
Real return after charges, inflation and after tax	<u>-0.10</u>

Sources: BAPI, own calculations

Over a 14-year period (2000-2013), occupational pension schemes managed by IORP experienced negative nominal returns before charges three times: in 2001, 2002 and 2008. Over the period 2000-2013, the annual average return after charges, inflation and tax is slightly negative at -0.1%.

Occupational pension schemes managed by insurance companies (Branch 21 contracts)²⁶

“Assuralia” provides returns net of charges in percentage of the total reserves.

Table 28. Returns of occupational pension managed by insurance companies (%) (2002-2012)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Nominal return before charges, inflation and tax	5.4	6.3	6.3	6.8	6.7	6.6	2.0	5.4	5.3	4.0	5.4
Nominal return after charges, before inflation and tax	4.1	5.3	5.4	5.8	5.7	5.7	1.2	4.6	4.5	3.3	4.6
Real return after charges and inflation and before tax	2.5	3.7	3.4	3.2	3.3	3.8	<u>-3.2</u>	4.6	2.2	<u>-0.1</u>	1.9

Sources: “Assuralia”, own calculations

Table 29. Occupational pension managed by insurance companies annual average return (2002-2012) (%)

Nominal return before charges, inflation and tax	5.45
Nominal return after charges, before inflation and tax	4.56
Real return after charges and inflation and before tax	2.29
Real return after charges and inflation and tax	1.24

Sources: “Assuralia”, own calculations

Over an 11-year period (2002-2012), Branch 21 “Assurance Groupe” occupational pension plans experienced positive nominal returns before charges. The annual average return over the period is significantly lowered by inflation and taxation. However, it remains positive at 1.24%.

However, this is not true for Branch 23 “Assurance Groupe” occupational pension plans which suffered a very negative real return over the last 13 years²⁷.

²⁶ “Assuralia” does not provide information on Branch 23 contracts in “Assurance Groupe”.

²⁷ See Annex: Case study of a Branch 23 “Assurance Groupe” occupational pension plan.





Pillar 3

Pension savings funds

The Belgian Asset Management Association (BeAMA) provides quarterly data on the average annual returns of pension savings funds. The most recent data provided by BeAMA is the average return of pension savings funds on an annual basis at the end of 2012.

Table 30. Average returns of pension savings funds on annual basis at the end of 2013 (%)

Over 1 year	Over 3 years	Over 10 years	Since the launch of first pension savings funds (1987-2013)
11.2	5.6	5.7	6.7

Source: BeAMA

These average returns were calculated based on the average returns of all funds available on the market, after expenses but before inflation and taxation.

Annual returns are also available in the prospectus of each pension savings fund provided by the asset management company that commercialises the fund. Annual returns are generally displayed on a 10-year period. No information on returns before 2002 is available in the funds' prospectuses. The following table displays the average return of all funds available for subscription on the Belgian market from 2000 to 2013.

Concerning charges, as historical data for TER is not available, we assume that TER expressed as a percentage of total assets under management observed in 2012 stay the same in the considered period (2003-2012).



Table 31: Returns on pension savings funds after expenses, inflation and taxation (%)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	annual average return (2000-2013)
Nominal return before charges, before inflation, before tax	-2,8	-3,3	-13,4	16,0	21,3	18,7	11,0	3,8	-24,7	19,6	8,3	-4,1	12,8	12,8	4,5
Nominal return after charges before inflation, before tax	-4,0	-4,5	-14,5	14,6	19,8	17,2	9,6	2,5	-25,7	18,2	7,0	-5,3	11,4	11,2	3,2
Real return after charges, after inflation, before tax	-6,5	-6,7	-15,8	12,9	17,6	14,3	7,1	0,7	-28,9	18,2	4,6	-8,4	8,6	9,9	1,0
Annual average real return after charges, after inflation and tax (2000-2013)															0,6



Pension savings funds within pillar 3 experienced negative nominal returns from 2000 to 2002, as well as in 2008 and 2011. Unlike occupational pension schemes, these pension savings funds are not constrained to pay a guaranteed return to retirees. They delivered higher nominal returns over the 14 year period (2000-2013). Moreover, benefits are taxed at a flat rate of 10%, considering an annual return of 4.75% during the accumulation phase, whatever the effective return of the pension savings funds. The annual average real return after taxation was less affected by the taxation than occupational pension schemes and remained positive during the period at 0.6%.

Individual life-insurance contracts

Table 32. Returns of Branch 21 contracts (%)²⁸

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Nominal return before charges, before inflation, before tax	2.78	3.79	4.80	5.44	5.14	5.24	0.10	4.32	4.02	2.51	4.42
Nominal return after charges before inflation, before tax	2.75	3.75	4.75	5.40	5.10	5.20	0.10	4.30	4.00	2.50	4.40
Real return after charges, after inflation, before tax	1.13	2.22	2.80	2.83	2.74	3.34	<u>-4.21</u>	4.30	1.66	<u>-0.87</u>	1.75

Sources: "Assuralia", own calculations

Table 33. Annual average return of Branch 21 contracts 2002-2012 (%)

Nominal return before charges, before inflation, before tax	3.86
Nominal return after charges before inflation, before tax	3.83
Real return after charges, after inflation, before tax	1.58
Real return after charges, tax and inflation	1.17

Sources: "Assuralia", own calculations

²⁸ "Assuralia" provides information on the returns of life insurance before the year 2002 only on aggregated basis with no breakdown between Branch 21 and Branch 23.

Table 34. Returns of Branch 23 contracts²⁹ (%)

	2005 ³⁰	2006	2007	2008	2009	2010	2011	2012
Nominal return before charges, inflation and tax	16.72	7.46	1.62	<u>-18.21</u>	13.25	7.46	<u>-2.61</u>	9.43
Nominal return after charges, before inflation and tax	11.50	7.10	1.30	<u>-18.50</u>	12.90	7.10	<u>-2.90</u>	9.10
Real return after charges and after inflation and before tax	8.78	4.69	<u>-0.49</u>	<u>-22.01</u>	12.9	4.69	<u>-6.09</u>	6.34

Sources: "Assuralia", own calculations

Table 35. Annual average return of Branch 23 contracts 2005-2012 (%)

Nominal return before charges, inflation and tax	3.33
Nominal return after charges, before inflation and tax	2.96
Real return after charges and inflation and before tax	0.53
Real return after charges, inflation and tax	0.27

Sources: "Assuralia", own calculations

Returns of individual life-insurance contracts give an idea on returns of reserves invested in life-insurance contracts within pillar 3. Pillar 3 reserves represented 18.6% of individual life-insurance reserves in 2012. Pension savings insurances correspond to Branch 21 contracts with a guaranteed capital. Long-term savings products can combine Branch 21 and unit-linked Branch 23 contracts. In our calculations, we considered that benefits from Branch 21 contracts were taxed like pension savings schemes and a flat tax rate of 10% was applied to the benefits from Branch 23 contracts.

Over the period 2002-2012, the nominal returns of Branch 21 contracts were

²⁹ Including individual and collective life insurance.

³⁰ Information before 2005 not available.





positive. However, Branch 23 contracts experienced negative nominal returns in 2008 and 2011.

The taxation lowered the real returns, however, if the same taxation as for occupational pension schemes had been applied, then the returns would have been negative.

Conclusions

Belgians are encouraged to save for their retirement in private pension funds. In 2004, the implementation of the law on supplementary pensions defined the framework of pillar 2 for sector pension plans and supplementary pension schemes for self-employed. The number of employees covered by an occupational pension scheme keeps rising as well as the number of self-employed covered by a supplementary pension scheme.

Over a 14 year period (2000-2013), the annual average real return of private pension funds (pillar 2 and 3) after charges, after taxation and inflation ranged from -0.1 to 1.24% depending on products and schemes. The tax burden significantly lowered returns of occupational pension funds.

Funds managed by IORPs (pillar 2) and personal pension funds (pillar 3) had annual average returns of -0.1% and 0.6%. These funds offer returns linked to the performance of the underlying assets. Unlike insurance companies, asset management companies are less constrained in their asset allocation and can thus benefit from potential increases in markets. However, there is a debate on the affordability of defined benefits schemes managed by IORPs in pillar 2, which depends on the discount yields chosen to determine the pension promises. Most DB pension schemes use a discount rate near to 5%, which is considered too high compared to market yields.

Over the period 2002-2012, “*Assurance Groupe*” and individual life-insurance through Branch 21 contracts delivered an average annual real return of 1.17% respectively 1.24%. The Solvency II regulation constrained insurance companies in their asset allocation. They have thus less incentive to offer “*Assurance Groupe*” schemes as they must offer an annual guaranteed return of 3.25% on employer’s contributions, which is becoming challenging with the current level of market interest rates on investment grade bonds.

ANNEX: Case study of a Branch 23 “Assurance Groupe” occupational pension plan

This corporate “Branch 23” (unit-linked) insurance pension plan offers three investment options: low, medium and high depending on the equity/bond asset allocation.

The “medium” investment option provides the returns of an investment fund that has the following benchmark:

- 50% equity (MSCI World equity index);
- 50% bonds (JPM Euro Bond Index).

Table 36. Capital markets vs. Belgian occupational pension fund 13 year performance (2000 to 2012)	
Capital markets (benchmark index*) performance	
Nominal performance	48%
Real performance (before tax)	11%
Fund performance	
Nominal performance	8%
Real performance (before tax)	-19%
* 50 % Equity / 50 % bonds (MSCI World equity index and JPM Euro Bond Index)	

Sources: Insurance provider and Better Finance Research

As the table above shows:

- The real performance (before tax) of the pension fund is very negative.
- The real performance of the pension fund is disconnected and much below that of the capital market benchmark which is positive: the performance of capital markets cannot be used as a proxy for pension savings performance, even if the capital market benchmark used is exactly the same.

What are the reasons for such a bad performance of the pension funds?

The key explanation factor is charges (fees). While the benchmark does not bear any fees, the pension fund does. It appears that the fund is a fund of funds. This





means it bears two layers of fees: those of the fund itself plus those of the funds it invests in.

Better Finance also discovered that this fund of fund is not a UCITs fund, but an AIF (alternative investment fund). Therefore it is not required to publish a Key Information Document (KID) that must disclose the total annual charges of the fund of funds. Actually, Better Finance had to complain to the Belgian regulator to finally obtain the yearly charges on the fund of funds itself (0.50% per annum). We had then to search the disclosed underlying funds (biggest positions in the fund of funds portfolio) on the internet to find those funds' charges. It appeared that for the main equity funds, the weighted average annual charge in 2012 was 2.01%. In total the annual charge paid by the pension saver on the equity portion of this pension fund was therefore 2.51% of assets under management.

This expense rate is very high and more than explains the huge performance. Most of these expenses could have been saved by investing in an equity index exchange-traded fund (ETF) on the same benchmark (MSCI World) as the table below shows.

Table 37. Charges taken from funds over a year
This Belgian occupational pension fund (equity part): 2.51%
Average European equity fund: 1.70%
Average US equity fund: 0.77%
Exchange traded fund (world equities): 0.19%
<i>Sources: Better Finance, Morningstar, Financial Times</i>

Conclusions:

- Belgian “Assurance Groupe” pension funds should disclose full charges and the “inducements” they get from investing in underlying funds (commissions paid by those funds’ management firms).
- They should not invest in high fee funds when it is clearly not the fund participants’ interest as in this case.

Private Pensions: The Real Returns

2014 Edition

Country Case: Denmark (Update)

Introduction

The Danish pension system is built of four elements:

- Basic State Pension (“*Folkepension*”) – Pay-as-you-go;
- ATP, Mandatory Occupational Pension; Savings based; Provided by ATP;
- Occupational pensions; Voluntary system based on agreements between the social partners; Savings based; Provided by life insurance companies, lateral pension funds, banks and company pension funds;
- Private pensions; Voluntary individual; Savings based; Provided by life insurance companies and banks.

The statutory retirement age in Denmark is 65. This will increase in stages to 67 between 2019 and 2022. Post 2022 the retirement age will be linked to life expectancy. Through this the government tries to reduce its contribution to the pension system.

The Danish pension system is a mix of mandatory and voluntary components. Table 38 shows how the assets are distributed between the different types of providers. Denmark has close to universal pension coverage, with the ATP covering nearly 90% of the workforce. The mandatory system runs two schemes in parallel, the basic State pension – the “*Folkepension*” – and a State administered defined contribution scheme – the “*Arbejdsmarkedets Tillægspension*” (ATP)³¹. The “*Folkepension*” (public pension system) is a pay-as-you go scheme restricted to Danish citizens, and EEA Member States or Swiss citizens who are resident in

³¹ ATP is established by law. The Minister of Employment appoints the Committee of Representatives on recommendations offered by the social partners. The Minister also appoints the members of the Board.





Denmark or have been residents in Denmark during a certain number of years. Citizens from other countries can qualify if they fulfil certain more demanding criteria. The pension pays a flat rate for all those who are eligible, with supplementary entitlements assessed on family status and income. The ATP is a fully funded defined contribution scheme, which provides a lifelong pension from the age of 65 and a survivors' lump sum benefit for dependents in the case of the death of the ATP member. All employed persons are obliged to contribute, with contributions divided 2/3 and 1/3 between employer and employee, the contribution rate is a function of monthly working hours. The self-employed are invited to join the ATP system, which advertises itself as having lower administration costs (64 DKK/year) than any private pension scheme in Denmark, though the total cost, investment and administration charges, approach 330 DKK/year.

Table 38. Savings based pension assets in Denmark 2009-2011

Billion DKK	2009	2010	2011	Mkt. share
Life insurance companies	996	1,092	1,208	46%
Lateral pension funds ³² (Tværgående pensionskasser)	354	382	411	16%
Commercial banks and savings banks	379	407	401	15%
Company pension funds (Firmapensionskasser)	36	38	43	2%
ATP, LD ³³	420	478	579	22%
Total	2,186	2,398	2,643	100%

Source: Danish FSA

Company pension funds cover only 2% of the savings based pension assets. Other occupational pension schemes in Denmark, based on agreements between the

³² Danish nationwide occupational pension funds covering employees from more than one company (in contradiction to company pension funds).

³³ "Lønmodtagernes Dyrtidsfond" (Employees' Fund). The government suspended the indexed regulation of salaries in both the public and the private sector from 1977 – 1979. The amounts were placed on individual accounts in a pension fund LD "Lønmodtagernes Dyrtidsfond" (the fund for the wage earners cost of living allowance) created for that purpose by law. The amounts paid in to the fund for a full employed person was DKK 4368. And that has increased to DKK 110,000 for those who left the investment management fully to the fund.

social partners are schemes covering more than one employer, typically a branch of industry or a profession.

Danish pension funds are very large by international standards. In most countries, pension funds cover one company only (or even a single person), which is much more expensive. Large collective schemes have much lower costs for the beneficiaries. The Danish pension funds can benefit from economies of scale, as they provide the same product to a number of people, and therefore gain from important cost savings. Another reason for the low costs at ATP is that ATP only offers a single pension product, without much availability of choice for the scheme member (which would entail higher costs to be deducted from the pension benefits)³⁴.

The self-employed, if they decide to join the ATP system, pay a fixed contribution equal to 270 DKK/month each quarter. The description of the ATP and its associated charges are clearly presented on the ATP website³⁵. Although the ATP is an independent fund managed by the social partners and the government, it is regarded as a private pension fund under OECD terminology. This makes sense, especially for the self-employed, as they decide whether to join this scheme or not³⁶.

The pay-out from the “*Folkepension*” is DKK 69,650/year, supplementary entitlements can increase this pay-out to DKK 72,300/year. These supplementary entitlements start to reduce in value when other income exceeds DKK 65,300/year, they fall to zero when other income exceeds DKK 299,400/year. On average the pay-out from the ATP scheme is around DKK 16,000/year. Naturally, for a DC scheme, the actual pay-out is the sum of contributions, investment performance and the age of retirement. There are other existing legislation-based mandatory pension schemes, but these are no longer open to contributions or new members and hence not mentioned here.

The voluntary system is a combination of labour market related pensions and occupational pensions (“*Arbejdsmarkedspensioner*”). These schemes are organised either as collective agreements between social partners within a special part of the labour market, or as agreements between the employer and the employees of a

³⁴ www.atp.dk

³⁵ Idem.

³⁶ OECD Pensions at a Glance 2011: Retirement-Income Systems in OECD countries: Denmark, page 2 <http://www.oecd.org/denmark/47272339.pdf>





company. The occupational pension scheme is normally mandatory. It is a right for all employees of the company to become members of the scheme, but it is not possible to opt out of the scheme. Members may take their pension capital from one scheme to another within three years of changing jobs, in practice very few do it in time.

Approximately 75% of Denmark's working population (2.9 millions) contributes to an occupational pension scheme. Insurance companies or lateral pension funds manage these schemes, while employers only manage a minority. 90% of the population between 16 and 66 years contributed to the ATP (contributions are automatically deducted from the salary and/or from the public benefits the person may receive). Close to one million people contribute to private pension schemes other than occupational schemes³⁷. Contribution rates for occupational schemes vary between 9% and 20% of salary. As with the ATP, the burden of contributions normally falls at 2/3 on the employer and 1/3 on the employee.

Currently, there are two areas of public debate in the pension sector. The first, put forward by employees, seeks to allow employees the freedom to choose the provider of their occupational pension scheme. The second debate concerns the large number of changes in legislation and tax regulation related to pensions. It is difficult for consumers to find out how the "Folkepension", the ATP and the occupational pension should be supplemented by private pensions or future savings. Even pension funds, insurance companies and banks find it difficult to give the right advice to consumers.

Pension Vehicles

Denmark has four major types of private pensions:

- Life annuity ("*Livrenter*") with a guaranteed or market based pension payment for the total life period of the member;
- Annuity or instalment pension (Rate pension) with a guaranteed or a market based pension payment for an agreed number of years, typically ten years;
- Lump sum pension ("*Kapitalpension*") with one pay-out³⁸;

³⁷ Figures from Torben M.Andersen, Torben Möger Pedersen, Cristina Lage, Peter Melchior, Lars Rohde "Basispension" October 2012, Penge- og Pensionspanelet.

³⁸ Pay out from rate pension and "*Kapitalpension*" can be changed by the saver to a life annuity.

- Lump sum pension (“*Alderspension*”) with one pay-out.

All private pension products are defined contribution schemes. The asset selection is not directly regulated; it is the responsibility of the each company to select assets that enable it to fulfil its obligations to the saver. This may take the form of a guarantee or more commonly an asset selection that faithfully matches the description of the product. All pension companies offered, until 1994, a guaranteed basic return rate of 4.5% per annum; effectively this forced the pension companies to invest heavily in bonds (government bonds or mortgage bonds).

Since 1994, the Danish FSA has progressively reduced this guaranteed return to the current level of 0.5%. Whilst these reductions have protected the solvency of these schemes, they no longer protect the real value of their pension savings.

With the decline in interest rates, there has been a shift towards market-based products. While this has expanded the freedom of portfolio managers to invest in real assets, such as shares, it has also increased the investment risk of pension portfolios.

Charges

Disclosure on charges has been very poor. There is a plethora of pension products on offer in Denmark, public information, where it is available, is of little value as the data offered by providers is not comparable. Providers calculate yearly costs for members both in DKK and as a percentage of assets. However, the basis for these calculations differs between banks, insurance companies and pension funds. These circumstances present significant information barriers to users, who may choose to compare products on the basis of past performance and charges.

Pressure from consumers on providers to improve disclosure appears to be having some effect. All pension companies, from the end of 2012, must inform their clients or members, of the yearly costs related to their pension scheme both in DKK and as a percentage. Providers will offer a cost-calculation facility, on their websites, making it possible to compare costs.

In December 2012, the Danish Insurance Association opened a new public service called “Facts on pensions”. This web-based system gives information about occupational pension products from insurance companies and lateral pension





funds. Through the website, it is possible to compare information about savings, insurance, service and advisory services, interest, returns and charges from all providers. However, design limitations restrict the viewer's ability to make comparisons to four providers in each search. The website posts information on charges, as yearly charges in DKK, as a percentage of assets. The information is further disaggregated into administration costs, in DKK, investment costs and the contribution to the owners of the providing company, if the scheme has a guarantee. The system does not give an overview of the costs, but a random search of different schemes displays yearly charges of between 0.6% and 1.4%.

Taxation

The Danish taxation system on pension contributions, assets and pay-outs from schemes are multidimensional, Table 39 rationalises the system by pension vehicle.

Pension Vehicle	Life assurance contract	Unit-linked pension product	Personal pension	Personal pension
			"Rate pension"	"Alderspension"
Contributions	Tax deductible		Tax deductible	Non deductible
			Up to 50,000 DKK a year	Max contribution 27,600 DKK a year
Tax on the investment	Interest, dividends, earnings and losses are taxed at 15.3%			
Pay-out ^{39 40}	Taxed like personal income On average 42% to 46%		Tax free	

Source: Better Finance Research

Contributions to occupational pension schemes and individual private pension schemes are tax deductible, with limits on certain schemes. From 2013 however, deductibility exemption ends for the lump sum pension scheme ("*Kapitalpension*").

³⁹ Special tax on high pensions, i.e. more than 362,800 DKK in 2010 (limit will be adjusted).

⁴⁰ Pay out exceeding the limit is taxed at 6% in 2012. The tax will decrease 0.5% per year until it becomes zero by 2020.

A new lump sum scheme called “age-pension” (*“Alderspension”*) has been introduced; contributions are not tax deductible and consequently the pay-out is tax-free.

All schemes are subject to a tax on pension returns (changes in market value) of 15.3%. Originally known as the “real interest duty”, the base of the tax was expanded to the return on assets (capital, interest and dividends), with tax rates varying by asset type. In 2001, the tax rate was harmonised to 15% across all pension assets and increased to 15.3% in 2012.

Pay-outs from personal pension schemes are taxed as income, with prevailing marginal rates between 32% and 49%. The pay outs from *“Kapitalpension”*, now closing, were taxed at a flat rate of 40 %. As mentioned above, payments from the *“Alderspension”* are free of tax.

Pension Returns

We could not find a source for aggregate information detailing the investment returns for pension savers. While life insurance companies, lateral pension funds, company pension schemes and banks have to give scheme information to members on the development of pension plans, none of this information is publically available in aggregated form. The information published by the Danish FSA breaks information down by business type:

- Life-insurance companies and lateral pension funds;
- Company pension funds;
- Commercial banks and saving banks; and
- ATP.

The Key Performance Indicators of private pension funds of the National Danish supervisor provide a good overview of the last years’ after tax performance of the first category of pension plans⁴¹. Only companies active in all five years are shown in table 40a and 40b.

⁴¹ <http://www.finanstilsynet.dk/en/Tal-og-fakta/Statistik-noegletal-analyser/Noegletal.aspx>





Table 40a. Return on customer funds after expenses⁴² but before income tax – Life Insurance

Selskabsnavn (Company)	2007	2008	2009	2010	2011	2012
SEB Pensionsforsikring A/S	6.2	<u>-4.5</u>	4.3	9.3	4.2	9.3
Sampension KP Livsforsikring A/S	<u>-2.1</u>	1.1	0.8	16.0	20.8	11.6
Forsikringselskabet Alm. Brand Liv og Pension A/S	<u>-0.1</u>	<u>-1.2</u>	8.1	7.4	6.9	6.9
Skandia Livsforsikring A/S	0.0	<u>-14.2</u>	<u>-1.0</u>	16.1	4.2	2.9
PFA Pension, forsikringsaktieselskab	0.4	2.2	5.3	7.1	10.5	9.6
PenSam Liv Forsikringsaktieselskab	0.9	<u>-11.5</u>	18.3	9.9	8.7	41.9
Danica Pension, Livsforsikringsaktieselskab	0.0	<u>-1.3</u>	5.5	4.6	6.1	7.7
PMF-Pension, Forsikringsaktieselskab	8.6	<u>-11.4</u>	10.1	3.3	15.2	-
FunktionærPension, Pensionsforsikringsaktieselskab	0.3	<u>-5.6</u>	6.9	11.5	15.2	14.4
Nordea Liv & Pension, livsforsikringselskab A/S	1.1	<u>-3.4</u>	5.5	6.4	6.6	8.7
PKA+Pension Forsikringselskab A/S	3.2	0.2	6.6	6.5	2.5	8.9
Industriens Pensionsforsikring A/S	<u>-0.7</u>	3.5	10.9	16.9	4.8	17.3
PensionDanmark Pensionsforsikringsaktieselskab	2.1	<u>-5.4</u>	14.6	6.6	12.1	4.5

⁴² Return on insurance provisions before tax, Source: <https://www.finanstilsynet.dk/en/Tal-og-fakta/Statistik-noegletal-analyser/Noegletal.aspx>

Lærernes Pension, forsikringsaktieselskab	1.6	<u>-3.9</u>	12.7	11.8	6.1	14.6
AP Pension livsforsikringsaktieselskab	3.3	<u>-6.6</u>	7.1	8.9	15.3	9.3
Skandia Link Livsforsikring A/S	17.8	<u>-19.4</u>	31.3	0.0	<u>-6.6</u>	13.5
Topdanmark Livsforsikring A/S	1.4	<u>-13.3</u>	10.1	4.7	<u>-1.0</u>	5.2
Forsikrings-Aktieselskabet ALKA Liv II	0.0	0.0	0.0	0.0	<u>-1.4</u>	<u>-1.9</u>
Topdanmark Livsforsikring III A/S	<u>-9.7</u>	<u>-32.6</u>	<u>-22.1</u>	<u>-18.7</u>	<u>-12.3</u>	0.0
PFA Soraarnej, forsikringsaktieselskab	<u>-1.3</u>	<u>-7.2</u>	8.1	5.8	3.4	<u>-14.5</u>
Nykredit Livsforsikring A/S	<u>-23.7</u>	<u>-19.7</u>	<u>-15.6</u>	<u>-22.0</u>	<u>-22.7</u>	2.0
Topdanmark Livsforsikring V A/S	<u>-1.8</u>	<u>-1.1</u>	5.7	9.6	9.7	10.7
Skandia Livsforsikring A A/S	<u>-44.8</u>	<u>-263.8</u>	4.0	8.6	10.8	0.0

Source: Table 18a and 18b Danish FSA





Table 40b. Return on customer funds after expenses but before income tax - Lateral pension funds

Selskabsnavn (Company)	2007	2008	2009	2010	2011	2012
BANKPENSION, Pensionskasse for Finansansatte	4.1	<u>-15.4</u>	9.3	12.8	4.4	9.7
Danske civil- og akademiingeniørers Pensionskasse	<u>-8.2</u>	2.7	6.4	6.9	3.1	5.4
Pensionskassen for Sundhedsfaglige	0.8	3.5	7.6	8.1	10.3	11.7
Arkitekternes Pensionskasse	4.3	<u>-22.0</u>	16.2	7.4	4.4	5.7
Pensionskassen for teknikum- og diplomingeniører	16.6	<u>-9.9</u>	4.3	8.1	18.4	7.7
Pensionskassen for Jordbrugsakademikere og Dyrlæger	1.9	<u>-13.0</u>	14.5	9.7	3.9	5.6
Juristernes og Økonomernes Pensionskasse	2.7	5.3	8.3	8.1	12.2	13.7
MP Pension, Pensionskassen for magistre og psykologer	<u>-0.5</u>	<u>-5.7</u>	10.4	1.7	5.4	6.5
Finanssektorens Pensionskasse	4.8	<u>-5.2</u>	4.7	10.5	6.2	-
Pensionskassen for Sygeplejersker	0.8	0.4	10.5	8.6	10.6	12.4
Pensionskassen for Farmakonomer	6.1	2.6	3.1	6.1	5.5	5.8
Pensionsk. for sygehjælpere, beskæftigelsesvejledere, plejere og plejehjemsass.	<u>-4.0</u>	0.7	3.8	8.6	10.1	8.9
Pensionskassen for Kontorpersonale	1.3	1.2	9.9	8.30	9.8	11.7
Pensionskassen for Lægeseekretærer	1.0	0.4	10.6	8.3	10.0	11.6

Pensionskassen for portører	<u>-3.1</u>	<u>-0.1</u>	4.0	10.3	13.0	6.2
Pensionskassen for trafikfunktionærer og amtsvejmænd m.fl.	<u>-2.7</u>	<u>-4.8</u>	3.3	9.2	11.1	8.7
Pensionskassen for Socialrådgivere og Socialpædagoger	<u>-0.3</u>	7.9	3.0	15.2	11.2	14.1
Pensionskassen for Børne- og Ungdomspædagoger	1.1	<u>-12.10</u>	<u>-2.5</u>	<u>-6.8</u>	<u>-14.6</u>	12.2
Lægernes Pensionskasse	0.7	<u>-8.4</u>	7.3	13.3	13.4	-0.8
Pensionskassen for Apotekere og Farmaceuter	0.6	<u>-6.2</u>	3.7	6.2	2.9	5.4
Arbejdstagernes Pensionskasse	<u>-1.8</u>	<u>-21.9</u>	14.5	10.9	0.5	8.9

Source: Table 18a and 18b Danish FSA

Finally, as regards the ATP, the “*Finanstilsynet*” has praised this scheme for having achieved, in the 10-year period from 2002 to 2011, an average market return, after tax and expenses, of 8.8%, which is 3.9% higher than the average for the Danish life insurance and pension companies. The “*Finanstilsynet*” stated that the size of future pensions depends on creating a high, stable return year on year.

According to ATP, there are three factors explaining their impressive performance. Firstly, the use of bonds and interest rate swaps to hedge the interest rate risk of the pension obligations gave a significantly positive return due to the decline in interest rates during the period. Secondly, due to the extensive use of risk diversification, and thirdly, the ATP portfolio largely consisted of Danish equities. Shares held by ATP outperformed the average Danish stock market performance. The Danish stock market also outperformed shares of many leading markets during the decade. Additionally, as explained before, the very low management costs of the system certainly contributed to translating such good results into positive and significant net returns for private investors.

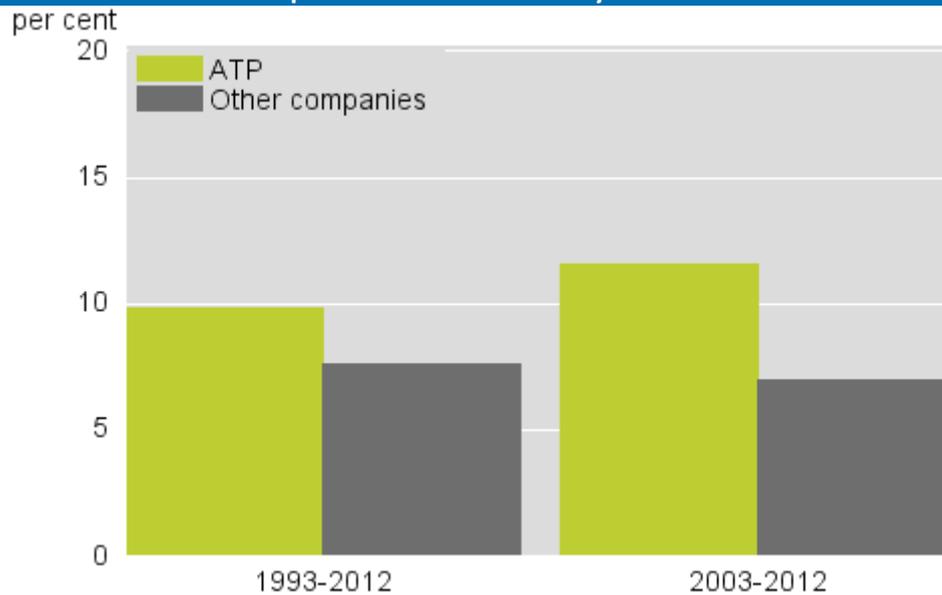
ATP itself claims that its singular investment strategy and cost structure enables them to outperform its local competitors (life insurance companies and lateral





funds in Denmark). ATP's average market return relative to the industry over 10- and 20-year horizons is an additional 4.7% per year and additional 2.3% per year, respectively.

Graph 1. ATP's returns relative to the returns of life-insurance companies and lateral pension over 10- and 20-year horizons



Source: www.atp.dk

In order to obtain an aggregated returns rate in spite of the missing data for company pension funds and for commercial banks and saving banks, we have endeavoured to build our own estimated returns from the available public data. The return on customers' funds after expenses but before tax reported to the Danish FSA by the providers of private pension products for each year between 2007 and 2011 have been weighted by the contributions reported for 2011. This information can be found in table 41. Unit-linked products are not covered by this information. To develop an appreciation of the return to savers after inflation we have taken the return data and subtracted inflation derived from Denmark's consumer price index published by Eurostat. Table 41 thus gives a view on the real returns for savers before tax. The taxation on pension saver investment returns is displayed in Table 42.

Table 41. Pension funds' real average net annual rate of investment returns, 2002 to 2012 (after inflation, before taxes)⁴³ in %

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2002-2012 average
-6.7	6.3	11.5	14.8	1.3	-3.3	5.1	1.2	7.1	12.1	5.4	3.82%

Source: OECD

Table 42. Taxes raised on investment returns on pension savings⁴⁴ (DKK bn)

Billions DKK	2007	2008	2009	2010	2011
Banks	2.6	0.3	0.6	3.7	0.5
Life ins. and pensions	1.7	2.4	2.4	1.2	2.8
Total	0.9	-5.1	4.8	6.8	5.6

Source: Danish Ministry for Taxes

Conclusion

There is little information on performance and charges, making it possible to compare across different types of pension providers (pension funds, insurance companies, banks). The recent web based tools launched by the Danish Insurance Association may represent a substantial improvement on the previous condition for the occupational pensions provided by members of that organisation.

Denmark has managed not only to protect the real value of the beneficiaries' pension pot, but also to grow this pot in real terms. This is something that unfortunately just some of the countries included in our analysis have managed. This in turn suggests that other EU Member States could learn from Danish pension practices and prudent fiscal policy. The low cost structure of the ATP is perhaps a model for European provision.

⁴³ Note: figures are not adjusted for the effect of taxation.

⁴⁴ Note: the figures differ from the "NR-accounts" by including taxed raised from Den Sociale Pensionsfond (DSP).





It is important that consumers, when considering the different possibilities for private pension savings, have access to detailed information about the investment policies, the costs and the tax regime in order to be able to choose a pension provider.

The taxation of investment returns has a material impact on net investment returns to savers. It is therefore important for consumers to be informed about the tax consequences of a pension scheme.

What matters to people who retire from the working life and their dependents is the quality of the pension. Will the pension make it possible to pay for housing and living? Will the pension live up to the forecasts and expectations during the working life? The Denmark case shows how difficult it is to get information about the quality of pensions. How are the pensions developing during the contribution period, what is the return on customers' funds after taxation year by year and how does that relate to the inflation? Politicians are acting in the dark when they do not have aggregated information on the development of pensions.

Private Pensions: The Real Returns

2014 Edition

Country Case: France (Update)

Introduction

In 2013, the value of financial assets held by French households increased by 5.0%. Direct holdings of securities and investment funds grew the most, due to the rise of stock prices. However, one should be aware that shares reported in national accounts are mainly non-quoted shares such as participations in small or very small family companies. Bank deposits and life insurance contracts still represent the two largest blocks of financial savings products in French households' portfolios. Finally one should note that pure pension products recorded in national accounts are still a very small part of the financial assets of French households: total outstanding life insurance contracts grew by 5.1% in 2013, from €1,308 billion to €1,358 billion whereas deferred annuity plans⁴⁵ grew by 7% from €168 billion to €180 billion.

Table 43. Financial assets of French households at the end of 2013

	% of total financial savings	2013/2012
Currency and bank deposits	32.0%	2.2%
Investment funds	7.2%	4.5%
Life insurance	34.8%	3.8%
Pension funds	4.6%	7.1%
Direct investments (direct holdings of bonds and shares)	21.4%	11.2%
Total	100.0%	5.0%

Source: Banque de France, «National Financial Accounts»

⁴⁵ Deferred annuity plans include personal pension products (PERP), pension products for the self-employed (“contrats Madelin”) or farmers, sectorial collective pension plans (“Préfon” for public employees, CRH for hospital employees), and company pension plans, with either defined benefits (“article 39”) or defined contributions (“Article 83” and PERCO).





Pension Vehicles

Life insurance contracts (individual)

In 2012 and 2013, mathematical provisions related to unit linked contracts rose more than those of “*contrats en euros*” (capital guaranteed) and their share in total mathematical provisions slightly increased from 15% to 17%. This increase is due to capital gains only in 2012 and to both capital gains and net inflows (contributions less benefits) in 2013. In 2012, unit-linked contracts accounted for no more than 14% of the net inflows of life insurance contracts, against 24% in 2011. But in 2013, unit-linked contracts accounted for 34% of net inflows to life insurance in France.

Table 44. Mathematical provisions					
	2011	2012	2012/2011	2013	2013/2012
Capital-guaranteed contracts	1,133	1,160	2.4%	1,203	3.7%
Unit-linked contracts	201	218	8.3%	241	10.6%
All contracts	1,334	1,378	3.3%	1,444	4.8%

Source: FFSA

Deferred annuity contracts

Personal pension plans (PERP⁴⁶)

Thanks to higher contributions and still low paid benefits⁴⁷, mathematical reserves in personal pension plans PERP increased from €7.5 billion in 2011 to €8.8 billion in 2012(+18.3%) and €10.4 billion in 2013 (+18.2%). However, the share of the PERP in overall savings of French households remains very small.

The number of subscribers increased only slightly in 2012 (2.2 million plans, +1.5%) and in 2013 (+2%, i.e. 85,000 new PERP contracts).

“Contrats Madelin” subscribed by self-employed

Mathematical provisions related to “*contrats Madelin*” increased by 12.6% in 2012, from €21.1 to €23.8 billion. There were 1,081 million outstanding contracts at end of 2012 (+7.3%). The “*contrats Madelin*” are widely used by self-employed workers

⁴⁶ “*Plan d’épargne retraite populaire*”.

⁴⁷ The legal framework of the PERP was established in 2003.

because the pay-as-you-go system is less generous (and contributions lower) than for employees.

“Contrats Madelin agricole”

Technical reserves of “*contrats Madelin agricole*” increased by 8.9% in 2012, from €3.7 billion to €4.1 billion. 303,000 farmers had an open contract at the end of 2012.

Individual deferred annuity plans

Préfon, a deferred annuity plan open to all current and former public employees and their spouses, had 384,000 participants at the end of 2012. Its assets under management reached €12.3 billion (market value) at end of 2012.

Corem, a deferred annuity plan mainly subscribed by civil servants, had 400,000 participants at the end of 2013. Its assets under management grew from €7.7 billion at the end of 2012 to €8.0 billion (market value) at the end of 2013⁴⁸.

CRH (“*Complémentaire Retraite des Hospitaliers*”), a deferred annuity plan open to all public employees from the health sector and to their spouses, has 358,000 participants. Its technical reserves amount to €2.83 billion. It is very difficult to find more precise information on their website.

Collective deferred annuities

Defined contributions plans “Article 83”: assets under management decreased by 8% from €47.3 billion at end of 2011 to €43.7 billion at end of 2012, in the context of a massive increase in taxation of employers’ contributions to these schemes (see below the section on taxation).

Defined benefit plans “Article 39”: assets under management grew by 15% from €31.3 billion at end of 2011 to €35.9 billion at end of 2012.

⁴⁸ Combined participants and assets of *Corem* and “R1”, a closed pension plan related to *Corem*.





Corporate long-term savings plans

The “*Plan d’Epargne Entreprise*” (PEE) total assets continued to grow in 2012, from €85.3 billion to €94.6 billion at the end of 2012 (+11%) and €104.4 billion at the end of 2013 (+10%). The number of members in those plans is stable (more than 11 million people) but the average contribution increased and the plans benefitted from favourable market trends.

The “*Plan d’Epargne Retraite Collectif*” (PERCO) is still less mature than other pension plans as it started in 2003. But it continues to grow rapidly. Assets under management amounted to €6.7 billion at the end of 2012 (+34% as compared to 2011) and to €8.6 billion at the end of 2013 (+28%). 1,540,000 employees had a PERCO at the end of 2013 (an annual growth of +23%) and 177,000 companies propose this type of plan to their employees.

Charges

Financial savings of French households slowed down in 2012 and the competition for attracting retail investment flows increased. Insurance companies diminished slightly subscription fees on life insurance contracts. We estimate that average entry costs were around 2.3% in 2012.

The competitive pressure has also constrained annual management fees charged by insurance companies. Unit-linked contracts cumulate the units (investment funds) charges and the contract ones (those later alone are 0.85% average per annum on assets).

Taxation

Since August 2012, the taxation of employers’ contributions to corporate savings plans (PEE and PERCO) and defined contribution plans (“Article 83”) increased from 8% to 20%.

Although there was no change of taxation specifically applying to life insurance in 2012, the general rise in taxation of savings also impacted life insurance.

The law of 29 February 2012 increased the rate of “social contributions” from 13.5% to 15.5%. This new rate applies since 1 January 2012 to property income and

financial capital gains, and from 1 July 2012 onward to interest, dividends and real estate capital gains. So, the minimum tax rate on life insurance income is now 23 % (7.5% income tax + 15.5% social contributions).

The law of 16 August 2012 established an extraordinary additional contribution on wealth applicable to individuals owning more than €1.3 million.

A report on the taxation of savings was commissioned by the minister of finance to two members of the Parliament (the "*Berger-Lefèbvre report*"). However the report did not recommend any dramatic change in the taxation rules. The only innovation was the creation of a new type of life insurance contract, named "*Eurocroissance*", a contract that does not guarantee the invested capital in case of withdrawal before 8 years after subscription. This new type of contract is supposed to incite savers to accept a higher risk in the short-term for a better long-term return, for example by investing more on the equity market.

Pension Returns

Life insurance contracts – capital guaranteed

The real returns of guaranteed life insurance contracts returned to their 2010 levels in 2012 and almost doubled in 2013. In net terms, such returns are still low (1.3%), especially when one takes into consideration that they relate to long-term investments: the last data available from the wealth survey of INSEE indicate that outstanding life insurance contracts were open for 10 years on average and the 32% were open for more than 12 years⁴⁹.

Over a 14-year period, real return after tax of guaranteed life-insurance contracts varied from a maximum performance of 3.1% in 2001 to a negative performance of -0.3% in 2011.

⁴⁹ Christophe Benne, Alain Peuillet, "*L'assurance-vie en 2010: Une composante majeure du patrimoine des ménages*", INSEE Première n° 1361, July 2011.





Table 45. The returns of French life insurance contracts – capital guaranteed (%)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Disclosed return	5.3	5.3	4.8	4.5	4.4	4.2	4.1	4.1	4.0	3.6	3.4	3.0	2.9	2.8
Real return before tax	3.5	3.8	2.6	2.1	2.0	2.4	2.4	1.3	2.8	2.6	1.4	0.3	1.4	1.9
Real return after tax	2.8	3.1	1.9	1.5	1.4	1.6	1.6	0.5	2.0	1.8	0.7	<u>-0.3</u>	0.7	1.3

Source: FFSA, Eurostat (ICPH index), IODS calculation (deduction of HICP price index variation from disclosed returns)

Contradictory factors impacted real returns after tax in 2012 and 2013:

- Nominal returns decreased slowly but regularly, by 10 basis points each year in 2012 and 2013. This reflects the downward trend of interest paid on government bonds issued by countries of the North of Europe. Insurance companies are less and less able to offset such unfavourable trend because accounting rules, market discipline and prudential rules (Solvency II) prevent them from holding more stocks, which tend to perform better on the long-run but are more risky on a short-term basis.
- Also, these average returns mask important differences depending on the distribution network and governance: for the contracts distributed by banks, the 2013 return was only 2.62%, whereas the return of contracts subscribed by independent associations was 3.29%⁵⁰.
- Inflation slowed down dramatically, from 2.7% in 2011 to 1.5% in 2012 and 0.8% in 2013⁵¹. Consequently, for a given nominal return, inflation reduced the real return less.
- Taxation increased by 200 basis points, as a result of the rise in social contributions from 13.5% to 15.5% in 2012.

⁵⁰ Sources: Faider, Facts & Figures. Independent associations representing life insurance contracts holders include AGIPI, AMAP, AMIREP, ANCRE, ASAC-FAPES and GAIPARE.

⁵¹ Source: Eurostat, HICP.

Table 46. French nominal and effective tax rates on capital guaranteed life insurance returns (%)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Inflation	1.7	1.4	2.2	2.4	2.3	1.8	1.7	2.8	1.2	1.0	2.0	2.7	1.5	0.8
Nominal tax rate	13.4	13.4	13.4	13.4	13.7	18.5	18.5	18.5	18.5	19.6	19.6	21.0	23.0	23.0
Effective tax rate	20.3	18.6	24.9	29.2	29.8	32.4	32.0	60.1	26.6	27.7	48.5	201.4	49.3	33.1

Source: Eurostat (HICP index), IODS computation

Life insurance contracts – unit-linked

Nominal returns were pushed upwards by the rise in stock prices in 2012 and 2013, in the background of declining inflation. Despite heavier taxation, real returns after taxes were above 7% in 2012 and 2013.

Over a 14-year period of time, real returns after tax of unit-linked life-insurance contracts were very volatile. The worst performance was recorded in 2008 (-19.1%) and the best one in the following year (10.4% in 2009).

Table 47. The returns of French life insurance contracts – unit-linked (%)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Disclosed return	<u>-2.0</u>	<u>-9.5</u>	<u>-15</u>	8.4	6.4	14.4	8.8	1.5	<u>-22</u>	14.4	5.2	<u>-7.0</u>	11.3	10.7
Real return before tax	<u>-3.7</u>	<u>-11</u>	<u>-17</u>	5.9	4.0	12.4	7.0	<u>-1.3</u>	<u>-23</u>	13.2	3.1	<u>-9.4</u>	9.6	9.8
Real return after tax	<u>-3.4</u>	<u>-9.5</u>	<u>-15</u>	4.8	3.1	9.8	5.4	<u>-1.5</u>	<u>-19</u>	10.4	2.1	<u>-8.0</u>	7.0	7.3

Source: FFSA, Eurostat (HICP index), own calculation (deduction of HICP price index variation from disclosed returns)





Life insurance contracts – 14 years returns

For calculating the real return of an investor who would have subscribed at end of 1999 to a life insurance contract and would have withdrawn his funds 14 years later, one has to subtract the entry costs paid the year of subscription because these fees are not taken into account in the disclosed returns. We estimate that entry costs in 2000 represented 2.76% of the investment, to be deducted from the real returns that year.

A saver would thus get a return of 19.47% for these 14 years period of investment on guaranteed contracts, and a negative one of -14.35% on unit-linked contracts. On a yearly basis, the rates of returns would be 1.28% and -1.10% respectively. It is worth noting that although unit-linked contracts are more risky for the subscribers they did provide returns significantly lower than those of the riskless guaranteed contracts. But unit-linked contracts' performance is very sensitive to the period of reference.

Table 48. Real returns of all life contracts 2000-2013		
(based on the relative weight of both categories in the overall mathematical reserves)		
	14-year return	Average yearly return
Capital guaranteed contracts	19.47%	1.28%
Unit-linked contracts	<u>-14.35%</u>	<u>-1.10%</u>
All contracts (avg.)	9.47%	0.91%

PERP

It has still been impossible to find global return data on PERPs. The insurance industry body (FFSA) publishes the average return of ordinary capital guaranteed and unit-linked life insurance contracts ("*fonds en euros*"), but not that of PERPs. Based on the disclosed nominal returns of PERPs accounting for 54% of total PERP assets at the end of 2013, the weighted average nominal return of the capital guaranteed PERPs ("*fonds en euros*") was 2.47% in 2013, significantly lower than the nominal return on ordinary life insurance "*fonds en euros*" of 2.78%. In addition, this does not take entry fees into account, which are probably at least as high as for life insurance (2.76% average in 2003 for those). A majority of PERPs are structured like ordinary life insurance contracts in the accumulation phase: a combination of capital guaranteed funds ("*fonds en euros*") and "units" representing investment funds. A minority of PERPs are structured as deferred

annuities like the main pension savings products for public employees (see next section below).

Table 49. Average nominal returns of PERPs (“fonds en euros”)			
Retail network (banks)	Assets (end of 2013)	2012	2013
BNP Paribas	444.6	3.00%	2.80%
Banques populaires	370.4	2.10%	2.20%
Caisses d'épargne	789.5	2.35%	2.35%
Crédit agricole	2,800.0	2.40%	2.40%
Crédit mutuel	119.0	3.00%	3.00%
Banque postale	8.0	2.40%	2.40%
LCL	400.0	2.40%	2.40%
Société générale	700.0	2.80%	2.80%
Total	5,631.5	2.48%	2.47%
Total PERP all networks*	10,400.0		

Sources: LesEchos.fr, Better Finance, FSA

Deferred annuity plans for public employees (Préfon, Corem, CRH)

One difficulty in assessing real returns of deferred annuity plans is that up to 2010, it was not mandatory for those plans to disclose investment returns, *Préfon* being one example. Following Better Finance French member organisations’ action, a 2010 Law⁵² made this a legal requirement from 2011 on.

Préfon

Préfon published a return on its investment portfolio for 2011, but did not specify if it is gross or net of fees (which are about 60bps per annum), probably gross. The accounting return was 3.71% in 2011. However, the accounting return does not take into account the changes in the market value of assets. *Préfon* did not publish its 2012 return, despite the above-mentioned legal requirement and 2013 figures were not released at the time of print (June 2014). In addition, most of the investment return is currently set aside in order to replenish reserves. Since 2010, the French Supervisor (ACPR) decided this was still not sufficient, and, forced *Préfon*’s insurers to contribute €508 million of their own funds since then to help *Préfon* balance its assets and liabilities⁵³. In addition, the value of the participants’

⁵² Law n° 2010-737 of 1 July 2010 - art. 35 (V) which modified Article L441-3 of the French Insurance Code.

⁵³ “*Les Echos*” 27 December 2010. This information was not disclosed by *Préfon* to the participants.

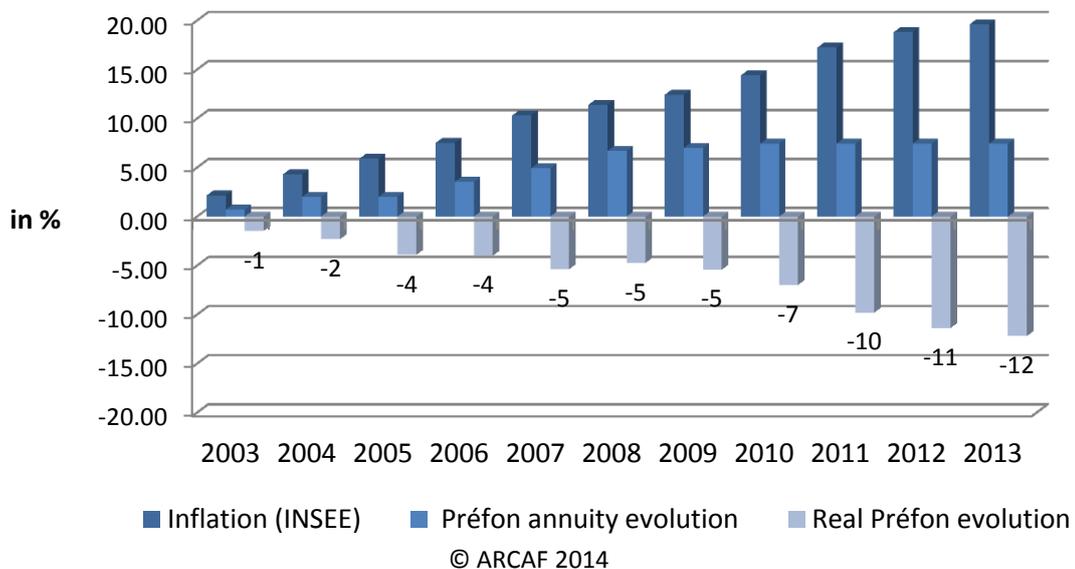




accumulated savings is not communicated to them. It is therefore impossible to compute a real rate of return individually and for all participants with the data currently made available by the Plan.

Another difficulty for deferred annuity products is to translate the impact of investment returns and other factors such as the capital conversion rate into annuities, the discount rate and the evolution of annuities paid on the actual long term return for the pension saver. One proxy return indicator is the one computed and published by the French association of pension fund participants ARCAF. It has been collecting for several years the annual rate of pension annuities increases before tax (see Graph 2). Since 2002, *Préfon* participants have lost 12% of the real value of their entitlements (before tax). This key performance information is not disclosed to new participants⁵⁴.

Graph 2. *Préfon* annuities real value, compounded evolution in %



Source: ARCAF 2014

It is difficult to compute the evolution of the *Préfon* annuities paid after tax, as they are taxed at the marginal income tax rate on pensions and salaries, and as contributions have been deducted from taxable income for income tax purposes (but not for social levies).

⁵⁴ ARCAF <http://www.EpargneRetraite.org> 2014.

Corem

Corem publishes the annual return on its investments, but also does not specify if these are gross or net of fees. The accounting return for 2013 was +5.04 % slightly down from 5.25% in 2012. However, this accounting return does not take into account the changes in the market value of assets. In addition and more importantly, all the investment return is also set aside in order to replenish reserves. It is therefore impossible to compute a collective real rate of return.

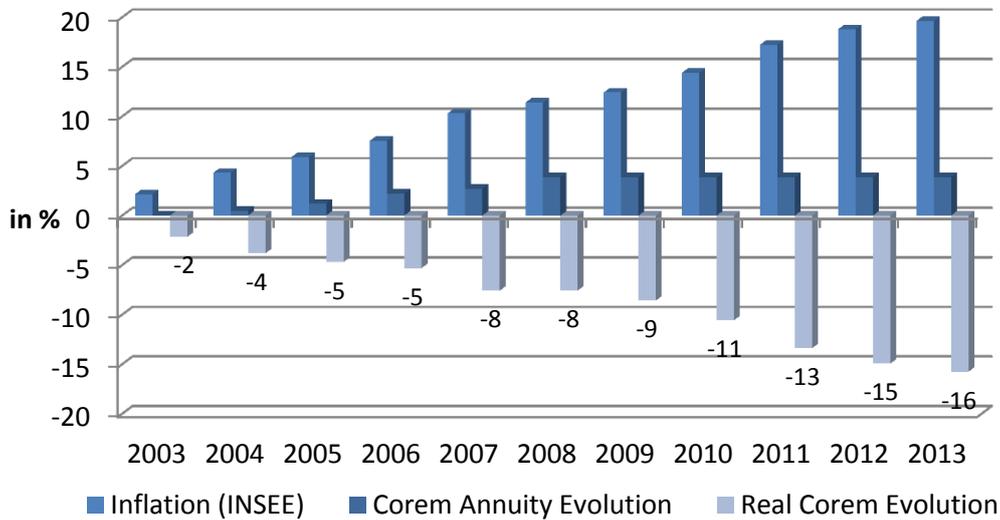
The deferred annuity mechanisms of *Corem* are similar to those of *Préfon*, with the same difficulties in estimating the real return for the pension saver. Therefore, we also use here the proxy return indicator computed by ARCAF. The *Corem* is in deficit, the main – undisclosed – tool of its recovery plan in place since 2002 is not to increase the nominal value of annuities served. As a result, the annuities served by CREF have lost 16% of their real value before tax (purchasing power) over the last 11 years (see Graph 3). These figures are before tax. This key performance information is not disclosed to new participants. The situation is not likely to improve soon as *Corem* disclosed in its latest annual report a reserve gap of €459 million at the end of 2013, even using a 3% discount rate⁵⁵, which is above the maximum discount rate allowed for other pension products in France.

⁵⁵ Source: UMR – Rapport annuel 2013, page 61.





Graph 3. Corem annuities real value, compounded evolution in %



© ARCAF 2014

Source: ARCAF 2014

Overall, Better Finance estimates the last eleven years' (2002-2013) loss of purchasing power of participants to French Public Employee Pension Schemes at minus 13.5% (-1.2% per annum), based on the relative asset portfolio size of *Préfon* and of *Corem*.

CRH

CRH does not disclose any annual report and financial data publicly. Even its pre-contractual publications do not disclose past performance. Because of an on-going restructuring started in 2008, the real returns of this plan are probably low and below inflation.

Defined contribution corporate plans

Table 50. French corporate savings – Average 14 years returns of funds 2000-2013								
Fund ("FCPE") category	Equity*	Equity euro	Equity intl	Equity France	Diversified	Bond	Money market	All funds
14Y nominal return	1.0%	3.5%	<u>-1.7%</u>	2.0%	27.5%	60.0%	42.8%	31.6%
Yearly average	0.1%	0.2%	<u>-0.1%</u>	0.1%	1.7%	3.4%	2.6%	2.0%
14Y real return	<u>-21.6%</u>	<u>-19.7%</u>	<u>-23.7%</u>	<u>-20.8%</u>	<u>-1.0%</u>	24.2%	10.9%	2.2%
Yearly average	<u>-1.7%</u>	<u>-1.6%</u>	<u>-1.9%</u>	<u>-1.6%</u>	<u>-0.1%</u>	1.6%	0.7%	0.2%

Source: AFG/Europerformance, Own calculation

*Excluding company stock

We combine information provided by “Europerformance” on the performance of each category of funds with data from AFG on their relative weight in total outstanding⁵⁶ to estimate the overall returns of corporate savings.

Returns of corporate savings plans on a 14-year period, from the end of 1999 to the end of 2013, were low: the yearly average real performance of the aggregate of all funds was 0.2%. Indeed, stock markets were at a still historical high in real terms at the end of 1999.

The overall returns are influenced predominantly by the very small return of balanced funds (-0.1% yearly real return on average) as those funds account for almost one third of total outstanding assets of the funds. Money market funds are the next category by size of assets: their performance was positive at the beginning of the period but it fell since 2008 due to the historical low level of short term interest rates. On the contrary, equity funds, which account for about 15% of total outstanding assets (excluding company stock), suffered from the burst of the Internet bubble at the beginning of the 2000s, they recovered from 2003 on, fell sharply in the aftermath of the financial crisis of 2007-2008 and are again on an upward trend since 2012. Bond funds (around 15% of assets) showed a 1.6% average yearly real return over the period.

⁵⁶ Data published by AFG relate to “FCPE L214-39”. These funds are diversified funds which do not buy the own shares of the concerned company (“company stock”). There is another category of corporate savings funds, the “FCPE L214-40” dedicated funds which can invest without limit in the own shares of the concerned company but there are no data available on the returns of these “FCPE L214-40” funds. The “FCPE L214-39” assets represented 61% of all FCPE assets at the end of 2012.





A limitation of such calculation is that performance indexes provided by “Europerformance” only relate to balanced funds inside the corporate savings plans. They do not take into account the part of corporate savings which is invested in shares of the concerned company (company stock), which account for about one third of all corporate savings plans.

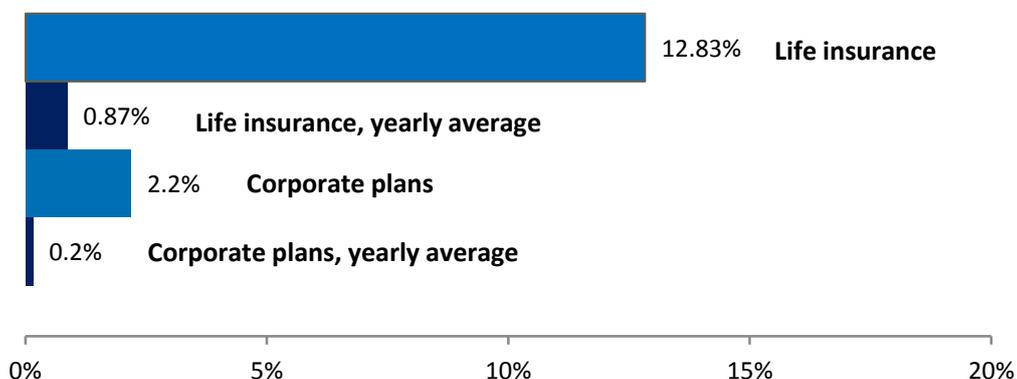
Conclusions

After a year of negative real returns before tax in 2011, subsequent years were more favourable to investors. In the background of bullish stock markets and a lower inflation, unit-linked life insurance contracts showed a real performance before tax of 9.6% in 2012 and 9.8% in 2013. Capital-guaranteed life insurance contracts (“*contrats en euros*”) remained positive, but their returns were still rather low (1.4% in 2012 and 1.9% in 2013) when their long-term time horizon is taken into account.

The performance of capital-guaranteed contracts is obviously diminished when taxation is taken into account. Taxation of savings increased by 200 basis points in 2012, as “social contributions” rose from 13.5% to 15.5%. After taxation, the average real return of capital-guaranteed contracts was 0.7% in 2012 and 1.3% in 2013. Unit-linked contracts provided a real return of 7.0% in 2012 and 7.3% in 2013.

On a 14 year period of time, from the end of 1999 to the end of 2013, capital-guaranteed life-insurance contracts show an average positive yearly performance of +1.28% in real terms and the unit-linked contracts a negative yearly return of -1.10%.

Graph 4. French Pension Savings Real Returns, 2000-2013



The performance of corporate savings is also very low when the time period 2000-2013 is considered. We find an average +0.2% real annual return for corporate savings plans on the last 14 years.





Private Pensions: The Real Returns

2014 Edition

Country Case: Germany

Introduction

The German pension system can be divided into three pillars:

- Pillar 1: Statutory pension insurance
- Pillar 2: Occupational pension plans
- Pillar 3: Personal pension plans

In 2007, the German government raised the statutory retirement age from 65 to 67. In 2012, a transitional phase to attain the retirement age of 67 was started, which involves a gradual increase of the retirement age up until 2029.

The statutory pension insurance, structured as a pay-as-you-go scheme that goes back more than 110 years, is the largest social security scheme in Germany. It covers approximately 52 million people and almost 90% of Germany's employees are entitled to benefits from the statutory pension insurance⁵⁷. In 2013, all persons subject to social security charges contributed 18.9% of their gross income to the scheme, with contributions divided equally between employer and employee⁵⁸. In 2012, the German public spending on old-age benefits was amongst the highest in OECD countries. At 57.2% for average earners entering the labour market in 2012, the net replacement rate from all mandatory sources of retirement was considerably lower than for comparable countries. One of the worst demographic shifts in Europe – increasing life expectancy while fewer children are being born – is forcing younger generations to assure an adequate retirement income through

⁵⁷ "Deutsche Rentenversicherung", 2013.

⁵⁸ All social security contributions are usually (and historically) divided equally. There might be exceptions, e.g. in the case of "Minijobs". The variable contribution cap ("Beitragsbemessungsgrenze") for 2014: €71,400 for the old "Bundesländer" ("Beitragsbemessungsgrenze West") and €60,000 for the new "Bundesländer" ("Beitragsbemessungsgrenze Ost").

private savings⁵⁹.

Since 2002, the German government ran several reforms to promote private pension savings through subsidies and tax incentives, as well as social contribution savings in the case of occupational pension plans. In 2002, company pension plans (pillar 2) that have traditionally been provided on a voluntary basis by employers have been transformed into an employee's right to have a part of their earnings paid into a company pension plan under a deferred compensation arrangement. The same year, the "Riester" reform was introduced to boost personal pension savings and in 2005 the "Rürup" pension was introduced to further complement personal pension plans.

Pension Vehicles

Private pensions are divided into occupational pension plans and personal pension plans.

Occupational pension schemes

For a long time, occupational pension plans have typically been provided by employers on a voluntary basis. Since January 2002, employees have the right to occupational pensions through deferred compensation, which means that future salary or special payments, such as vocational benefits or salary increases, for up to 4% of a variable contribution cap⁶⁰ can be converted to entitlements to a pension, if not regulated differently by a labour agreement. While employers have to comply with the demand for occupational pensions and execute them, they have the free choice when it comes to structuring the retirement provision. There are five types of occupational retirement schemes that can be divided into two sub-pillars: one direct pension promise, the "Direktzusage" (book reserves), and four external types of occupational pension schemes, the "Unterstützungskasse" (support funds), the "Direktversicherung" (direct insurance), the "Pensionskasse" and the "Pensionsfonds" (pension funds)⁶¹.

Two or more types of occupational pension plans can also be combined, while employers have to at least offer a direct insurance, so that employees may benefit

⁵⁹ OECD, 2013a.

⁶⁰ "Beitragsbemessungsgrenze"

⁶¹ BVI, 2014.





from tax advantages and social security contribution savings. There is no legal obligation for the employer to participate financially in the occupational pension plan. When there is a binding labour agreement, occupational pensions are generally organised for whole industrial sectors and there is no employee's right to demand divergent occupational pension provision. Many collective agreements also oblige employers to participate financially in occupational pensions and withdraw the employer's right to choose the retirement scheme. Indeed, employer-funded pensions present the largest share of occupational pensions, though an increasing number of deferred compensation arrangements can be found. If the occupational pension is structured as a deferred compensation and contributions are thus exempted from taxation and social security contributions, this will in return lower claims from the statutory pension insurance.

Book reserves (“Direktzusage”)

Book reserves are pension provisions that the employer realises on the company's balance sheet in order to pay an occupational pension once the employee reaches the retirement age. It is also possible to transfer these provisions to a trust under a Contractual Trust Arrangement (CTA). Book reserves are subject to deferred taxation. The legislator obliges to protect claims from book reserves through the “Pensions-Sicherungs-Verein” (PSVaG) in the case of an employer's insolvency. Reserves transferred to a trust are protected from creditors in the case of insolvency through legal independency. Book reserves are usually designed as pure benefits given by employers, though deferred compensation is generally possible too. If an employee leaves the company, there is no possibility to continue the retirement provision through private funding, though by then deferred benefits are maintained. Book reserves are the most widely utilised type of occupational pension plans and are well-suited for small companies due to their simplicity.

Support funds (“Unterstützungskasse”)

Support funds, one of the oldest forms of occupational pension schemes, are institutions funded by one or several companies to provide retirement provisions for employees. The latter have no direct legal claim to benefits from support funds but only from their employers. Support funds invest the deposited money to pay a company pension at a later date. If there is not enough money in the support fund to meet retirement commitments, employers have to compensate the difference. The PSVaG protects employee's benefits in the case of an employer's insolvency. However, support funds are not subject to BaFIN supervision. Support funds are subject to deferred taxation.

Direct insurance (“Direktversicherung”)

These types of occupational pensions are life insurance contracts that an employer concludes with an insurance company for its employees. Contributions can either be entirely paid by the employer or by the employee in the form of deferred compensation or be split between both parties. Only employees or surviving dependents have claims to benefits from direct insurances. The insurance contracts can be continued with personal contributions if the employee leaves the company. If an employee solely contributes to a direct insurance through deferred compensation, exemptions from taxation and social security contributions can be granted or, alternatively, the employee can make use of the “Riester” support.

“Pensionskasse”

“Pensionskassen” are institutions, formed by one or several companies, which take the form of special life insurance companies. Contributions are paid by employers but employees can also participate and benefit from tax exemptions and social security contribution exemptions up to a contribution cap⁶². It is likewise possible to make use of the “Riester” support if employee’s contributions are made from individually taxed incomes. Benefits from “Pensionskassen” are subject to deferred taxation. “Pensionskassen”, legal entities that continue to pay benefits even in the case of an employer’s insolvency, are supervised by the German Federal Financial Supervisory Authority (“Bundesanstalt für Finanzdienstleistungsaufsicht”; BaFin). In contrast with direct insurances, employees become direct insureds and often even members of the “Pensionskasse”. Retirement provisions through “Pensionskassen” can be maintained with personal provisions if employees leave the company. Usually, “Pensionskassen” offer classic life annuity contracts that may invest a maximum of 35% of the capital in equity.

Pension funds (“Pensionsfonds”)

Pension funds, introduced on 1 January 2002, as a new type of occupational retirement scheme, are legal entities that grant employees a legal right to pension benefits. They can invest employee’s contributions more freely than direct insurances and “Pensionskassen”. Since their risk is higher, they are supervised by

⁶² For direct insurance, *Pensionskasse* and pension funds: 4% of the contribution cap “Beitragsbemessungsgrenze West” (BBVG-RV West) + 1,800 EUR is tax exempted; 4% of the BBVG-RV West is exempted from social security contributions.





the German Federal Financial Supervisory Authority (BaFin) and protected by the PSVaG in the case of insolvency. Employees can contribute to pension funds through deferred compensation while benefitting from tax exemptions and social security contributions exemptions up to a contribution cap. It is likewise possible to profit from the “*Riester*” support if contributions are made from individually taxed incomes. Vested retirement provisions through pension funds can be maintained with personal provisions if employees leave the company. Retirement payments can be fulfilled as lifelong annuities but there is also the possibility to have a lump sum pay-out at the beginning of the retirement phase. In contrast to “*Pensionskassen*” and direct insurances, pension funds are not subject to quantitative investment rules⁶³.

Overall, the growth of entitlements to occupational pension plans was mainly effected from 2001 to 2005. Since then, the percentage of employees with such entitlements has hardly changed. However, in recent years, entitlements have particularly grown for “*Pensionskassen*”. Pension funds, that have been available as occupational pension plans since 2002, also showed a dynamic increase, although implications are considerably smaller than for the more established funds. It should be noted that an individual can have several entitlements and surveys of the German Federal Ministry of Labour and Social Affairs have shown that individuals are often poorly informed about their occupational pension provisions.

Table 51. Entitlements to active occupational pensions (in million)

	2001	2003	2005	2007	2009	2011
Book reserves and support funds	3.86	4.05	4.72	4.54	4.50	4.68
Direct insurance	4.21	4.16	4.08	4.18	4.34	4.72
Pension funds	na	0.09	0.12	0.32	0.34	0.38
<i>Pensionskassen</i>	1.39	3.24	4.08	4.45	4.51	4.63
Total	9.46	11.54	13.00	13.49	13.69	14.41

Source: “*Bundesministerium für Arbeit und Soziales*”, 2012

The “*Riester*” support is rarely used within the framework of occupational pension schemes. It is registered in only 1-2% of the cases⁶⁴.

⁶³ aba, 2014.

⁶⁴ “*Bundesministerium für Arbeit und Soziales*”, 2012.

Personal pension plans

Over the last few years, German governments have undertaken significant communication efforts to advertise personal provisions for old age to supplement the statutory pension insurance. Since 2002, “*Riester*” pension savings are encouraged by the government through two different channels: subsidies and taxation reliefs. In 2005, the “*Rürup*” pension was introduced specifically to support the self-employed through tax exemptions.

“*Riester*” pensions

“*Riester*” products are certified personal pension plans with the objective of building up a funded retirement pension supplement. Subscribers to a “*Riester*” product receive subsidies from the German state whose amount depends on the personally invested contributions. Subsidies are at their maximum if the total contributions to a “*Riester*” product (that is, personally invested contributions plus subsidies), reach at least 4% of the individual’s previous year’s income. The subsidies add up to €154 per adult plus €300 for each child born since 2008 respectively and €185 for those born before 2008. The minimum contribution is €60 per year with corresponding lesser subsidies. Subscribers that are younger than 25 years of age receive a bonus of €200 at the moment of subscription to a “*Riester*” product. Though little used (see above), the “*Riester*” support by the German state is also applicable to occupational pension plans for the following three types: “*Pensionskassen*”, pension funds and direct insurances. “*Riester*” products are subject to deferred taxation⁶⁵.

“*Riester*” pension benefits can be paid out starting at the age of 62 respectively at the age of 60 for contracts concluded before 2012. The subscriber obtains the right to convert the invested capital into a life annuity or a programmed withdrawal where up to 30% of the accumulated savings can be paid out as a lump sum, a right that can also be bequeathed. Furthermore, one fifth of the accumulated savings is reserved for life annuities starting at the age of 85.

The following types of investments are eligible as “*Riester*” products:

- “*Banksparkplan*” (bank savings plan): These contracts are typical long-term bank savings plans with fixed and variable interest rates.
- “*Rentenversicherung*” (pension insurance): These “*Riester*” plans,

⁶⁵ “Bundesministerium für Arbeit und Soziales”, 2014.





offered by insurance companies, exist in two forms: there are typical pension insurance contracts consisting of guaranteed annuities and a participation in profits. Additionally, there are also hybrid contracts where a fraction of the retirement savings is invested into investment funds. They consist of a guaranteed part and a unit-linked part that depends on the performance of investment funds.

- *“Fondssparplan”* (investment fund savings plan): Savings are unit-linked, invested into investment funds chosen by the subscriber from a pool of funds proposed by a financial intermediary. The intermediary has to at least guarantee that the invested money plus the state’s subsidies are available at the moment of retirement. In the case of premature withdrawals, a loss of capital is possible.
- *“Wohn-Riester/Eigenheimrente”*: These contracts take the form of real estate savings agreements⁶⁶.

At the end of 2013, about 15.9 million *“Riester”* contracts have been subscribed to. After increases of about 1 million contracts per year in recent periods, only 0.4 million contracts have been added in the year of 2012 and 0.2 million in the year of 2013. Brought up explanations involve the financial crisis along with less favourable media coverage of *“Riester”* products that has reinforced general doubts concerning funded retirement savings. It should be noted that an individual can subscribe to several *“Riester”* contracts at the same time so a direct inference to the number of individuals possessing a *“Riester”* contract is not possible. About 70% of the *“Riester”* contracts take the form of pension insurance contracts⁶⁷.

⁶⁶ GDV, 2014.

⁶⁷ *“Bundesministerium für Arbeit und Soziales”*, 2012.

Table 52. Number of “Riester” contracts (in thousand)

	Pension insurance	Bank savings plan	Investment fund savings plan	Building savings agreements	Total
2001	1,400	na	na	na	1,400
2002	3,047	150	174	na	3,371
2003	3,486	197	241	na	3,924
2004	3,661	213	316	na	4,190
2005	4,797	260	574	na	5,630
2006	6,468	351	1,231	na	8,050
2007	8,355	480	1,922	na	10,757
2008	9,185	554	2,386	22	12,147
2009	9,794	633	2,629	197	13,253
2010	10,380	703	2,815	460	14,359
2011	10,882	750	2,953	724	15,309
2012	10,956	781	2,989	953	15,679
2013	10,898	806	3,027	1,154	15,885

Source: Bundesministerium für Arbeit und Soziales:

<http://www.bmas.de/DE/Themen/Rente/Zusaetzliche-Altersvorsorge/statistik-zusaetzliche-altersvorsorge.html> (Accessed on 11.06.14).

“Rürup” Pensions

Introduced in 2005, the “Rürup” pension (or “Basisrente”) is a relatively new form of pension insurance and, next to occupational pension plans and “Riester” pension plans, the third kind of private pension that is supported by the German state through tax exemptions. The “Rürup” pension actually has similar characteristics to the statutory pension insurance. Contributions are utilised for monthly life annuities starting with the retirement phase at the age of 62 respectively at the age of 60 for contracts concluded before 2012. The benefits are personal thus non-transferable and cannot be bequeathed, lent, disposed or capitalised. There is no possibility to pay out lump sums. Contributions are exempted from taxation up to a deduction cap. “Rürup” pensions that were particularly designed for self-employed persons and freelancers, who could not benefit from state supported pension savings till 2005, are beneficial for high revenues because of the high tax exempted savings amount. “Rürup” pension plans take the form of pension insurance contracts that are, in contrast with the “Riester” one, irredeemable and where invested money cannot be regained before the retirement phase. It is also possible to subscribe to “Rürup” contracts that invest into investment funds through savings plans. Such contracts can be designed⁶⁸ with or without capital guarantees⁶⁸.

⁶⁸ “Deutsche Rentenversicherung”, 2013.





At the end of June 2012, about 1.6 million “Rürup” contracts have been subscribed to. After a dynamic increase since their introduction in 2005, growth has slowed down in the first half-year of 2012 similar to the development observable for “Riester” contracts⁶⁹.

Table 53. Number of “Rürup” contracts (in thousand)

	2005	2006	2007	2008	2009	2010	2011	I/2012	II/2012
Number of contracts	153	327	602	855	1,092	1,228	1,488	1,530	1,552

Source: “Bundesministerium für Arbeit und Soziales“, 2012.

Life insurance and pension insurance contracts

Retirement provision in Germany is also carried out through classic pension insurance products or life insurance products, possibly ones that are unit-linked. However, if not certified in the framework of the “Riester” pension, the “Rürup” pension or as an occupational pension plan, these contracts do not benefit from allowable deductions or subsidies. The classic pension insurance however does play an important role in personal retirement provisions with about 22.4 million contracts⁷⁰ concluded at the end of 2012, whilst at the end of 2001, about 11.4 million contracts were concluded⁷¹.

Charges

Information on charges for private pension products are rather hard to obtain and often non-transparent for individuals, which complicates the decision making process.

In the case of book reserves and support funds, an employer has to meet the retirement commitments agreed upon. There is also neither a direct legal relationship between employees and support funds nor an employee’s claim for benefits from support funds. Consequently, charges will not be discussed within this scope for book reserves and support funds.

⁶⁹ “Bundesministerium für Arbeit und Soziales“, 2012.

⁷⁰ Contracts have a very diverse nature. They usually start paying out at the moment of retirement though there are also contracts that pay immediately after conclusion (“Sofortrente”). It is possible to redeem both via lump sums and annuities. As of 2012, there were 89.1 million life insurance contracts with €764.5 billion AUM.

⁷¹ GDV, 2013.

One of the main advantages of occupational pension schemes is that charges are usually lower than for personal pension plans because they are spread over larger groups. Employers often receive quantity discounts or customised rates with lower administrative charges. This is especially the case if rates are defined for whole industry sectors. For instance, commissions for occupational pension schemes in the chemical industry, building industry, metal and electrical industry and printing industry are about 1.6% of premiums (entry fees) while “Riester” contracts reach about 4%.

In general, occupational pension plans are designed for employees with preferably long affiliations to the company since the charges on initial contributions can be high.

The following operating expenses (administrative costs) for both “Pensionskassen” and pension funds are expressed as a percentage of the funds’ total assets.

**Table 54. Operating expenses as a % of total assets for
“Pensionskassen” and pension funds**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Administrative charges	0.251	0.758	1.004	0.615	0.439	0.323	0.279	0.266	0.247	0.219	0.211

Source: OECD Global Pension Statistic

Table 55 details information on charges for all types of life insurance contracts:

Table 55. Life insurance expense ratios

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Acquisition charges (as % of total premiums for new policies)	5.60	5.50	5.40	5.00	4.50	5.60	4.90	5.20	4.90	5.20	5.10	5.00	5.00
Administrative charges (as % of mean capital investments)	0.40	0.39	0.38	0.37	0.35	0.35	0.33	0.31	0.30	0.29	0.27	0.25	0.25

Source: GDV, 2013

Charges for “Riester” products are often the topic of negative media coverage in





Germany. It is frequently stated that the charges consume almost all of the state's subsidies. Especially challenging for individuals is the complicated cost structure and the lack of transparency of "Riester" contracts. For instance, there are internal costs like acquisition costs, distribution costs and administrative costs that are derived from differing and sometimes ambiguous determination bases as well as external costs if parts are invested into investment funds. This opacity has created a curious situation where even providers with favourable charges are unable to properly set themselves apart from the expensive ones. Calculations in the early 2000s by the German government, estimated the total charges to be 10% of the yearly savings premium; this has become the standard for "Riester" charges calculations ever since⁷². The German legislator only dictates that acquisition and distribution charges of "Riester" products have to be spread over 5 years so the initial cost burden is slightly alleviated. Own research shows that estimations of total charges of, on average, 10% to 12% of the yearly savings premium can be assumed. However, one can observe an enormous cost span reaching from 2.5% to 20% for insurance contracts⁷³.

With regard to "Rürup" contracts and their short history, information is even harder to obtain. There is no transparency regarding the cost structure (there is no obligation by law for detailed disclosures; current improvements only aim at "Riester" contracts thus far starting from 2015). The total charges for "Rürup" pensions expressed as percentages of the yearly savings premium are estimated by practitioners to be a little lower than for "Riester" pensions. In contrast to "Riester" products, there is no obligation to spread the initial acquisition and distribution charges over a defined period⁷⁴.

Other personal retirement provisions such as pension insurance contracts and life insurance contracts are often stated to have slightly lower total charges than "Riester" products.

The German legislator recently decided to oblige "Riester" providers to indicate binding and comparable cost figures starting from 2015, such as the reduction in yield ratio.

⁷² Rürup-Kommission, 2003.

⁷³ Gasche, Bucher-Koenen, Haupt, Angstmann 2013.

⁷⁴ ZEW (ZEW – Zentrum für Europäische Wirtschaftsforschung – The Centre for European Economic Research), 2010.

Taxation

A reorganisation of retirement savings taxation has been instructed by a Federal Constitutional Court decision from 2002. This revision came into effect in 2005 whereupon taxation is based on a model that divides the different forms of retirement savings according to three groups.

The statutory pension insurance and the “*Rürup*” pension belong to the first group. Funded pension schemes like occupational pensions and the “*Riester*” pension belong to the second group. The third group covers the standard pension insurance or life insurance products due to their likewise existent function as investment products.

Contributions to products from the third group always have to be paid from taxed income. The products from the first two groups are subject to deferred taxation. Contributions up to a deduction cap are exempted from taxation and generally subject to tax in its entirety during the pay-out phase.

While products from the second group have already been partially subject to deferred taxation before 2005, this has not been the case for products from the first group. A transitional phase towards complete deferred taxation was started in 2005 and since then, every year, higher amounts of contributions can be deducted from taxation and consequently the amount of retirement pay-outs subject to taxation rises. In 2025, pension savings for up to €20,000 for individual insurees and €40,000 for spouses will be exempted from initial taxation. 60% of the maximal amount was tax deductible in 2005 which means the percentage rises 2% each year until the maximum is attained in 2025. The 50%-contribution of employers is already tax exempted so in 2013, 26% of employee’s total contributions to retirement savings were tax exempted.

The percentage of retirement pay-outs subject to taxation was 50% in 2005. Since then, for each year following, the percentage of retirement pay-outs subject to taxation for new retirees rises at a rate of 2% which means that in 2020, new retirees will pay taxes on 80% of their retirement pay-outs. From 2020 on, the rate rises at 1% and consequently retirees from 2040 on have to pay full taxes on their retirement pay-outs⁷⁵.

⁷⁵ “*Deutsche Rentenversicherung*”, 2013.





Occupational pensions schemes

For occupational pension plans in 2013, and for commitments starting from 2005 on, the following taxation rules apply for the individual types of occupational pension schemes:

Book reserves and support funds

Book reserve and support fund contributions, through deferred compensation, are fully tax exempted while up to 4% of a variable contribution cap is exempted from social security contributions. Benefits are taxed as income at the personal rate.

Direct insurances, “Pensionskassen” and pension funds

Direct insurances, “Pensionskassen” and pension funds are treated identically according to taxation legislation. In 2013, contributions through deferred compensation are tax exempted for up to €4,584 (4% of the 2013 contribution cap +€1,800⁷⁶) and exempted from social security contributions for up to €2,784 (4% of the 2013 contribution cap)⁷⁷. Investment income is tax exempted while benefits are subject to taxation⁷⁸.

Personal pension plans

“Riester” pensions

Since 2008, total contributions to a “Riester” product of at most €2,100 are exempted from initial taxation even if this amount is more than 4% of the previous year’s income. During the savings accumulation period, investment income is likewise tax exempted. In case the tax relief surpasses the state’s subsidies, this is reviewed by fiscal authorities within the framework of the income tax statement. If so, individuals benefit from tax exemption for the difference between the subsidies and the maximum amount of tax exemption. Benefits from “Riester” pensions are taxed in the retirement phase but are exempted from social security contributions.

⁷⁶ Not exempted from social security contribution.

⁷⁷ If the limits have not already been reached by employers’ contributions.

⁷⁸ “Bundesministerium für Arbeit und Soziales”, 2013.

“Rürup” pensions

Contributions to “Rürup” pensions will be exempted from taxation for up to €20,000 per adult in the year of 2025. As of 2005, 60% of this ceiling was exempted from taxation and during the transitional phase⁷⁹.

Table 56. Tax exemptions for “Rürup” contributions

Year of contribution	2005	...	2013	...	2020	...	2025
Tax deductible	60%	...	76%	...	90%	...	100%

Source: “Bundesfinanzministerium”

Benefits from “Rürup” pensions are taxed in the retirement phase at the personal rate. In 2005, 50% of the benefits were subject to deferred taxation. Until the year 2020, the taxable part of each year increases by 2%. From then on, the proportion increases by 1% each year until finally, from the year 2040 on, benefits are entirely taxed⁸⁰.

Table 57. Taxation of “Rürup” benefits

Year of benefit	2005	...	2013	...	2020	...	2040
Tax deductible	50%	...	66%	...	80%	...	100%

Source: “Bundesfinanzministerium”

Life insurance and pension insurance contracts

Other retirement savings products that are not particularly promoted by the German state are taxed as follows for contracts subscribed to since 2005: contributions are no longer tax deductible as special expenses and have to be paid as taxed income. Furthermore, one has to differentiate on the basis of whether the insurance benefit is carried out as a one-time lump sum payment or if a lifetime annuity payment is granted. For standard pension insurance contracts and life insurance contracts, benefits are taxed on the corresponding earnings (the difference between contributions and total pay-outs) in the retirement phase. If the contract runs at least 12 years and the insuree is older than 62 years, only 50% of this amount is subject to taxation when a lump sum pay-out is chosen. If these

⁷⁹ The percentage will rise at a rate of 2% in each year.

⁸⁰ “Bundesfinanzministerium”, 2014.





conditions are not met, all earnings are taxed and are subject to the flat rate tax of 25% (and not the individual tax rate). For the case of life annuities, even further tax reliefs are possible depending on the age of the first retirement pay-out. If the retiree is 62, 21% of the earnings are subject to taxation, at the age of 65, 18% and at the age of 67, 17%. Once defined, the percentage does not change and the earnings are taxed at the personal tax rate. These taxation rules are applicable for classic insurance contracts as well as unit-linked ones.

Pension Returns

There is no information on the return of book reserves and support funds. These are individual commitments to employees that will not increase or decrease depending on asset performances. The commitments are protected by the PSVaG hence employees could estimate the exact amount they can expect in the retirement phase.

In general, there are no taxes on dividends, income or capital gains to take into account during the accumulation phase of the real return calculations. However, the calculations are considerably complicated by the fact that EET and TEE taxation formulas (or intermixtures) can still be found. This should be kept in mind when interpreting real return results.

Occupational pension schemes

“Pensionskassen” and pension funds

The following real return calculations for pillar 2 aggregate “Pensionskassen” as well as pension funds.

Table 58. “Pensionskassen” and pension funds' average annual rate of investment returns (in %)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Annual average
Nominal return* before charges, inflation, tax	2.81	4.58	4.94	5.07	4.78	4.28	1.65	4.86	5.12	3.07	4.82	4.17
Nominal return after charges and before tax, inflation	2.55	3.79	3.89	4.43	4.32	3.94	1.37	4.59	4.86	2.84	4.60	3.74
Real return after charges, inflation and before tax	1.13	2.76	2.05	2.48	2.48	1.60	<u>-1.39</u>	4.38	3.62	0.34	2.45	1.98

* Nominal return after investment management costs

Source: OECD, 2013b; OECD Global Pension Statistic; Eurostat; Own Research.

To estimate the impact of taxation on the real return of “Pensionskassen” and pension funds, the average income tax rate for retirees has been determined utilising customised data from the Federal Statistical Office of Germany (“Destatis”). This average income tax rate for retirees is estimated to be about 5.44%. Furthermore, at the end of 2012, 64% of the pay-outs were subject to deferred taxation.





Table 59. The real return of “Pensionskassen” and pension funds

	Real return after charges, inflation, tax (11-year average, in %) / 2002-2012
Pensionskassen and pension funds	1.87
<i>Source: Destatis; Own Research</i>	

German pension funds and “Pensionskassen” are predominantly offered as defined benefit plans, so employees bear minor risks when investment assets perform poorly⁸¹.

Personal pension plans

Information on the performance of personal pension plans is hard to obtain and there are considerable controversies about the proper estimation method, notably for “Riester” insurance contracts.

Calculations for real returns on personal pension plans are only executed for insurance contract types since information on returns and charges is not consistently available for other types of personal pension plans. Nonetheless, this provides an important insight into the most important part of promoted personal pension plans since 70% of all “Riester” pensions are designed as pension insurance contracts, as are all “Rürup” pensions.

The following real return calculations are based on the average return rate for new insurance policies calculated by “Assekurata”⁸². The return rate is composed of a guaranteed interest part and a surplus sharing part. One has to keep in mind that the calculations made by “Assekurata” are based on voluntary participations. For instance, in the year of 2013, 76 providers have been asked to participate while 7 providers did not respond. This may lead to a bias based on voluntariness.

Though already introduced in 2002, data on investment return rates has only been available since 2005 for “Riester” pensions, as for “Rürup” pensions which were

⁸¹ OECD, 2013b.

⁸² “ASSEKURATA Assekuranz Rating-Agentur GmbH” (www.assekurata.de) is a private company specialised in the quality assessment of insurance companies from a customer's perspective providing rating and analysis services. For instance, ASSEKURATA is the only rating agency incorporating policy holder's opinions on their insurers gathered from customer surveys directly into their verdicts. ASSEKURATA, as a licensed European rating agency, is supervised by the European Securities and Markets Authority (ESMA).

introduced that year. Return rates for classic pension insurances are available for a 14-year period.

“Riester” pension

Table 60. “Riester” pension insurances’ average annual rate of investment returns (in %)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Annual average
Nominal return before charges, inflation, tax	4.24	4.18	4.18	4.36	4.27	4.19	4.05	3.92	3.56	4.11
Nominal return after charges and before tax, inflation	2.81	2.77	2.80	2.98	2.90	3.91	3.79	3.66	3.30	3.21
Real return after charges, inflation and before tax	0.90	0.96	0.48	0.18	2.70	2.68	1.26	1.53	1.67	1.37

Source: Assekurata; Eurostat; GDV; Own Research

One has to note though that for “Riester” products, subsidies, which are not included in these calculations, can play an important role in determining their performance. This is especially the case for low earners or for families with many children. Average and high earners rather benefit from the tax exemptions.

“Rürup” pension

Table 61. “Rürup” pension’s average annual rate of investment returns (in %)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Annual average
Nominal return before charges, inflation, tax	4.31	4.20	4.21	4.37	4.27	4.21	4.07	3.90	3.57	4.12
Nominal return after charges and before tax, inflation	2.88	2.79	2.82	2.99	2.90	3.93	3.81	3.64	3.31	3.23
Real return after charges, inflation and before tax	0.96	0.98	0.51	0.19	2.70	2.70	1.28	1.51	1.68	1.39

Source: Assekurata; Eurostat; GDV; Own Research

As discussed above, the contributions to “Rürup” pensions are, in contrast to “Riester” pensions⁸³, not guaranteed and cannot be recalled or capitalised, which can lead to the following difficulty: “Rürup” pensions were especially introduced for self-employed persons and freelancer where income may vary considerably from year to year, in particular in times of crises. If contributions can no longer be maintained, and with contracts that are concluded “until death”, administrative

⁸³ Contribution and state subsidies in “Riester” unit-linked contracts are guaranteed.





charges can gradually diminish invested retirement savings. Hence, consumer advice centres⁸⁴ usually only advise “Rürup” pensions if consumers are professionally established and if the payments of contributions are secured in the long run⁸⁵.

Personal pension insurance

For our estimations, we assumed that acquisition charges are spread over five years for all insurance contract types. Consequently, the charge burden in the first five years is considerably aggravated. Again, the average income tax rate for retirees has been utilised to calculate real returns after tax. The classic pension insurance is not subject to deferred taxation so one has to be careful with the interpretation of its return. Since contributions have to be paid from taxed income, classic pension insurances are generally less favourable than “Riester” or “Rürup” pensions with regard to the tax burden. However, the complexity of taxation in all three stages (contribution phase, accumulation phase and pay-out phase) could not be taken into account within this study and consequently only taxation in the capital accumulation phase and in the pay-out phase is included in real return calculations. This is an important estimation drawback that the government-supported “Riester” and “Rürup” pensions have to face compared to the classic pension insurances. For last-mentioned, we also assumed characteristics as if a lump sum pay-out was chosen, that the retiree is older than 62, and that the contract ran at least 12 years.

Table 62. Pension insurances’ average annual rate of investment returns (in %)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Annual average
Nominal return before charges, inflation, tax	7.15	7.1	6.12	4.84	4.43	4.31	4.24	4.25	4.39	4.28	4.20	4.07	3.91	3.61	4.77
Nominal return after charges and before tax, inflation	5.63	5.59	4.63	3.38	3.00	3.94	3.90	3.93	4.08	3.98	3.92	3.81	3.65	3.35	4.05
Real return after charges, inflation and before tax	4.17	3.62	3.19	2.36	1.17	2.01	2.06	1.59	1.24	3.77	2.69	1.28	1.52	1.72	2.31

Source: Assekurata; Eurostat; GDV; Own Research.

⁸⁴ Such as, for instance, Verbraucherzentrale Hamburg e. V.

⁸⁵ Gasche, Bucher-Koenen, Haupt, Angstmann 2013.

Table 63. The real return of “Riester” and “Rürup” pensions	
	Real return after charges, inflation, tax (9-year average, in %)
	2005-2013
“Riester” pension insurance	1.27
“Rürup” pension	1.29
Source: Destatis; Own Research	

Table 64. The real return of personal pension insurances	
	Real return after charges, inflation, tax (14-year average, in %)
	2000-2013
Personal pension insurance	2.22
Source: Destatis; Own Research	

There is no information available on the return of life insurance contracts only in the context of occupational pension schemes.

Conclusions

The performance of “Pensionskassen” and pension funds in real terms has been positive over the period from 2002-2012 with about 1.9% after taxation. The only year with a negative performance could be witnessed in 2008 with a real return of about -1.4% while the difficult year of 2011 still produced a slightly positive real return of about 0.3%.

The real return of personal insurances has also been positive, about 1.3% for “Riester” and “Rürup” pensions over a 9-year span, and 2.2% for classic pension insurances over a 14-year span. Yet there is a continuous decline of nominal returns observable in recent years in coincidence with a lowering of the guaranteed interest part (from 2.25% in 2011 to 1.75% in 2012). At the same time investment risk generally rises with providers pushing for unit linked contracts. The legislator consequently decided to reform the general framework of personal pension schemes again before long, e.g. with the implementation of binding and comparable cost figures for “Riester” pensions in 2015. The opacity of charges is a particularly controversial subject in Germany where further regulation might lower consumers’ cost burden and eventually increase real returns.





Private Pensions: The Real Returns

2014 Edition

Country Case: Italy

Introduction

The pension macro context

Italy spends 15.3% of its GDP on State pensions, while the average OECD level is at about 9.3%. Pensions, therefore, represent a massive ratio of GDP in the country. Employment rates also compare unfavourably to other OECD countries, with respectively 62% and 30% of males aged between 55-59 and 60-64 working against 78% and 54%, respectively on average in OECD countries. Looking at the eldest workers (aged 65-69) only 13% are employed, compared to 29.3% in other OECD countries.

Given this context, the urgency to reform the pension system was clear. In 2011, the minister of Welfare and Social Policy under the Monti government, Elsa Fornero, put into place a huge pension reform (Law n. 214) to set the system back to equilibrium. Under the new system, pension eligibility is based on working years rather than age. Earlier retirement is possible but with penalties. Given the increase in retirement age, the expected replacement rate of currently active workers, who work a full-time career without interruption, is about 70% (OECD, Pension at a glance) and is still one of the highest in Europe; this compares well with previous replacement rates, although it was obtained through a substantial increase in the pension age. Within this context, with a substantial replacement rate obtained through high mandatory contribution (33%) and a high retirement age, the income drop at retirement is not worrisome like in other countries, such as in the UK. There, the mandatory contribution rate is set at 10% and, correspondingly, the replacement rate, due to State pension, is about 30%. It is worth reminding that mandatory contributions are directed solely to the statutory and compulsory system.

Given this strong component of mandatory contributions, we would expect both complementary pensions and private savings to play a small role, which should, in turn, be driven by a foreseen reduction in income levels, such as during retirement. While the former savings in pension funds are tiny, private savings are still consistent. If all pension contributions and housing were transformed into an annuity, the corresponding stream of generated incomes at retirement would be very high.

In a broader view, all savings, not only pension savings, should be accounted for to measure income adequacy at retirement, without forgetting that one of the main actors in this broader picture is housing.

The Italian Pension System

The Italian Pension System is composed of i) a compulsory (now Notional Defined Contribution) pension system and ii) a voluntary private and funded pension system, including the pension schemes at the individual and collective levels.

In Italy the pillar 1, the State Pension, represents the main pension vehicle. Since the structural reform done by Dini in 1995, the Italian pension system has been re-designed according to the National Defined Contribution system, in order to guarantee the stability of public finances.

Given the predominance of the public pension system in the country, it is not surprising that complementary pensions have little chance to take off. The possible effect of the crowding out of public pensions into the private pension has been studied extensively. However, consensus on the issue has been very low. If anything, displacement is very small or even negative (Rossi, 2009).

In the following page there is a table with information on pension contribution into the public and private systems. If individuals are already covered by a strong public pension system (such as in Italy, where pension contributions are the highest), one can expect smaller private savings, mostly in the form of voluntary contributions to private pension funds. From the picture below, we can observe that there is indeed a negative correlation between mandatory pension contributions and voluntary private contributions. However, private savings should also be taken into consideration. Ultimately, all savings can be converted into additional income to increase pension income. Italy has traditionally been a country with a high savings rate, which could be seen as contradictory given the high mandatory pension



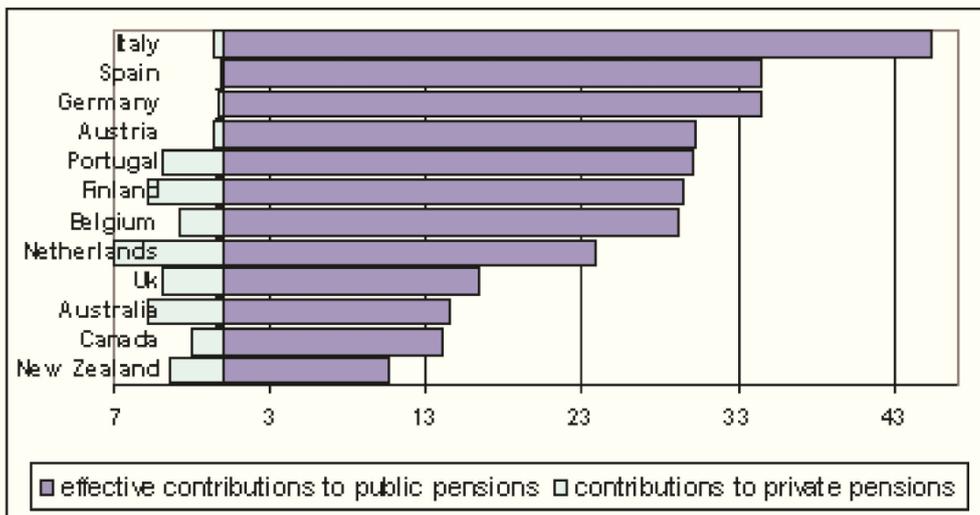


contributions. In 2008, the household net savings rate was 8.5%, it then declined to 7.5% in 2009, and in 2012 it was down to 4.3%, the lowest level ever experienced in history.

This dramatic decline suggests that the bad financial situation of the country, with stagnant growth, translated into fewer resources for households and, thus, lower savings rate.

However, sticking to the percentage of total resources channelled to pension schemes, Italy stands out as the most “prepared” country for retirement, with a percentage of pension contributions equalling approximately 44%, which is, by far, the highest percentage of mandatory savings for retirement purposes. Adding to that the 5% savings rate, we can infer that approximately 50% of household income is set aside for retirement. In countries, such as the UK, the total amount of pensions contributions and traditional savings is about half of Italian savings.

As large contributions to PAYG crowd-out private pensions...



The TFR, Severance Payment

Severance payment, which is paid upon work termination, represents a peculiar vehicle for pension asset accumulation, also known as “*Tattamento di Fine*”

Rapporto” (TFR). The TFR is computed on an annual basis and is equal to 6.91% of remuneration. It is mandatorily saved and returned upon termination of employment (such as retirement, the most common form).

The TFR (corresponding to Severance Payment upon work termination) rate of return is 1.5% on a yearly basis, in addition to the partial inflation coverage (75%). The TFR can also partially be drawn (70%) before the end of the contract, but only under very special circumstances of need, which include health problems, first-house purchase and parental leave. The fiscal regime is peculiar, as the tax rate is equal to the average tax rate of the last five years and capital gains are taxed at 11% (Cannata and Settimo, 2007).

The TFR represents a huge savings pot and its management underwent heavy changes from January 2007 onwards. Since then, each worker can opt for accumulating their TFR by joining a supplementary pension system. In the case of “silence”, the TFR is transferred to sector funds. If a worker does not express any decision, the tacit consent applies and the funds are transferred to collective pension funds, if there are any for that specific contractual decision.

This change represented a small cultural revolution in the Italian pension structure, where pensions had previously been provided by the public sector, with no active role by workers in choosing how much to invest. Workers have mandatorily contributed a conspicuous amount of their income, through pillar 1 State system, with no involvement in where to invest their savings. With the TFR law, workers are now offered the possibility to join pension funds (Cannata and Settimo, 2007). The severance indemnity stock of workers who did not opt for pension funds, if belonging to companies with more than 50 employees, is transferred to INPS (National Institute for Social Security), who manage the severance payment according to the law. For those who work in firms with less than 50 employees and who did not opt for pension funds, their TFR remains in the firms they work in, acting, de facto, as a loan to the firm.

If employees decide to opt for the pension funds, they can choose among open pension funds, closed pension funds or PIPs (Individual Pension Plans). An important aspect of this is that, if opting for PIPs, workers can decide the amount they contribute, a new element in the Italian framework, with no discretion in terms of pension contributions.





Table 65. Pension contribution rate (% of gross earnings)

	1994	1999	2004	2007	2009	Employee 2009	Employer 2009
Italy	28.3	32.7	32.7	32.7	32.7	9.2	23.8
EU27	na	na	23.8	23.3	22.5	7.9	14.0

Source: OECD, *Pension at a Glance*; 2011

Current Pension System

The current pension system is based on a Notional Defined Contribution system while in the past it was a generous Defined Benefit system. The Italian pension system has been reformed intensively and with many reforms. The year 1995 has been taken as the threshold for moving from defined benefit towards a defined contribution system, due to one of the most important laws that restructured the pension system, the Dini reform (Law n. 335/1995). Indeed, all workers entering the market after 1995 have been accruing their pension entitlement according to a defined contribution method, while, before 1995, pension entitlements were computed according to an earnings related system.

The three pillars of the Italian pension system can be wrapped up as follows:

- Pillar 1 (state and mandatory) is made up of two tiers. The zero tier consists of a social pension ensuring a minimum level of income for the elderly. The first tier covers employed people and constitutes for the current new generations a notional defined contribution system, as explained above.
- Pillar 2 is made up of supplementary occupational schemes. These can be closed occupational pension funds (managed by social partners) and open pension funds relative to collective affiliations (managed by financial institutions) (Guardiancich, 2010). The TFR is also part of pillar 2. TFR is a deferred indemnity. Each year the employer has to put aside (by law) part of the worker's salary which will be returned to the employee upon termination of the employment contract.
- Finally, pillar 3 is made up of voluntary contributions to pension schemes, Individual Pension Plans (PIP), as well as by contributions to open funds for individual affiliations.

Pension Vehicles

Complementary pension funds

Complementary pension funds were introduced in 1993 and they are composed of contractual funds, open funds and individual pension plans provided by life insurance companies.

At the end of 2011, the total stock of pension funds amounted to €90.7 billion, of which 50% belonged to pre-existing pension funds.

In Italy, the percentage of Private Pension funds out of total GDP is rather small, one of the main reasons being that pillar 1 dimension makes it very difficult for private funds to take-off. 33% of contributions from gross income are compulsorily put into pillar 1 pension contribution, which leaves little space for personal pension fund development.

Individual pension funds can represent the main vehicle for the pension accumulation, albeit when the State pension contributions are high, it comes natural to expect that private pension funds will not have a predominant role in shaping retirement savings. This is likely to be the case of Italy.

At the end of 2012, the total workers enrolled into personal pension amounted to 5.8 million (COVIP⁸⁶, annual report 2012). The average annual return of open pension funds from 2001 to 2012 was 0.7% (own calculation, from COVIP annual report 2012). During the same time horizon, the TFR has accrued at the pace of 2.7% (annual average). The main increase in enrolment is due to new PIP subscribers, which increased by 25%. It is worth noting that about 200,000 individuals have very little stock stored into complementary pensions, around €100.

The vast majority of members of the complementary pension funds are employed in the private sector (about 4 million).

⁸⁶ “Commissione di Vigilanza sui fondi Pension”, the Commission of Vigilance on Individual Pension funds.





Table 66. Number of subscribers in Complementary pension funds (2012)

	Employees			Total
	Private Sector	Public Sector	Self Employed	
Closed pension funds	1,813,998	151,427	4,346	1,969,771
Open pension funds	435,273	-	478,640	913,913
Pre-existing closed pension funds	632,902	3,339	23,679	659,920
New PIP	1,101,193	-	675,831	1,777,024
Old PIP	178,139	-	356,677	534,816
Total	4,160,898	154,766	1,513,010	5,828,674

Source: COVIP, *relazione annuale*; 2013

The main features of complementary pensions are:

- Voluntary membership;
- Funded;
- Managed by banks, financial institutions, insurance companies;
- Supervisory authority: COVIP (*Commissione di Vigilanza sui fondi Pensione*).

Looking at the portfolio composition of the complementary pension system as a whole, “safe” assets constitute the majority, by 58% (out of which 80% is in Treasury Bonds). Shares represent 12% and investment funds (OICR – *Organismi di Investimento Collettivo del Risparmio*) 15%. The average duration of the portfolio is about 3.7 years, which is homogeneous across different types of pension products, with the exception of PIPs, personal pension funds, which have a higher duration, of about 6.7 years.

They are defined contribution schemes. Below we describe the different types of complementary forms of pensions.

Contractual funds or Closed funds⁸⁷

Contractual funds are also called closed funds, as only certain groups of people can join. As an example, among employees, subscription is reserved to those whose contract is regulated by a collective agreement. As for self-employed, contractual

⁸⁷ Data on number of people enrolled and workers and returns are related to 2012 data (COVIP, 2013).

agreements are usually provided by professional associations; and only their members can subscribe.

They are defined contribution schemes and the contribution amount is established by the fund's bylaws (Paci et al, 2010).

All complementary pension funds are independent legal entities, with their own capital. The governance is based on the principle of equal representation among employers and employees.

The Board of Directors is responsible for the investment strategies and chooses the investment manager, as well as the depositary bank and the designated entity dealing with administration.

The fund must report at least on an annual basis. Given the long-term characteristic of funds, a manager's mandate is usually five years or even longer for certain types of assets.

At the end of 2012, assets managed by contractual funds amounted to €30.2 billion⁸⁸.

Open funds

In contrast to closed funds, membership is not restricted to certain groups. In addition the fund is not a legal entity. It can be established for collective or individual members or both.

Like contractual funds, open funds are defined contribution funds.

As in closed funds, a depositary bank is required and administration costs can be outsourced.

At the end of 2012, assets managed by open funds amounted €10.1 billion.

⁸⁸ Source: COVIP annual report, 2012.





PIP, individual pension funds

They are subscribed on individual basis only, as insurance contracts in the legal framework of complementary pension funds.

Within PIPs policies, two types of insurance contracts are offered: with-profits or unit-links. A combination of the two is possible to get a more flexible risk-profile.

The with-profits policies guarantee a minimum interest rate (guaranteed and consolidated in the company's accounts) as well as a quota related to the financial performance. The unit-linked policies do not have a guarantee. Their performance depends on the value of the unit where contributions are invested.

Public employees

Public employees deserve a special mentioning, as the law introducing pension funds excluded them. Up to now the coverage of public employees is limited. Contractual pension funds are only possible for school personnel (Espero) and the National Health and regional or local authorities (Perseo and Sirio).

All these forms of pension funds are supervised by the Commission of Vigilance on Individual Pension funds (COVIP).

The legislation putting into place pension funds dates back to 1993. Before the law implementation, pre-existing pension funds already existed. Pre-existing pension funds are the most numerous and they benefit from a more favourable treatment than the new ones. As they were created before the 1993 law, they were semi-autonomous in their management, and they still benefit of this treatment.

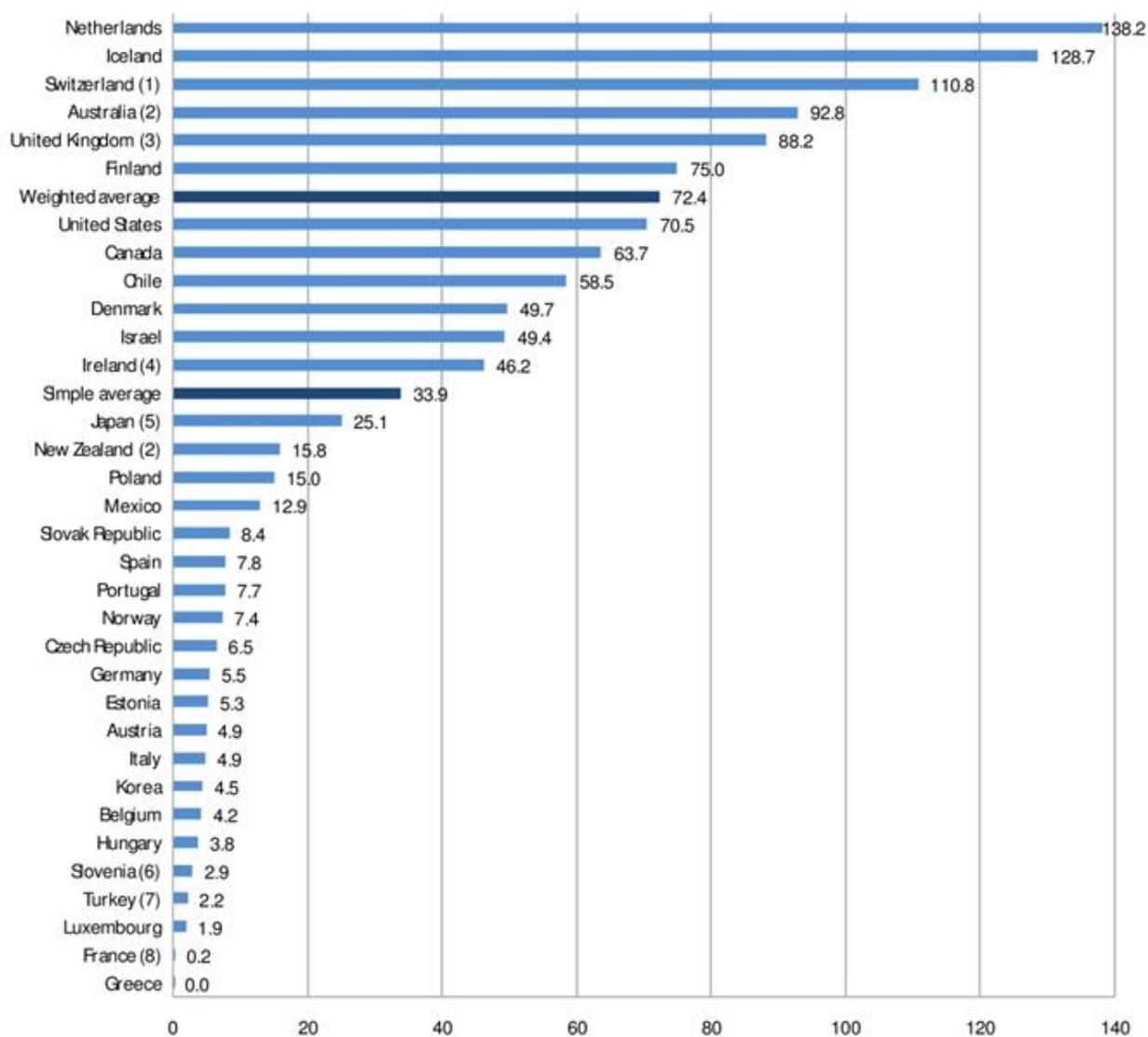
They can collect money directly from subscribers and distribute them without intermediaries.

The number of new members into pension plans is not increasing fast and it is driven by insurance companies and banks.

In order to give the relative importance of the pension dimension across Europe, we illustrate in the picture below the pension fund assets as a percentage of National GDP, in the graph TFR is also included (which has been part of private

pension funds since 2007). Italy has one of the lowest ratios of pension funds' assets to GDP. This result comes as no surprise given the intensity of State Pension Contribution in the system.

Pension funds assets as a percentage of GDP in OECD countries - 2011

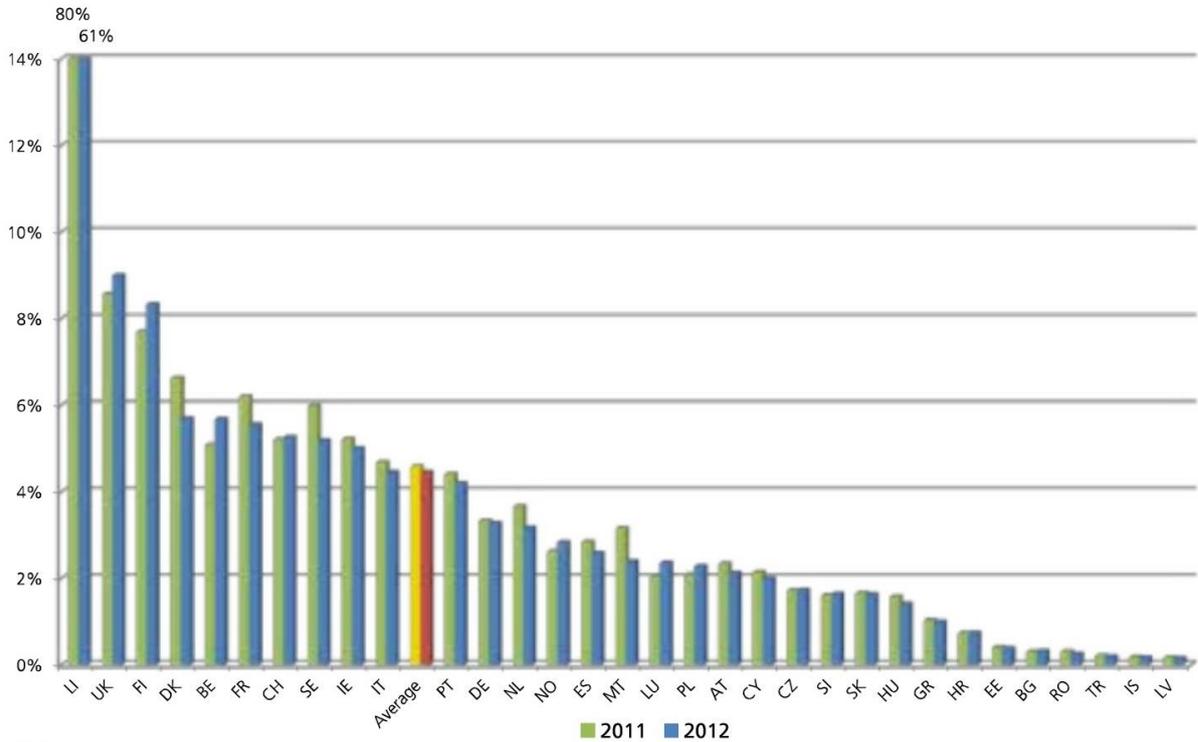


Source: OECD Global Pension Statistics.





Chart 10: Ratio of life premiums to GDP — 2011–2012



Notes:

- Calculated at constant exchange rates
- Denmark includes life insurance and multi-employer pension funds under Danish supervision. Company pension funds are not covered, but only make up 3% of the market and do not write new contracts
- Finland includes pension funds
- Germany includes "Pensionskassen" and pension funds
- Liechtenstein includes cross-border business

Life Insurance

Despite being a potential great channel for savings and a replacement for traditional pension channels, the life insurance market is very thin in Italy. Jappelli and Pistaferri (2008) show that a reform of tax breaks, which could have dramatically increased the demand for life insurance, actually had no effect. The table below illustrates the dimensions of the market (as a percent of GDP). Another recent paper by Bottazzi et al. (2009) finds that households have responded to the cut in pension benefits mostly by increasing real estate wealth, particularly among households that are able to estimate more accurately future social security benefits. On the other hand, they do not observe an increase in the propensity to purchase private pension funds and life insurance after the reform.

Charges

Costs declined over the past decade. The costs differ across types of funds ranging from a minimum of 0.2% (Closed funds) to 2.5% (PIPs) of managed asset, after 35 years of subscription. The incidence of the cost has been declining over the years due to the nature of fixed cost of the fund. Costs consist of administrative fees for asset management and custody.

Table 67. Average costs (in %)*				
	2 years	5 years	10 years	35 years
Closed funds	1.0	0.6	0.4	0.2
Min	0.5	0.4	0.2	0.1
Max	3.9	2.0	1.1	0.4
Open funds	2.0	1.3	1.2	1.1
Min	0.6	0.6	0.6	0.5
Max	4.5	2.8	2.1	1.7
PIP (new)	3.6	2.4	1.9	1.5
Min	0.9	0.9	0.9	0.7
Max	5.4	3.8	3.0	2.5

Source: COVIP Relazione annuale; 2013

* Costs differ depending on the number of contribution years.

(1st, 2nd, 3rd, 4th columns correspond respectively to 2, 5, 10 and 35 years of contributions).

There is a huge variation in pension funds costs. In closed pension funds, the indicator cost is about 1% for two years participation, while it drops to 0.2% after 35 years of participation. With respect to PIP it drops from 3.6% to 1.5%. It has to be reminded that small differences in the cost will reflect into effects of consistent magnitude. Ceteris paribus, PIP will have a final return 23% lower than that corresponding to closed pension funds; while the return of open funds will be of 17%.

The synthetic cost index indicator has been built by COVIP as an average of the costs associated to each sector investment (stocks, bonds, guaranteed and balanced).





Taxation

The regime of taxation chosen by Italy is essentially an ETT (exemption, taxation, taxation), corresponding to the following three stages: contribution, accumulation and payment.

At stage 1, contributions paid benefit from a favourable tax treatment. Contributions can be deducted from the taxable income up to €5,164,57 per year (the computation includes employer's contributions).

At stage 2, accruals are taxed. 11% of tax is applied on the accrued income paid by the insurer or by the pension fund.

In order to avoid double taxation, benefits are taxed only in relation to the shares not taxed during the accumulation phase. Hence, contributions that have not been deducted and thus have already been taxed will not be taxed again.

At stage 3, taxes apply corresponding to benefits. Taxation of benefits varies from 9 to 15% according to the duration of membership. Moreover the returns generated after retirement started (accruals on the asset after the annuity has started) are taxed at 12.5%.

Pension Returns

Below we illustrate gross returns broken down by type of activities. The variation across returns varies by type of investments.

Table 68. Gross return by type of investments								
	2005	2006	2007	2008	2009	2010	2011	2012
Closed funds	7.5	3.8	2.1	-6.3	8.5	3.0	0.1	8.2
Mono sector funds	8.3	3.7	1.4	-	-	-	-	-
Multi sector funds	-	-	-	-	-	-	-	-
Guaranteed	-	-	-	3.1	4.6	0.2	-0.5	7.7
Bonds only	2.1	2.6	2.2	1.6	2.9	0.4	1.7	3.0
Bonds mixed	6.9	2.7	2.1	3.9	8.1	3.6	1.1	8.1
Balanced	7.9	5.6	2.4	-9.4	10.4	3.6	-0.6	9.2
Stocks	14.9	8.2	1.3	-24.5	16.1	6.2	-3	11.4
Open pension funds	11.5	2.4	-0.4	-14	11.3	4.2	-2.4	9.1
Guaranteed	2.9	1.0	1.9	1.9	4.8	0.7	-0.3	6.6
Pure bonds	3.3	-0.2	1.6	4.9	4.0	1.0	1.0	6.4
Mixed	6.4	1.0	0.3	-2.2	6.7	2.6	0.4	8.0
Balanced	11.4	2.4	-0.3	-14.1	12.5	4.7	-2.3	10.0
Stocks	16.2	3.7	-1.6	-27.6	17.7	7.2	-5.3	10.8
PIP new	-	-	-	-	-	-	-	-
With-Profits—Separate management	-	-	-	3.5	3.5	3.8	3.5	3.8
Unit-linked	-	-	-	-24.9	16.3	5.2	-5.7	8.9
Bonds	-	-	-	2.7	4.1	0.7	0.9	5.3
Balanced	-	-	-	-9.3	8.8	2.8	-4.0	7.4
Stocks	-	-	-	-36.5	23.1	7.5	-8.8	10.8

Closed funds

Table 69 estimates the total net returns for closed pension funds. Line (1) gives the nominal return for closed pension funds as in the COVIP report (2013 and previous years). Line (2) is equal to Line (1) minus Inflation Rate (as CPI index variation in %). Line (3) is equal to line (2) once 0.2% of the return has been taken out. This number being the percent cost for a 35 year subscriber. Line (4) is the net return, equal to line (3), once 15% of the return has been taken out.





More specifically the pension benefit is taxed at 15%, calculated on the difference between capital and premiums paid. The tax can be reduced each year after the 15th by 0.3%, for a maximum of 6 percentage points of reduction in taxation of the benefit.

Between the end of 1999 and the end of 2013, the real return of closed funds after deduction of inflation, charges and taxes have been almost zero.

Table 69. Closed pension funds' average annual rate of investment returns (in %)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Annual average
Nominal return	3.8	<u>-0.4</u>	<u>-3.2</u>	5.2	4.8	7.7	4.0	2.3	<u>-6.1</u>	8.7	3.2	0.3	8.4	5.6	3.1
Nominal, after charges	.3.6	<u>-0.6</u>	<u>-3.4</u>	5.0	4.6	7.5	3.8	2.1	<u>-6.3</u>	8.5	3.0	0.1	8.2	5.4	2.9
Real Return, after charges, before taxes	1.0	<u>-2.9</u>	<u>-5.9</u>	2.1	2.2	5.2	1.6	0.1	<u>-9.5</u>	7.6	1.4	<u>-2.7</u>	4.7	4.0	0.6
Real after charges and taxes															0.12

Open funds

We now proceed to calculate the returns for Opens Funds. The difference in calculation applies to line (3) only where charges are higher (1.1% for long term subscribers) and used to calculate the return. The same tax treatment applies.

Between the end of 1999 and the end of 2013, the real return of open funds after deduction of inflation, charges and taxes has been negative (-1.10% per year on average).

Table 70. Open pension funds' average annual rate of investment returns (in %)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Annual average
Nominal return	4.1	<u>-4.6</u>	<u>-12.2</u>	6.9	5.4	12.7	3.5	0.7	<u>-13.1</u>	12.5	5.3	<u>-1.3</u>	10.3	9.3	2.5
Nominal after charges	3.0	<u>-5.6</u>	<u>-13.1</u>	5.7	4.3	11.5	2.4	<u>-0.4</u>	<u>-14.0</u>	11.3	4.2	<u>-2.4</u>	9.1	8.1	1.4
Real Return, net of charges, before taxes	0.4	<u>-7.8</u>	<u>-15.4</u>	2.8	2.0	9.1	0.2	<u>-2.4</u>	<u>-16.9</u>	10.4	2.6	<u>-5.2</u>	5.6	6.7	<u>-0.9</u>
Real Return, net of charges and taxes															<u>-1.1</u>

Source: Own calculations based on COVIP, Eurostat

Individual Pension Plans

Next we turn to Individual Pension Plans, which have the highest costs on the pension product market in Italy. The charges applied to PIPs are 1.5% for long term subscribers.

The performance of the PIPs differs according to type. With-profits policies have a comparable performance with Open Funds while unit-linked PIPs have the worst average performance on the market, ranging from -1% to -4% and are very volatile. However, this could be associated to the relative short timeframe considered, and that in fact corresponds to the financial crisis years. Moreover, given the shorter time frame, the high variability might lead to misleading conclusions.





Table 71. PIP With Profits: Average annual rate of investment returns (in %)

	2008	2009	2010	2011	2012	Annual average
Nominal rate	5.10	5.1	5.40	5.1	5.4	5.17
Nominal return, after charges	3.50	3.50	3.80	3.50	3.80	3.62
Real return, net of inflation and charges, before taxes	0.00	2.70	2.20	0.60	0.50	1.18
Real return net of inflation, charges and taxes						0.63

Source: Own calculations based on COVIP, Eurostat

Table 72. PIP Unit Link: Average annual rate of investment returns (in %)

	2008	2009	2010	2011	2012	Annual average
Nominal	<u>-23.8</u>	18.0	6.8	<u>-4.3</u>	10.5	0.33
Nominal after charges	<u>-24.90</u>	16.30	5.20	<u>-5.70</u>	8.90	<u>-1.15</u>
Real net of charges, before taxes	<u>-27.44</u>	15.38	3.54	<u>-8.36</u>	5.42	<u>-3.49</u>
Real net charges and taxes						<u>-3.31</u>

Source: Own calculations based on COVIP, Eurostat

Conclusions

The Italian pension system has a strong state connotation, which is likely to displace the Complementary Pension Funds. Currently, around five millions individuals are enrolled in pension funds. Given the mandatory contribution rate amounting to 33% for pension contributions only, and the system being pre-funded, the contribution to the pension system will translate one to one to the future pension incomes. It is thus plausible, in this scenario, that the development of the second and pillar 3 is taking a long time to take off.

The pension funds can be of three types. Closed Occupational Pension Funds (managed by social partners), Open Funds (managed by financial institutions) and

Individual Pension Plans (PIP), which are split into with-profits policies and unit-lined policies.

We calculated the return rate associated to Open Funds, closed funds and PIPs. The average fund exhibited a huge variability over the years taken into consideration for this research. For the 2000-2013 period, we calculated an estimated net return rate on closed and open funds and PIPs. The results show an average yearly return of almost zero for Closed Pension funds and around -1.1% for Open Pension Funds. With profit PIPs delivered smaller returns since their inception in 2008.





Appendix

Appendix 1. Enrolment to specific pension

	Number of enrolled	%Variation 2012/2011	Potentially enrolled	Subscription rate	Assets under management (Million euro)
FONCHIM	149,341	<u>-2.0</u>	191,500	78.0	3,698.2
FONDENERGIA	39,591		44,000	90.0	1,269.4
QUADRI E CAPI FIAT	11,315	0.4	16,000	70.7	373.9
COMETA	426,734	<u>-2.0</u>	1,000,000	42.7	7,310.5
FONDOSANITA'	4,180	5.1	804,000	0.5	98.0
SOLIDARIETA' VENETO	45,913	0.9	891,000	5.1	605.7
PREVIAMBIENTE	49,202	0.1	250,000	19.7	594.7
ALIFOND	49,820	2.2	248,000	20.1	853.4
LABORFONDS	113,526	0.2	245,000	46.3	1,464.0
COOPERLAVORO	73,285	1.5	349,000	21.0	635.0
FOPEN	43,752	0.2	47,000	93.1	1,236.0
PEGASO	30,087	<u>-0.4</u>	50,000	60.2	567.2
PREVICOOPER	32,048	<u>-0.6</u>	74,500	43.0	470.6
TELEMACO	62,361	<u>-2.0</u>	150,000	41.6	1,149.5
ARCO	35,568	<u>-4.4</u>	244,800	14.5	416.3
FONCER	15,632	<u>-3.0</u>	29,500	53.0	302.2
FONDAPI	39,139	<u>-3.5</u>	500,000	7.8	488.2
PREVIMODA	60,937	<u>-2.4</u>	400,000	15.2	698.0
CONCRETO	7,175	<u>-2.9</u>	10,000	71.8	131.2
FONTE	194,716	0.5	2,500,000	7.8	2,001.1
BYBLOS	34,951	<u>-3.6</u>	200,000	17.5	519.9
GOMMAPLASTICA	51,452	<u>-2.8</u>	100,000	51.5	746.4
MEDIAFOND	2,697	<u>-1.9</u>	8,500	31.7	58.5
PREVAER	10,759	3.1	31,000	34.7	236.7
FILCOOP	10,233	0.3	160,000	6.4	69.3
EUROFER	38,893	<u>-4.0</u>	90,000	43.2	628.1
PREVEDI	44,420	<u>-6.9</u>	580,000	7.7	399.8
PRIAMO	58,750	<u>-2.8</u>	130,000	45.2	882.9
FOPADIVA	6,806	1.3	28,000	24.3	101.0
FONDOPOSTE	93,555	1.3	150,000	62.4	1,059.0
ESPERO	98,307	1.3	1,200,000	8.2	515.9
ASTRI	8,400	0.5	15,000	56.0	141.6
AGRIFONDO	8,440	0.6	329,000	2.6	52.0

PREV.I.LOG.	8,880	0.4	100,000	8.9	84.8
FONTTEMP	926		290,000	0.3	0.6
PERSEO	250	-	1,200,000	-	-
SIRIO			415,000		
FUTURA	21		87,000		
FONDADERO	7,709		13,500	57.1	314.6
TOTAL	1,969,771	<u>-1.2</u>			30,174.1

Notes: COVIP 2012 annual report. Potential enrolled are totalling the number of employees, equal to the potential subscribers





Private Pensions: The Real Returns

2014 Edition

Country Case: Poland

Introduction

The old-age pension system in Poland was introduced in 1999 as a multi-tier solution consisting of three elements:

- Pillar 1 – a mandatory, PAYG system;
- Pillar 2 – a mandatory, funded system;
- Pillar 3 – voluntary, occupational and individual pension vehicles.

Table 73. Multi-pillar pension system in Poland

Pillar 1	Pillar 1	Pillar 3
Mandatory	Mandatory/Voluntary	Voluntary
PAYG	Funded	Funded
NDC	DC	DC
Basic benefit	Basic benefit	Complementary benefit
<u>Publicly managed:</u> Social Insurance Institution (ZUS)	<u>Privately managed:</u> Open Pension Funds (OFEs) managed by Pension Societies (PTEs)	<u>Privately managed:</u> pension savings managed by different financial institutions, depending on the form organized by employer or individual

Source: own elaboration

The first part of the system is contributory and based on a Non-financial Defined Contribution (NDC) formula. The total pension contribution rate amounts to 19.52% of gross wages (pillar 1 + pillar 2) and a premium is financed equally by employer and employee. 16.72 p.p.⁸⁹ of pension contributions is transferred to pillar 1 (being written down on individual accounts of those insured and sub-accounts) and 2.8 p.p.⁹⁰ goes to open pension funds (pillar 2). If a person has not joined pillar 2 and did not choose open pension funds (some people born before

⁸⁹ Starting from 1 April 2014 it amounts to 16.60 p.p., if the insured is a member of OFE.

⁹⁰ 2.92 p.p. from April 2014.

1968), all contributions are transferred to the PAYG system (pillar 1).

Pillar 1 is managed by the Social Insurance Institution (ZUS) that writes down the quota of contributions to be paid out to every member on individual insurance accounts. The balance of the account (pension rights) is switched into pension benefits when an insuree retires. Statutory retirement age is 60 for women and 65 for men but it has started to increase since 2013 (by one month every three months) until it reaches 67 for both men and women.

The amount of pensions from pillar 1 depends solely on two components: 1) the insured person's total pension entitlement accumulated during his/her entire career (balance of NDC account), 2) the average life expectancy upon retirement.

Pillar 2 of the Polish pension system consists of open pension funds ("*otwarte fundusze emerytalne*", OFE) managed by pension societies ("*powszechna towarzystwa emerytalne*", PTE). Until the end of March 2014, 2.8 p.p. of the mandatory pension contributions went to pillar 2 and were invested on financial markets within limits imposed by the law. Members of the system choose just one fund out of 14 OFEs operating on the market. Starting from April 2014, participation in pillar 2 open pension funds is voluntary.⁹¹ The government has decided to seize accumulated pension assets (almost 300 billion PLN) to lower official public debt. The result was immediately noticeable as the changes included the transfer of OFEs' bond portfolios to Social Insurance Institution (ZUS)⁹² at the beginning of 2014. Now the participants' retreat from OFEs is expected.

OFE members now have the right to choose whether they stay in OFE or return to the PAYG system (NDC, pillar 1). When the insuree chooses to remain in Pillar 2 and contribute to the OFE, 2.92% of his/her gross salary will be transferred to the fund. But then his or her money will be invested more aggressively since the new pension law imposes a ban on the buying of bonds by OFE. If no decision is taken by the member himself/herself, the member's money will be automatically transferred back to the Social Insurance Institution (ZUS). This default option can result in a huge outflow of OFEs' participants.

Last but not least, recent regulations state that pension benefits from assets

⁹¹ The law of 6 December 2013 introduced from 1 January 2014 and 1 April 2014.

⁹² This operation resulted in huge reduction of assets – at the end of 2013 OFEs' assets amounted to PLN 299 billion but after shifting PLN 153 billion to ZUS dropped to ca. PLN 154 billion.





gathered in OFE are to be calculated in accordance with the Defined Contribution (DC) rule and are to be paid together with benefits from pillar 1 (NDC system).⁹³

Polish open pension funds are frequently treated as typical private pension plans (OECD, 2012) or even employer-arranged pension funds (Oxera, 2013) and presented in global private pension funds statistics. Such an assessment is incorrect in the sense that neither employer nor employee can decide on the creation of a pension plan. Moreover, contributions are set by law and pension benefits are paid by public institution (ZUS). Thus, Polish OFEs have merely been a mechanism to invest public pension system resources in financial markets (financial vehicles for the accumulation phase). Moreover, they formed an important part of public mandatory pension systems.

Pillar 3 supplements the basic, mandatory pension system (pillar 1 and pillar 2) and represents voluntary, additional pension savings. It consists of three different elements:

- employee (occupational) pension programmes (*“pracownicze programy emerytalne”*, PPE);
- individual retirement accounts (*“indywidualne konta emerytalne”*, IKE);
- individual retirement savings accounts (*“indywidualne konta zabezpieczenia emerytalnego”*, IKZE).

Employee pension programmes (PPE) are the plans organised by the employer for their employees. A PPE settlement happens after an employer agrees with the representatives of the employees on the operational conditions of the plan, signs the contract on asset management with a financial institution (or decides to manage the assets by himself) and registers a programme with the Financial Supervisory Commission (*“Komisja Nadzoru Finansowego”*, KNF). Basic contribution (up to 7% of the employee’s salary) is financed by the employer but an employee has to pay personal income tax on this money. Participants of the programme can choose to pay additional contributions that are deducted from their after-tax salaries. There is a yearly quota limit for additional contributions amounting to 4.5 times the average wage (PLN 16,857 in 2014). PPE’s returns are exempt from capital gain tax. Benefit is not taxable and can be paid out as a lump sum or

⁹³ Money gathered on individual accounts in OFE will be systematically transferred to Social Insurance Institution (ZUS) during 10 years before retirement. ZUS will pay all the benefits from the mandatory system (PAYG and funded components).

through scheduled withdrawal after the saver reaches 60 years of age.

Individual retirement accounts (IKE) were introduced in 2004. They offer people the possibility of saving for retirement and can be obtained in various financial institutions: asset management companies, life insurers, brokerage houses, banks, pension societies. An individual can gather money only on one retirement account but is free to change the form and the institution during the accumulation phase. Contributions are based on the net salary with a ceiling of 3 times the average wage (PLN 11,238 in 2014). Returns are exempt from capital gains tax and the benefits are not subject to taxation. When a saver reaches 60 years of age (or 55 years, if he/she is entitled by law to retire early), money is paid in the form of a lump sum or through a scheduled withdrawal.

Individual pension savings accounts (IKZE) are the most recent products within the voluntary pension sector. They started to operate in 2012 and are offered in the same form as individual retirement accounts (IKE), but have other contribution ceilings and offer different forms of tax relief. Premiums paid to the account can be deducted from the income tax base. Contributions and returns are exempt from tax, but the benefits are subject to taxation (at a reduced tax rate). Savings accumulated on IKZE are paid to the individual as a lump sum or via scheduled withdrawal after the saver reaches the age of 65.

Table 74. Architecture of voluntary pension system in Poland (III pillar) at the end of 2012

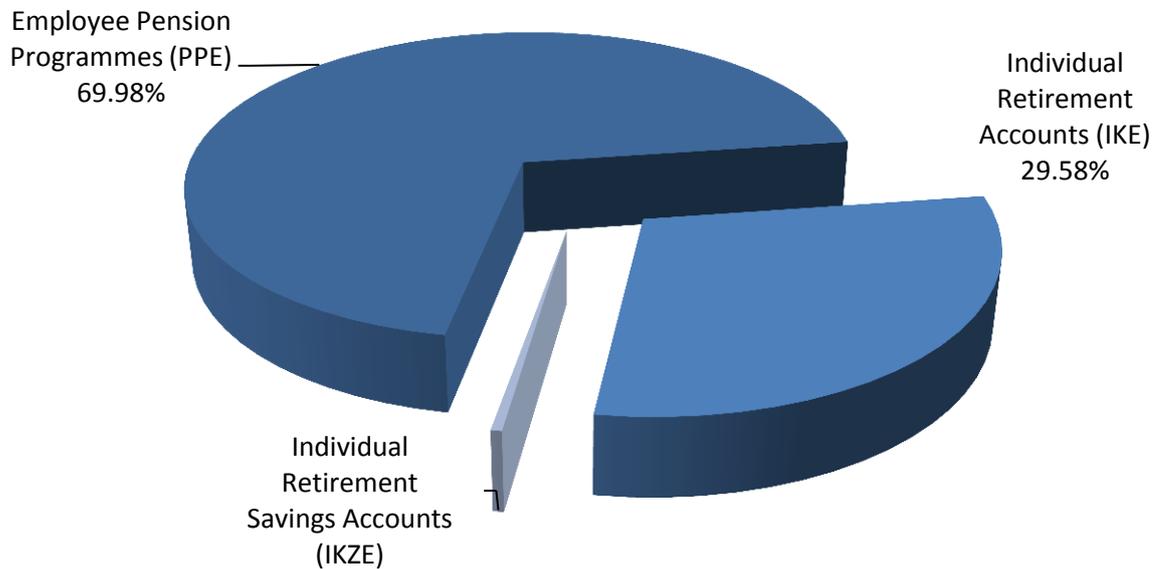
Name of the pension system element	Employee Pension Programmes (PPE)	Individual Retirement Accounts (IKE)	Individual Retirement Savings Accounts (IKZE)
Types of pension vehicles	<ul style="list-style-type: none"> · Unit-linked life insurance · Investment fund · Employee pension fund 	<ul style="list-style-type: none"> · Unit-linked life insurance · Investment fund · Account in brokerage house · Bank account · Voluntary pension fund 	<ul style="list-style-type: none"> · Unit-linked life insurance · Investment fund · Account in brokerage house · Bank account · Voluntary pension fund
Assets under management (PLN millions)	8,350.9	3,530.3	52.9

Source: own elaboration and KNF, 2013





Graph 5. Market share of Polish voluntary pension system elements by assets under management as of 31 December 2012



Source: KNF, 2013

Pension Vehicles

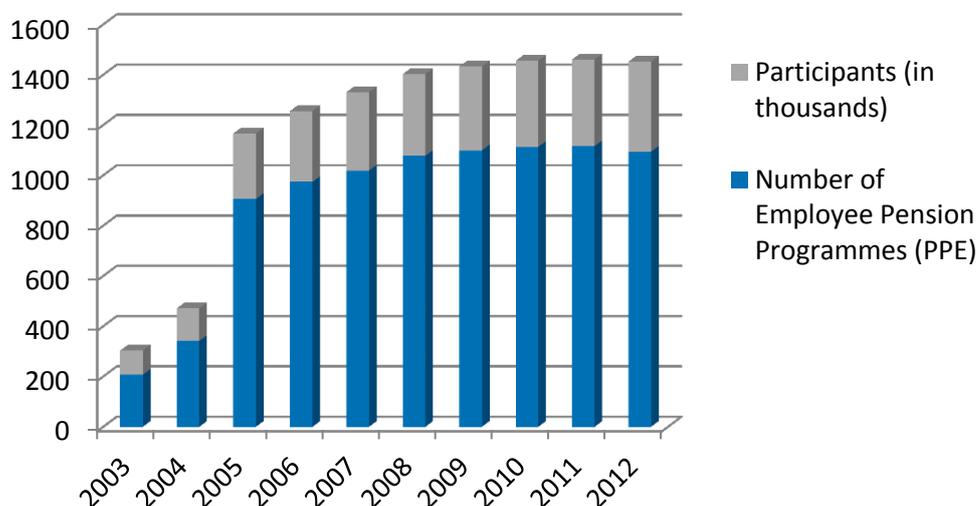
Employees' pension programmes

PPEs can be offered in four forms:

- contract with asset management company (investment fund);
- contract with life insurance company (group unit-linked insurance);
- employee pension fund run by employer;
- foreign management.

Employee pension programmes started to operate in 2004. The development of the market was very slow during the first five years of its functioning. Then due to changes in the law, many group life insurance contracts were transformed into PPE starting in 2005. By 2007 the number of programmes reached 1000 and the size of the market has remained more or less the same since that year. 1094 programmes were operating at the end of 2012 (graph below). PPEs cover 358,000 employees which represents only 2.9% of the working population in Poland.

Graph 6. Number of Employee Pension Programmes and the number of PPEs



Source : KNF, 2013

The most popular forms of PPE are group unit-linked life insurance and investment funds. These two forms represent more than 95% of PPEs (see table below). The proportion is lower when taking into consideration the number of participants (84%) and the level of assets (77.5% of total PPE's assets are invested in insurance funds and investment funds).

Table 75. Number and assets of Employee Pension Programmes (PPE) by form of the programme in 2012

	Number of PPE	Market share (as % of PPE number)	Market share (as % of participants)	Assets (PLN million)	Market share (as % of PPE assets)
Unit-linked life insurance	758	69.3%	37%	2,413.4	28.9%
Investment fund	301	27.5%	47.1%	4,058.5	48.6%
Employee Pension Fund	35	3.2%	15.9%	1,879.0	22.5%
Total	1,094			8,350.9	

Source: KNF, 2013

The average basic contribution paid in 2012 amounted to PLN 3,707. Additional contribution financed by the employee represented PLN 1.210 on average. PPE managed assets of PLN 8.35 billion and the average account balance equals PLN





23.8 thousand (2012). No data is available on the average percentage level of contributions paid to the programmes.

Individual Retirement Accounts (IKE)

According to Polish pension law (The Individual Pension Accounts Act of 20 April 2004), individual retirement accounts ("*Indywidualne Konta Emerytalne*", IKE) may operate in the form of:

- unit-linked life insurance contracts;
- investment funds;
- accounts in a brokerage house;
- bank accounts (savings accounts);
- voluntary pension funds.

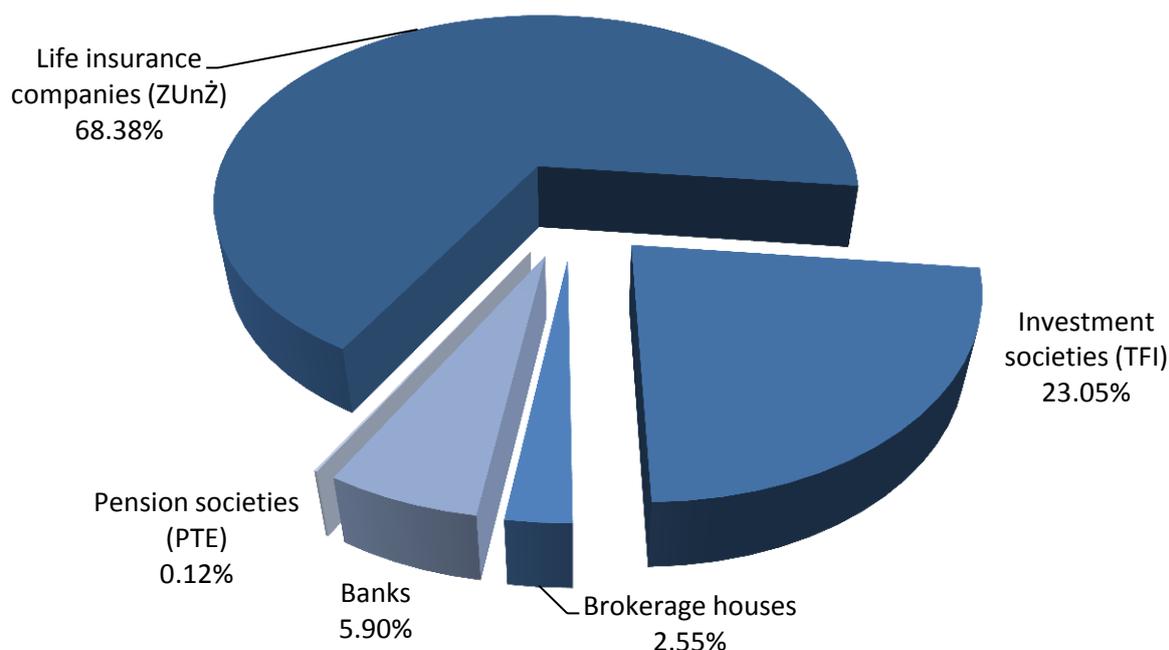
Pension accounts are offered by life insurance companies, investment societies (asset management companies), brokerage houses, banks and pension societies. The most recent pension vehicles are voluntary pension funds that were introduced in 2012 at a time of significant changes in the statutory old-age pension system.

A voluntary pension fund is an entity settled solely to gather savings of IKE (or IKZE) holders. Pension assets are managed by a pension society ("*powszechnie towarzystwo emerytalne*", PTE) that also operates one of the open pension funds (OFE under pillar 2) in Poland. The assets of the funds are of course separated to guarantee the safety of the system, also due to stricter investment regulations for OFE. Having millions of participants in the mandatory funds, pension societies have much easier access to potential clients from the voluntary pensions market. They are continuously gaining new participants.

The constructions of IKE products usually do not vary a lot from the standard offer that exists on financial markets. The difference relates to the tax treatment of capital gains (exclusion from capital gains tax) and contribution limits. Moreover, financial institution cannot charge any cancellation fee when an individual transfers money or resigns after a year from opening an account.

The most popular IKE products take the form of life insurance contracts (unit-linked life insurance) and investment funds. According to official data (KNF, 2013), these two forms of plans represent 91% of all IKE accounts.

Graph 7. Structure of IKE market by number of accounts and type of provider as of 30 June 2013



Source: KNF, 2013

At the end of June 2013 only 816,000 Polish citizens had an individual retirement account (IKE) which in turn represents 5.2% of the working population. On average each gathered 4.64 thousand PLN in an account. IKE holders do not fully use the contribution limit. The average contribution paid during years 2004-2013 is permanently below the statutory limit (3 times the average wage, table below). The total size of IKE assets amounted to PLN 3.8 billion as of 30 June 2013.





Table 76. Number of Individual Retirement Accounts (IKE) by type of the product (2004-2012)

Type of product	2004	2005	2006	2007	2008	2009	2010	2011	2012	VI 2013
Unit-linked life insurance	110,728	267,529	634,577	671,984	633,665	592,973	579,09	568,085	557,595	558,223
Investment fund	50,899	103,624	144,322	192,206	173,776	172,532	168,664	200,244	188,102	188,152
Account in the brokerage house	6,279	7,492	8,156	8,782	9,985	11,732	14,564	17,025	20,079	20,804
Bank account	7,570	49,220	53,208	42,52	36,406	31,982	30,148	29,095	47,037	48,128
Voluntary pension fund									479	1,018
Total	175,476	427,865	840,263	915,492	853,832	809,219	792,466	814,449	813,292	816,325

Source: KNF, 2013

Table 77. Assets of IKE (in PLN millions)

Type of product	2004	2005	2006	2007	2008	2009	2010	2011	2012	VI 2013
Unit-linked life insurance	47.44	235.00	491.41	722.65	716.74	964.15	1,167.64	1,146.79	1,397.18	1,412.02
Investment fund	91.02	307.15	578.11	846.46	564.26	800.44	972.29	894.56	1,128.87	1,197.91
Account in the brokerage house	19.20	43.86	67.08	96.16	121.06	190.66	293.76	384.05	524.25	605.30
Bank account	10.92	103.63	161.95	199.31	211.73	244.18	292.70	338.59	477.90	566.87
Voluntary pension fund									2.11	6.20
Total	168.58	689.64	1,298.55	1,864.57	1,613.79	2,199.42	2,726.39	2,763.98	3,530.31	3,788.30

Source: KNF, 2013

Table 78. Limits on contributions and average contribution paid into IKE in 2006-2012 (in PLN)

	2006	2007	2008	2009	2010	2011	2012
Contribution limit	3,521	3,697	4,055	9,579	9,579	10,077	10,578
Average contribution paid	2,199	1,719	1,561	1,850	1,971	1,982	2,584

Source: KNF, 2013

Individual Retirement Savings Accounts (IKZE)

Similar to individual retirement accounts, the group of IKZE products consists of:

- unit-linked life insurance;
- investment funds;
- bank accounts;
- accounts in brokerage houses;
- voluntary pension funds.

As this part pension system is only two years in existence (started in 2012), the number of participants is still at unsatisfactory level. Only about 3.2% of Polish working population is covered by this type of supplementary old-age provision.

Table 79. Number of Individual Retirement Savings Accounts (IKZE) by type of the product (2012-2013)

Type of the product	VI 2012	XII 2012	VI 2013
Unit-linked life insurance	233,611	363,399	373,533
Investment fund	1,099	5,202	8,619
Account in the brokerage house	3	559	623
Bank account	0	19	27
Voluntary pension fund	66,735	127,642	126,160
Total	301,448	496,821	508,962

Source: KNF, 2013

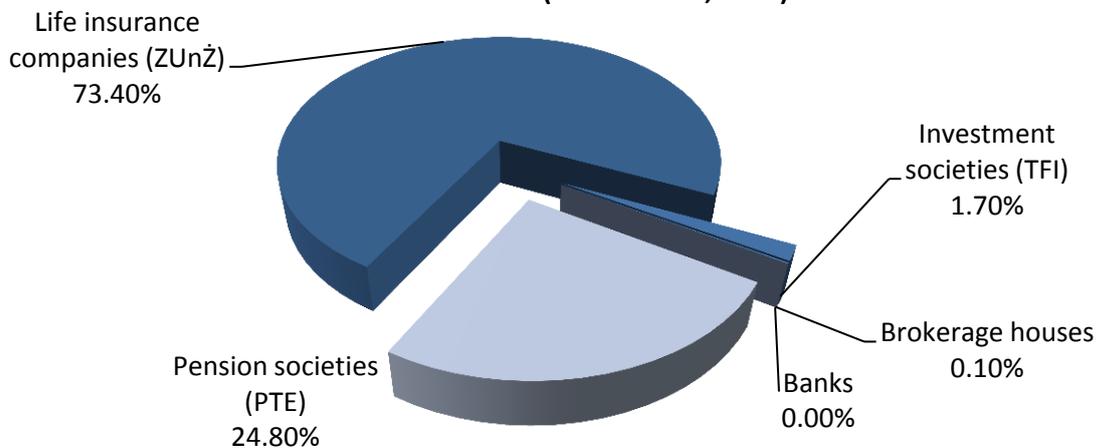
At the end of June 2013 circa 508,000 Poles had subscribed individual retirement savings accounts. As shown on the graph 8, the IKZE market is dominated by insurance companies that run more than 73% of accounts. Investment societies (*"Towarzystwa Funduszy Inwestycyjnych"*, TFI), brokerage houses and banks do not show huge interest in providing this type of old-age pension provision, although some of them put IKZE in their offers.

The savings pot of IKZE is very small compared to other elements of the Polish supplementary pension system. At the end of June 2013, financial institutions managed funds amounting to PLN 80 million. It is worth noting that this capital was raised through contributions covering a time frame of only a year and a half.





Graph 8. Structure of IKZE market by number of accounts and type of provider as of 30 June 2013 (Source: KNF, 2013)



A rapid growth of the IKZE market in regard to coverage and assets' value is expected in the next years. This may happen as a consequence of recent changes in IKZE taxation (higher contribution limit that can be deducted from tax base, benefit payment subject to reduced income tax rate).

Table 80. Assets of IKZE (in thousands PLN)

Type of the product	VI 2012	XII 2012	VI 2013
Unit-linked life insurance	4,056	36,393	52,961
Investment fund	665	7,973	15,282
Account in the brokerage house	0	1,673	2,311
Bank account	0	40	69
Voluntary pension fund	781	6,803	9,345
Total	5,503	52,882	79,968

Source: KNF, 2013

Charges

The type and level of charges deducted from pension savings depends on the vehicle used and the type of programme. Lower fees are charged in group old-age pension provisions organized by employers (PPE). Significant cost differences exist between various product types. Since no comprehensive data on the costs of Polish supplementary products is collected or officially published, the information given

below reflects the costs of selected products (examples) and plans functioning on the Polish market.

Employee Pension Programmes (PPE)

Data on PPE charges is hardly available. The Financial Supervisory Commission does not present any official statistics on the value and percentage of deductions of assets from employee pension programmes. Some information can be found in the statutes of the PPE but they rather describe the types of cost charged than the level of deductions. Since employers have to cover many administrative costs connected to PPE organisation (disclosure of information, collecting employees' declarations, transfer of contributions), participants savings are usually reduced by the management fee. Fee levels vary from 0.5% p.a. to 4% p.a. of AuM and depend on the investment profile of funds chosen.

The lowest charges are deducted as a form of employee pension funds ("*Pracownicze Fundusze Emerytalne*", PFE) managed by employee pension societies set up by the employer (in-house management of PPE). In this form, no up-front fee is deducted and a rather low management fee (0.5 - 1% p.a.) applies to assets gathered.

Individual Retirement Accounts (IKE) and Individual Retirement Savings Accounts (IKZE)

The type and level of charges depend on the type of product. There is a management fee incurred for investment funds, voluntary pension funds and unit-linked insurance. In addition, in unit-linked life insurance, financial institutions can charge up-front fee, use different buy and sale prices for investment units (spread) and deduct other administrative fees from the pension savings accounts (flat-rate administration fee, conversion fees, fees for changes in premium allocation, if the change occurs more frequently than mentioned in the terms of a contract). Charges that are not connected with asset management and the administration of a savings account cannot be deducted from IKZE (i.e. life insurance companies cannot deduct the costs of insurance from the retirement account). The accumulation of pension savings by direct investments (accounts in brokerage houses) is subject to fees which depend on the type of transaction and the level of activity on financial markets (trading fees and charges). Banks do not charge any fees for IKZE they offer, with the exception of a cancellation fee.





All financial institutions offering individual retirement accounts (IKE) can charge a cancellation fee (also called a transfer fee) when a member decides to transfer savings to a programme offered by another financial entity in the first year of the contract. No cancellation fee can be deducted from the account when a saver resigns from the services of a given institution after 12 months and transfers money to another plan provider.

The tables below show the level of fees charged in selected individual retirement savings accounts (IKZE).

Table 81. Charges in IKZE offered by Life insurance companies (unit-linked life insurance contracts)				
Institution	Name of fund	Management fee (as % of assets)	Up-front fee	Transfer fee
Aviva TUŃ	Aktywnej Selekcji - Stabilny	2.25%	8% - first PLN 6000, then 4%; 10% - first PLN 6000, then 6% (with add. insurance)	50% of assets
	Aktywnej Selekcji - Zrównoważonego	3.25%		
	Aktywnej Selekcji Dynamiczny	4.00%		
ING Źycie	ING Portfel Inwestycyjny Stabilny	2.00%	None	50% of assets
	ING Portfel Inwestycyjny Wzrostowy			
	ING Gotówkowy	0.00%		
	ING Obligacji	1.25%		
	ING Ochrony Kapitału	1.50%		
	ING Stabilnego Wzrostu	2.50%		
	ING Zrównoważony	3.00%		
	ING (L) Papierów Dłużnych Rynków Wschodzących (WL)	1.80%		
	ING (L) Globalny Długu Korporacyjnego			
	ING Akcji	3.50%		
	ING Selektywny			
	ING Środkowoeuropejski Sektórów Wzrostowych			
	ING (L) Globalny Spółek Dywidendowych	2.50%		
	ING (L) Spółek Dywidendowych USA			
	ING (L) Europejski Spółek Dywidendowych			
	ING (L) Nowej Azji			
ING (L) Rynków Wschodzących				
ING (L) Ameryki Łacińskiej				
ING (L) Japonia				
Pramerica Źycie TUiR	UFK Pramerica – Pioneer Akcji Polskich	2.5% - share funds	None	20% of assets
	UFK Pramerica – Pioneer Stabilnego Wzrostu			
	UFK Pramerica – Pioneer Obligacji	1.5% - stable growth funds;		
	UFK Pramerica – PKO Akcji	1% - bond funds		
	UFK Pramerica – PKO Stabilnego Wzrostu			
	UFK Pramerica – PKO Obligacji			
	UFK Pramerica – Arka BZ WBK Akcji			
	UFK Pramerica – Arka BZ WBK Stabilnego Wzrostu			
	UFK Pramerica – Arka BZ WBK Obligacji			
	UFK Pramerica – Legg Mason Akcji			
	UFK Pramerica – Legg Mason Senior			
	UFK Pramerica – Legg Mason Obligacji			
PZU Źycie SA	Stabilnego Wzrostu	4.5%	4% - in first 3 years,	10% of assets, not less than PLN 50
			3% - yrs 4-5,	
			2% - yrs 6-10,	
			1% - yrs 11+	

Source: own elaboration and Ostrowska K. (2012), Nowe konta emerytalne (IKZE) w ofercie instytucji finansowych, "Rzeczpospolita", 01.03.2012 r.





Table 82. Charges in IKZE offered by Investment Societies (investment funds)

Institution	Name of fund	Management fee (as % of assets)	Up-front fee	Transfer fee
KBC TFI	KBC Globalny Akcyjny	3.00%	none	none
	KBC Akcyjny	4.00%		
	KBC Aktywny	3.75%		
	KBC Globalny Stabilny	2.00%		
	KBC Stabilny	2.50%		
	KBC Papierów Dłużnych	1.35%		
	KBC Pieniężny	0.80%		
	KBC Akcji Małych i Średnich Spółek	2.30%		
Legg Mason TFI	LM Akcji	3.50%	none (a fee of PLN 400 for opening the account, not charged when opening the account directly at Legg Mason offices or online)	PLN 500
	LM Strateg			
	LM Senior	2.50%		
	LM Obligacji	1.50%		
	LM Pieniężny	0.80%		
Pioneer Pekao TFI	Pioneer FIO - subfundusz Pioneer Akcji - Aktywna Selekcja	3.60%	1.50-5.00 % +loyalty programme (20% reduction in fee in 0-4 years, 30% after 4 years, 50% after 6 years, no fee after 8 years)	PLN 100
	Pioneer FIO - subfundusz Pioneer Obligacji Plus	1.60%		
	Pioneer FIO - subfundusz Pioneer Lokacyjny	1.50%		

Source: own collaboration, detailed information from: Ostrowska K. (2012), *Nowe konta emerytalne (IKZE) w ofercie instytucji finansowych, "Rzeczpospolita", 01.03.2012 r. and analizy.pl.*

Table 83. Charges in IKZE offered by Pension Associations (voluntary pension funds)

Institution	Product	Management fee (as % of assets)	Up-front fee	Transfer fee
Allianz Polska PTE	Allianz Polska DFE	2.5%	1.5%	PLN 200
Amplico PTE	MetLife Amplico DFE	max 2.5 %	1-2.5%, if the account balance lower than PLN 20,000	15% of assets but not less than PLN 300
Nordea PTE	Nordea DFE (dostępne od połowy marca)	1.95% + success fee 15%, if results above benchmark and positive	0-4%, depending on the quota of contribution, 0-1% upfront-fee on money transferred from other institution	20% of assets but no more than PLN 500
Pocztalion-Arka PTE	DFE Pocztalion Plus	max 2.5%	0-3%, depending on the quota of contribution	10% of assets, PLN 100 at least
PTE PZU	DFE PZU	up to 2.99% + success fee max. 20% of the surplus above benchmark	3.4% in first 5 years, 2.9% - yrs 6-10, 2.4% - yrs 11-15, 1.0% - yrs 15+	10% of assets, PLN 50 at least
ING PTE	ING DFE	2% + success fee 15% of the surplus above 8% return	53.4% only from the first contribution (max PLN 80), next contributions: 0%	50% of assets
PKO BP Bankowy PTE	PKO DFE	max 3.5%	none	50% of assets
Pekao Pioneer PTE	Pekao DFE	max 2.6%	2.5% or 0% (if the total contribution amounts to more than PLN 10,000)	10% of assets, min. PLN 50

Source: www.analizy.pl, 2014

Taxation

Employees' Pension Programmes (PPE)

Basic contributions financed by employers are subject to personal income tax that is deducted from the employee's salary. Additional contributions paid by the employer and deducted from the net salary are treated the same way as salary deductions (contribution paid from after-tax wage). Returns and benefits are not taxed (TEE regime).

Individual Retirement Accounts (IKE)

Contributions are taxed, as they are paid by savers from their net income. An individual can pay up to 3 times the average wage annually (PLN 11,238 in 2014). There is a tax relief in capital gains tax. Benefits are not taxable (TEE regime).

Individual Retirement Savings Accounts (IKZE)

Contributions to IKZE are deductible from an income tax base. In 2012 and 2013 there was an upper limit for contributions amounting to 4% of the person's annual salary⁹⁴ from the previous year. Due to the most recent changes in pension system, this limit has been replaced with a flat-rate limit. Every individual can pay into an account up to 150% of the average salary (4,495.2 PLN in 2014).

Returns are not subject to taxation but benefits are taxed with a reduced flat-rate income tax (10%).⁹⁵ This part of the supplementary pension system is the only one that uses EET tax regime.

⁹⁴ It was exactly 4% of the individual pension contributory base for the previous year. The amount was really difficult to calculate for many Poles, especially when only a part of their salary was subject to mandatory pension contribution.

⁹⁵ A reduced flat-rate income tax on IKZE payments is the second biggest change introduced in the Polish supplementary old-age pension system in 2014. The standard rate of income tax amounts to 18% (first threshold) and 32% (second one).





Pension Returns

Asset allocation

Employee Pension Programmes (PPE)

Polish law does not impose any strict investment limits on voluntary pension savings accounts (IKE, IKZE, and most forms of PPE) with the exception of occupational pension programmes offered in the form of an employee pension fund (types of asset classes are prescribed by law). Every financial institution that offers IKE or IKZE puts the information on investment policy in the statutes of the fund. As most existing plans offer PPE participants the possibility to invest in one of the many funds from the broad group of investment funds operating in the market (not only the funds dedicated solely to pension savings), it is impossible to give an indication of the portfolio of the majority of PPEs⁹⁶.

The tables below present the investment portfolio of employee pension funds that are the only types of occupational pension products with official and separate statistics on asset allocation.

⁹⁶ Neither the Financial Supervisory Commission nor the Ministry of Labour and Social Policy collects data that would allow to indicate the name of investment funds in which pension savings are gathered or the value of accumulated capital.

Table 84. Portfolio of employees' pension funds (PFE) as of 31 December 2012 (as % of assets)					
	PFE "NOWY ŚWIAT"	PFE NESTLÉ POLSKA	PFE TELEKOMUNIKACJI POLSKIEJ	PFE UNILEVER POLSKA	PFE SŁONECZNA JESIEŃ
Shares	36.01	35.83	9.04	30.77	31.55
Gov. bonds	59.34	58.89	19.64	64.93	63.75
Other bonds	1.23	0.00	0.00	0.00	1.09
Investment funds units	0.00	0.00	69.35	0.00	0.00
Bank deposits	2.87	3.82	1.40	3.09	0.02
Other investments	0.56	1.46	0.56	1.20	3.58
Assets under management (in PLN mln)	362.08	37.45	1,103.25	43.63	346.77
Market share (as % of total PFEs' assets)	19.13	1.98	58.27	2.30	18.32

Source: KNF, 2013

Individual Retirement Accounts (IKE) and Individual Retirement Savings Accounts (IKZE)

There are no available statistics that allow for the identification of the asset allocation within Individual Saving Accounts (IKE) and Individual Retirement Savings Accounts (IKZE) offered as insurance contracts, investment funds and accounts in brokerage houses. It results from the fact that an individual can buy units of many investment funds (or financial instruments) that are also offered as non-IKE and non-IKZE products. Since no separate statistics for pension and non-pension assets of the a given fund are disclosed, it makes it impossible to indicate either which funds are in the portfolios of IKE and IKZE holders or what the rates of returns obtained by this group of savers are.

The only form of IKE and IKZE that is strictly separated from other funds and is dedicated solely to pension savings is the voluntary pension fund. These vehicles started in 2012. The table below shows the DFE's ⁹⁷ investment portfolios at the end of 2013.

⁹⁷ "Dobrowolny Fundusz Emerytalny" (Voluntary Pension Funds).





Table 85. Portfolio of voluntary pension funds (DFE) offered as Individual Retirement Saving Accounts (IKZE) and Individual Retirement Accounts (IKE) in 2013, as % of DFE assets

	Allianz Polska DFE	DFE Pekao	DFE Pocztylion Plus	DFE PZU	ING DFE	MetLife Amplico DFE	Nordea DFE	PKO DFE
Shares	41.16	51.99	23.97	68.87	64.82	48.04	40.93	34.77
Gov. Bonds	41.9	31.96	65.74	9.18	6.57	26.89	39.27	53.32
Nongov. Bonds	9.94	2.64	-	4.54	10.73	-	11.42	-
Other	7.00	13.41	10.28	17.41	17.88	25.06	8.39	11.91
Assets under management (in PLN mln)	1.82	3.02	0.34	5.89	2.3	11.96	0.45	2.76
Market share (as % of total DFEs' assets)	6.38	10.58	1.19	20.64	8.06	41.91	1.58	9.67

Source: *www.analizy.pl, 2014*

Rates of return

Investment efficiency of supplementary pension products is almost impossible to assess due to lack of necessary data published by financial institutions. In Poland there is no obligation to disclose rates of return to pension account holders. Generally, owners of savings accounts are informed of the contributions paid, the value of investment units and the balance on their accounts at the end of the reporting period. No data concerning investment efficiency of supplementary pension products is submitted to the Financial Supervisory Commission or published in official statistics.

Due to the shortage of detailed statistics, the assessment of the investment efficiency of pension products is possible only for the vehicles dedicated solely to PPE, IKE or IKZE, namely employee pension funds (PFE) and voluntary pension funds (DFE).

As the management fee is deducted from fund assets on a regular basis and the value of fund units is calculated based on net assets, the nominal rates of return given below take into account the levels of management costs. The only fee that is to be included when calculating after-charges returns is an upfront-fee deducted from contributions paid into accounts.

In the period of 2002 to 2012 employee pension funds (PFE) showed rather positive returns of up to 17.41% annually. Negative results appeared only in the years 2008 and 2011, when equity markets dropped significantly. After-charges real returns observed during 8 of the 10 years as well as the average return during the 11-year

period are highly positive as well. These satisfactory results were obtained due to proper portfolio construction, high quality of management and low costs.

Table 86. Nominal and real after-charges returns of Employee pension funds in 2002-2013 (in %)

Employee pension fund	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Annual average
PFE NESTLÉ POLSKA	-	-	11.25	12.53	12.41	5.10	<u>-10.10</u>	13.33	9.98	<u>-5.05</u>	15.82	5.19	6.73
PFE SŁONECZNA JESIEŃ	-	-	-	-	10.60	4.52	<u>-11.33</u>	14.83	9.60	<u>-3.10</u>	13.60	5.21	5.15
PFE TELEKOMUNIKACJI POLSKIEJ	11.35	10.28	12.30	14.82	15.40	6.10	<u>-13.54</u>	15.78	10.33	<u>-4.75</u>	14.96	3.45	7.66
PFE UNILEVER POLSKA	-	-	14.24	12.93	13.41	5.77	<u>-6.34</u>	12.74	9.75	-3.59	15.01	4.56	7.59
PFE "NOWY ŚWIAT"	9.76	10.44	13.64	13.81	15.25	6.23	<u>-13.86</u>	17.41	10.52	<u>-5.20</u>	14.15	5.71	7.77
PFE "DIAMENT"	<u>-21.05</u>	8.71	-	-	-	-	-	-	-	-	-	-	<u>-7.36</u>
Weighted nominal return after charges, before inflation	7.88	10.14	12.59	14.50	14.99	5.94	-13.14	15.85	10.22	<u>-4.51</u>	14.57	4.28	7.42
Inflation (HICP)	1.90	0.70	3.60	2.20	1.30	2.60	4.20	4.00	2.70	3.90	3.70	0.80	2.64
Weighted ⁹⁸ real return after charges and inflation	5.98	9.44	8.99	12.3	13.69	3.34	<u>-17.34</u>	11.85	7.52	<u>-8.41</u>	10.87	3.48	4.75

Source: KNF, Eurostat

⁹⁸ Weighted by the value of assets at the end of the year.





Table 87. Nominal and real returns of voluntary pension funds (DFE) in 2013 (in %)

	Allianz Polska DFE	DFE Pekao	DFE Pocztynion Plus	DFE PZU	ING DFE	MetLife Amplico DFE	Nordea DFE	PKO DFE
Nominal return	7.80	16.30	6.90	32.80	59.10	56.70	25.40	16.90
Real return	6.94	15.38	6.05	31.75	57.84	55.46	24.40	15.97
Nominal after charges*	6.18	13.39	3.69	28.28	52.74	52.78	20.38	16.90
Real after- charges* return	5.34	12.49	2.87	27.27	51.52	51.57	19.43	15.97

*Returns after charges were calculated with an assumption that an individual pays one contribution of PLN 2.000 at the beginning of the year 2013.

Source: *www.analizy.pl*, Eurostat.

Voluntary pensions funds (DFE) have reached extraordinary investment results from their start in 2012. The first years of their operation coincided with the time of Polish financial market recovery and allowed the funds to maximize rates of return from the equity portfolios. The best DFE reported more than 50% nominal return in 2013.

Conclusions

Starting in 1999, with individual supplementary elements introduced in 2004 and 2011, the Polish supplementary pension market is still in its early stage of operation. The coverage ratios show that only a small proportion of Poles decided to secure their future in old-age by purchasing individual pension products. This may be caused by low financial awareness, insufficient levels of wealth, or simply lack of information and low transparency of pension products.

The official information concerning supplementary pension products in Poland is definitely very limited. Financial institutions do not have any obligation to disclose rates of return, either nominal, real, or after-charges. Published data includes the total number of programmes or accounts by type of financial institution and total assets invested in pension products. The Financial Supervisory Commission (KNF) collects more detailed data about the market (the number of accounts and pension assets managed by every financial institution), but does not disclose the data even for research purposes⁹⁹.

⁹⁹ For the purpose of this study KNF was asked for the data on the popularity of various products (market share of the pension products by providers) and the assets collected by every institution

Moreover, no comparable tables on charges, investment portfolios and rates of return are prepared and made accessible to the public on a regular basis. Some details of a product have to be put in the fund statutes or in the terms of a contract, but they are hardly comparable between different providers. The Polish supplementary pension market is highly opaque, especially in terms of costs and returns.

Among a wide variety of pension vehicles, there are only a few products with sufficient official statistics to assess their investment efficiency: employee pension funds (PFE) managed by employee pension societies and voluntary pension funds (DFE) managed by pension societies (PTE). Other products are more complex¹⁰⁰, and due to the fact that supplementary pension savings are reported together with non-pension pots, it is impossible to analyse the portfolio allocations and rates of return for individual pension products separately.

After-charges returns in the “youngest” pension products offered in a form of voluntary pension funds (DFE) were extremely high in 2013, either in nominal and real terms. The second group of analysed products, namely employee pensions funds (PFE), delivered significant profits as well. But other pension vehicles may turn out not to be so beneficial, especially when a wide variety of fees and charges are deducted from contributions paid to the accounts.

To sum up, the disclosure policy in supplementary pension products in Poland leaves a lot to be desired. Savers are paying their money to the institutions without obtaining clear information on the charges and investment returns. Bearing in mind the pure DC character of pension vehicles and lack of any guarantees, it puts huge risks on savers. All this may lead to significant failures of the pension market during its very early stages of development.

that offers IKE and IKZE products, but it refused to send the statistics concerning the biggest part of the market (retirement accounts managed by life insurance companies).

¹⁰⁰ A small part of pension accounts is also run in a very conservative and simple form (bank accounts) but due to lack of sufficient long-term statistics the effectiveness of this form was not analysed in the report. Currently, interest rates offered in IKE run by banks equals to 2.2-5% annually (Ostrowska 2013), depending on the length of membership and sometimes connected with the purchase of other financial products (IKE is an element of a package offer).





Private Pensions: The Real Returns

2014 Edition

Country Case: Spain (Update)

Introduction

Household savings, through property and other forms of direct investment, have always been a significant feature of the Spanish economy. Historically, in the absence of a comprehensive welfare system, citizens have had to build capital to provide for major life events such as retirement. The recent development of Spain's welfare system and its capacity to offer comprehensive care has not blunted the Spanish citizen's appetite for saving. According to the Bank of Spain (2011), the savings rate has risen strongly since the beginning of the crisis in 2007, due to increasing expectations of unemployment and hard times. As of the second half of 2012, the household savings rate was 12.1%.

As of Q4 2013, financial assets owned by Spanish households amounted up to €1.89 billion¹⁰¹. Table 87 shows that households invested in a wide range of financial assets.

¹⁰¹ Financial Savings of Spanish Families Q4 2013, Inverco.

Table 87. Financial Savings of Spanish Households (non-real estate)

	% of total savings, 2011	% of total savings, 2012	% Δ 2012/2011
Bank Deposits	49.7	51.6	0.9
Collective Investments (funds and investment companies)	6.9	6.7	<u>-0.2</u>
Insurance	9.6	10.4	0.1
Pension Funds	5.4	5.5	0.2
Direct Investment	23.4	21.9	<u>-0.7</u>
Credits	1.5	1.3	0.0
Other	3.5	2.6	<u>-0.4</u>
TOTAL	100	100	

Source: 2012 Report on Insurances and Pension Funds, Directorate-General of Insurances and Pension Funds, Spanish Ministry of Economy and Competitiveness

The market for professional and individual-based pension schemes has only been recently established in Spain. The total capital invested in pension funds as of end Q1 2014 was €93,822 million, representing the interests of 9,902.812 policyholders (over 8 million citizens, as some people hold more than one policy).

Pension Vehicles

Pension schemes

When speaking of private pension provision in Spain, we should make a clear distinction between retirement plans and pension plans. Pension plans are complementary to and perfectly aligned with the public pensions system (heavily promoted by Spanish public administration through generous tax benefits). Retirement plans are products that stem from the initiative of Spanish financial institutions for retirement saving purposes.

Retirement plans cater for people with low income levels. They are flexible as they allow savers to withdraw funds in times of hardship, but at the expense of high withdrawal fees. Pension plan savers cannot drawdown on their funds until retirement, except under very limited circumstances – defined by Spanish Pension





Plans Law¹⁰² – such as severe illness or long-term unemployment¹⁰³. Consequently, retirement plans and pension plans have different degrees of liquidity, risk profile and tax treatment.

1.	Pension fund management firms 'Gestoras'	32.2
2.	Savings banks	20.8
3.	Banks	13.4
4.	Insurance companies	10.2
5.	Other	23.3

Source: Ministry of Economy and Competitiveness

Table 88 lists the leading providers of private pension plans by market share. The split by type¹⁰⁴ is 48% Occupational, 45% Individual and 7% Associational¹⁰⁵. Of the Occupational plans, 70% are DC (defined contribution), 28.7% DB (defined benefits) and 1.3% mixed. The composition of Associational schemes is 66.4% DC, 33.2% DB and 0.4% mixed¹⁰⁶.

The Spanish Association for Collective Investments and Pension Funds (INVERCO) established a classification system for individual pension funds by liquidity and risk. Table 89 describes the categories and allocation as a percentage of private pensions.

¹⁰² Royal Decrees 1/2002 and 304/2004.

¹⁰³ Royal Decree 1129/2009.

¹⁰⁴ Ibid.

¹⁰⁵ According to Spanish classification, those pension funds are promoted by associations or workers' unions.

¹⁰⁶ Ministry of Economy and Competitiveness.

Table 89. Pension fund categories and allocation

Category	Allocation
Non-mandatory 2 nd Pillar Pension Funds for employees	39.94%
Non-mandatory 2 nd Pillar Pension Fund from associations or worker unions to members	1.01%
3 rd Pillar Pension Funds – Fixed Return, short term – <i>no variable return assets or derivatives whose underlying asset is not a fixed return asset in portfolio, average asset holding less than 2 years</i>	11.54%
3 rd Pillar Pension Funds – Fixed Return, long term – <i>no variable return assets or derivatives whose underlying asset is not a fixed return asset in portfolio, average asset holding more than 2 years</i>	6.51%
3 rd Pillar Pension Funds – Fixed Return, mixed – <i>less than 30% of portfolio composed of variable return assets</i>	13.80%
3 rd Pillar Pension Funds – Variable Return, mixed – <i>between 30% and 75% of portfolio composed of variable return assets</i>	4.89%
3 rd Pillar Pension Funds – Variable Return – <i>over 75% of total portfolio invested in variable return assets</i>	5.26%
3 rd Pillar Pension Funds – Guaranteed Return Pension Funds – <i>those funds that count with the guarantee of a certain level of returns provided by a third party</i>	17.04%

Source: INVERCO

Life Insurance

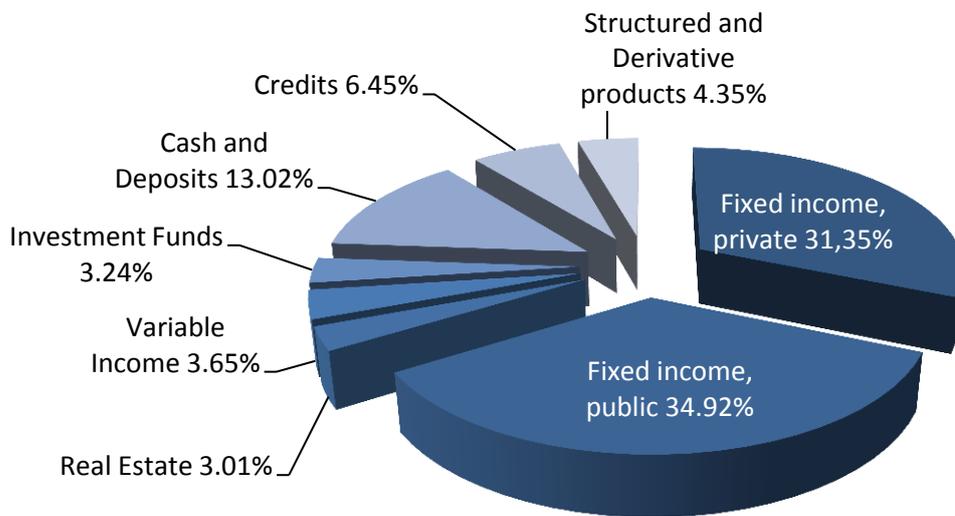
Life insurance policies are a quite popular savings product in Spain. According to UNESPA, the Spanish Insurance Industry Association, as of end Q1 2014 Spanish insurance companies were managing €197.8 billion in savings. Out of that figure, 82.5% (€163.23 billion) corresponds to savings through insurance contracts and 17.5% corresponds to pension funds¹⁰⁷. Life insurance capital is mostly invested in debt securities, as illustrated in graph 9.

¹⁰⁷ http://www.unespa.es/adjuntos/fichero_3749_20140514.pdf





Graph 9. Life insurance asset allocation, Q4 2012



Source: Directorate-General of Insurance and Pension Funds – 2012 Report on Insurances and Pension Funds, page 46

According to the Directorate-General of Insurances and Pension Funds (2012), the distribution of life insurance products is primarily through bank branches (76.38%) and exclusive agents (13.45%).

PPA, PIAS and PPSE

PPA (Insured Prevision Plans, “*Planes de Prevision Asegurados*”) and PIAS (Individual Systematic Savings Plans, “*Planes Individuales de Ahorro Sistemático*”) are an important category of financial products used for capital accumulation purposes. They are commonly considered as a type of life insurance. PPA and PIAS are individual long term savings products, which are constituted by periodic payments in order to accumulate capital and obtain a lifetime annuity from the moment the investor reaches a certain age (agreed in the contract), for the rest of his/her life. More specifically, PPA guarantee during the whole period of constitution of the capital a certain level of returns calculated through actuary methods. Unlike pension plans and PPA, which are not redeemable before retirement, it is possible to receive advanced annuity payment from PIAS.

As of 2012, PIAS amounted to €3,086 million in capital for over 700,000 investors (a 10.2% increase over the previous year) and PPAs amounted to €10,222.05 million for 1,018,038 investors:

A third vehicle is the PPSE (Social Entrepreneurial Prevision Plans, “*Planes de Prevision Social Empresarial*”) ¹⁰⁸. PPSE are very similar to occupational pension plans, with tax treatment similar to a PSE and other pension funds. However, they are much less popular than the two previous categories.

Charges

Public disclosure of charges related to private pension funds is poor. However, savers do benefit from some protection under the law, which limits management fees. However there is no mention on limits to commissions, which are usually paid out of management fees. Article 84 of the Royal Decree 304/2004 of Pension Plans and Funds ¹⁰⁹ establishes specific limits on chargeable fees for pension plan subscribers for depository and management of the pension fund. The law also allows for variable fees based on performance. In all cases, providers shall respect the following limits:

- Pension fund managers are able to charge a 2% maximum level of fees on the annual value of the managed accounts. This limit should be respected both for the pension fund as a whole as well as for the pension plans that compose the pension funds, and individually for each pension fund subscriber.
- Depositories of pension funds shall charge a maximum of 0.5% of the value of the accounts. This limit shall be respected for each individual pension plan as well as for the pension fund as a whole, and individually for each pension fund subscriber.

As regards distribution fees of pension funds, Aguirreamalloa, Corres and Fernández (2012) state that inducements (commissions paid from providers to financial advisors) are often presented to consumers as ordinary fees (such as deposit, management, subscription and reimbursement commissions). According to their research, the salespersons (financial advisors) of pension products earn more than the portfolio managers do. Commission rates varied between less than one to two and half percent (see graph 10).

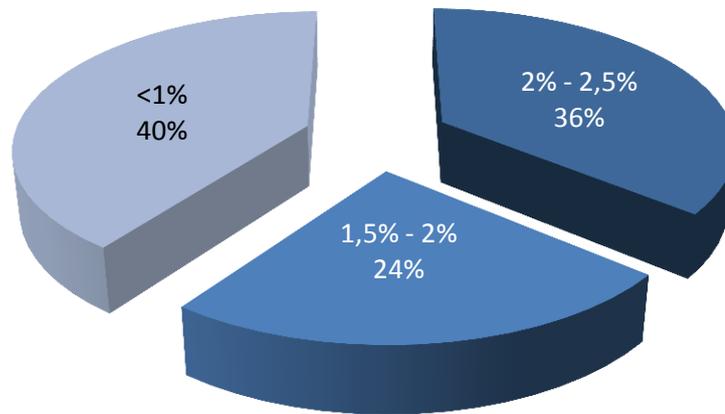
¹⁰⁸ According to according to Article 51.4 of the Income Tax Law 35/2006 and Royal Decree 1588/1999 (modified by the Royal Decree 1684/2007).

¹⁰⁹ <http://www.boe.es/boe/dias/2004/02/25/pdfs/A08859-08909.pdf>





Graph 10. Commissions charged to pension fund participants in 2007



Source: Aguirreamalloa, J; Corres, L. and Fernández, P. – Pension Funds Returns in Spain 2001-2011, IESE Research document, February 2012

Tables 90 and 91 demonstrate the evolution of management and depository fees for pension funds over the last few years. There is a clear difference in the magnitude of management fees charged on retail (Pillar 3) schemes over institutional (Pillar 2) schemes, in the order of nearly seven to one.

Table 90. Management Charges					
	2007	2008	2009	2010	2011
Pillar 1	0.16%	0.18%	0.16%	0.17%	0.21%
Pillar 2	1.53%	1.65%	1.41%	1.46%	1.52%

Source: Aguirreamalloa, Corres and Hernandez (2011)

This is repeated to a greater extent in depository fees, here the order of magnitude between retail and institutional is nearly 9 to 1. These differences in fees between retail and institutional accounts, illustrate the power of informed bargaining by institutional investors on the pricing of product providers and the high commissions charged by retail distributors.

Table 91. Depository Charges					
	2007	2008	2009	2010	2011
Pillar 2	0.04%	0.03%	0.03%	0.03%	0.03%
Pillar 3	0.32%	0.23%	0.22%	0.22%	0.20%

Source: Aguirreamalloa, Corres and Hernandez (2011)

According to Aguirreamalloa, Corres and Fernández (2012), managers do not report to pension fund participants about their portfolio management policy. They are critical of the quality of information that pension funds provide to participants. They consider that it is insufficient to permit informed judgment on whether portfolio manager activity created any value for the pension saver. Aguirreamalloa, Corres and Fernández believe that pension funds have a duty to inform the participants of their activities, including the fees they charge – information which is not generally available. They also consider it beneficial for pension funds to inform their clients on the returns that would have been obtained before portfolio manager activity, to assess the added value of the manager. Aguirreamalloa, Corres and Fernández conclude that most of the activity of pension managers destroys rather than creates value.

Additionally, they are also critical of the secondary effects of the beneficial tax structure on personal pension plans. In their view, the tax structure attracts funds to opaque money losing schemes. These plans offer no ultimate advantage to savers, as the associated costs of explicit and hidden commissions, custody and transaction fees outweigh the tax benefits.

Taxation

Pension savers receive favourable tax treatment when they contribute to pension saving products:

Retirement Plans

There are no tax benefits for contributions to retirement plans. At the end of the plan, the investment return will integrate the year's income tax declaration as capital gains.





Life insurance products

Tax benefits for contributions to life insurance products generally ended in 1999. The returns of the accumulated capital will be taxed as with any other financial capital gains. If the policyholder dies before maturity of the policy, his/her estate will pay usual inheritance taxes on the received capital. In some circumstances, it is possible to get tax relief on life insurance policies¹¹⁰.

PPAs (Insured Provision Plans, “*Planes de Prevision Asegurados*”¹¹¹)

These plans are exempt from capital gains tax and they receive increasingly favourable tax treatment (reductions of the tax base) according to the age of the saver at the beginning of pay-out (see Table 92).

Table 92. Tax base reduction on PPAs	
Beneficiary	Tax Base Reduction
<50 years	Up to either €10,000 or 30% of savers' income (the smallest amount)
>50 years	Up to either €12,000 or 50% of savers' income (the smallest amount)
Disabled (over 65% disability)	Up to €24,250 (maximum €10,000 for every relative making contribution to disabled beneficiary)
Spouse (up to 8,000 annual income)	Up to €2,000

Source: Spanish Ministry for Taxes

PIAS (Individual Systematic Savings Plans, “*Planes Individuales de Ahorro Sistemático*”)

These have favourable tax treatment under Law 35/2006 for Income Tax. There is a maximum annual deductible limit of €8,000 per year on PIAS. The maximum amount that an investor can accumulate in this plan is €240,000. If these requirements are met and the first contribution to the PIAS was more than 10 years ago, the saver will not pay tax on investment gains. There is no tax deduction for contributions to this savings product.

¹¹⁰ For instance, if its purchase was tied to the purchase of a mortgage loan.

¹¹¹ Royal Decree 439/2007 established tax benefits for PPAs. <http://www.boe.es/buscar/doc.php?id=BOE-A-2007-6820>

On the completion of the investment period in a pension plan, the saver has three options for the use of the accumulated wealth¹¹²:

- Take a lump sum; before 2007, a saver taking a lump sum payment would benefit from an additional 40% reduction in tax base for the capital. This dramatic increase on the marginal tax rate, even for people on historically low incomes, has effectively discouraged savers from taking lump sum payments.
- Purchase of an annuity; the purchase of an annuity is not compulsory. The income is subject to tax, but normally at a much lower rate than through receiving a lump sum payment. The annuity income will be added to any other source of income of the pensioner (public pension, dividends, coupons, etc.). However, there is an extra benefit for annuities derived from insurance-based products (life insurance, PIAS, PPAs, PPSE), which depends on the age at which the saver begins to draw down on the investment¹¹³, see Table 93.
- Mixed solution, a certain amount is received by a lump sum and the other part is constituted through an annuity. Money received is treated as income for the purposes of taxation.

Table 93. Tax base on insurance annuities

Age of the beneficiary when annuities start	% of the annuity for which to pay income tax
<40 years	40%
40 to 49 years	35%
50 to 59 years	28%
60 to 65 years	24%
66 to 69 years	20%
Over 70 years	8%

Source: Spanish Ministry for Taxes

Pension Plans

Private pension funds' investment is the most popular specific pension savings instrument due to the large tax benefits for the income tax declaration (Laws 46/2002 and 62/2003); such tax benefits are the main reason why people

¹¹² The end of the investment period will come with retirement age (pension plans, retirement plans) or whenever the saver decides to end the plan (life insurance, PPA, PIAS, PPSE).

¹¹³ <http://www.dgsfp.meh.es/gaspar/PPOtrosContratosPIASPrint.pdf>





contribute to private pension funds. Indeed, many contributions to private pension plans are made during the period when a tax declaration has to be presented (and therefore taxpayers can contribute to their private pensions' pot if they intend to pay less income tax).

Every taxpayer younger than 52 years of age can deduct, from their taxable income, up to €8,000 per year for contributions to pension plans. Taxpayers over the age of 52 have a cumulative additional contribution allowance of €1,250 per year. This tops out after 13 years to produce a maximum ceiling on deductible contributions of €24,250 per year.

Fund participants in Spain will have to pay income tax when they retire, not only on capital but also on the generated interests. Therefore we can say that the tax deduction is not indeed as a tax benefit, but as a tax payment deferral.

The amount of taxes to be paid upon retirement depends on whether the investor prefers to withdraw the lump sum or receive monthly payments until the moment of their death. In this case, annuities will receive the same tax treatment as salary income. This implies that the amount of taxes first deducted and later paid by the fund participant will generally not be the same; the net tax effect will vary from case to case.

Table 94. Income Tax Thresholds	
Annual Income	Marginal Tax Rate
< 17,707€	24,75%
17,707 to 33,007€	30%
33,007 to 53,407€	40%
53,407 to 120,000€	45%
120,000 to 175,000€	49%
175,000 to 300,000€	52% ¹¹⁴

Source: Royal Decree-Law 20/2011 of Urgent Budgetary Measures, 30 December 2011

¹¹⁴ According to last revision of the tax system by Spanish Government, December 2011.

For example, assuming capital returns of 3%, the capital generated by €1,000 after 15 years would be €1557, e.g. €557 of interests. The tax on those interests would be €105.83 (assuming returns taxed at 19%).

Table 95. Effects on Taxes on Savings Products	
Net Marginal Tax Effect (for every invested €1000)	Relative effect of taxes on saving products
€ -105.83	-6.8% ¹¹⁵ for 15 years, annually 1.13% ¹¹⁶)

Source: Better Finance Research

It is possible for subscribers of Spanish pension funds to decide whether, by the age they retire, they receive the lump sum or monthly annuities.

For the purpose of this report, we will assume that the future pensioner is choosing to receive the lump sum by the end of the pension plan. In this case, if the first contribution to the pensions plan was done more than 2 years ago, he will benefit of an extra taxable base reduction of 40%.

Table 96. Spanish Income Tax Formula

- Liquidative base = Tax base – Base reductions (e.g. for contribution to pensions fund)
- Integer quota = Liquidative base * tax rate (by thresholds)
- Liquid quota = Integer quota – Deductions
- Liquid quota - Other deductions = Final tax to pay

Source: Law 35/2006 for Income Tax

Retail investors care about final returns of pension saving products, e.g. the returns of investment products after inflation and taxes and the amount they will gain. It is only possible to know the actual returns at the final stage of the pension plan: it is the moment when the net tax effect can be calculated, by actualizing and deducing the past tax deductions to the paid taxes. Therefore, investment decisions between pension funds and alternative investment products for retirement are generally made without the required information on the final returns delivered by each of the options.

¹¹⁵ 105.83 / 1557 e.g., total tax to pay versus capital plus interests.

¹¹⁶ $15\sqrt[15]{6.8\%} = 1.13\%$.





It is however possible to estimate the real profitability of private pension plans versus alternative investment products through a practical example:

According to the Spanish income tax formula, for every €1,000 invested in a pension plan by an investor over 50 years old, the investor would get (assuming no additional tax reductions at a later stage of the tax calculation) a reduction for investment on private pensions plan of the 50% of €1,000, e.g. €500.

Assuming an inflation rate of 2%, we can actualize the tax benefits obtained at the moment when the €1,000 were saved.

Table 97. Net nominal and relative tax effect on returns

Annual income	Marginal tax rate	Tax savings	Actualized tax savings after 15yr (inflation of 2%)	Tax to pay (taxable base = €694.2)	Net marginal tax effect (for every invested €1000)	Relative effect of taxes on pension plans
< €17,707	24.75%	€123.75	€167	€171.80	€-5	<u>-0.50%</u>
€17,707 to €33,007	30%	€150	€202.50	€208.30	€-6	<u>-0.60%</u>
€33,007 to €53,407	40%	€200	€270	€277.70	€-8	<u>-0.70%</u>
€53,407 to €120,000	45%	€225	€303.75	€312.40	€-9	<u>-0.80%</u>
€120,000 to €175,000	49%	€245	€330.75	€340.20	€-9	<u>-0.90%</u>
€175,000 to €300,000	52%	€260	€351	€360.90	€-10	<u>-1.00%</u>

Source: Better Finance Research

As previously said, for a given return rate of 3%, the capital generated by the €1,000 after 15 years would be €1,557, e.g. €557 of interests. There is an extra tax benefit through a taxable base reduction by 40% if the capital is recovered as a lump sum¹¹⁷ e.g. €694.2. In turn, the person should pay taxes (depending on its situation of the tax scale) when withdrawing the money from the pensions plan.

¹¹⁷ This extra tax bonus disappeared as from 1 January 2007. However, it will be maintained for any capital contributions to the pension fund made before 2007. We will consider it as still in place.

In order to obtain the marginal net effect, we will deduct the actualized tax benefits to the tax paid when recovering the capital through a lump sum:

As shown in Table 97, there is a negative – and increasingly bigger – fiscal incentive to invest in pension funds e.g. the disincentive is greater the higher the income of the investor is when finalizing the pension plan.

It would be possible for the investor to somehow “escape” from this burdensome taxation by receiving the pay-out through a lifetime annuity and not lump sum; although it would not be possible to benefit of the 40% reduction in the taxable base. Lifetime annuities would be added to any other sources of income (dividends, interests, coupons) and pay tax according to the tax threshold as presented above.

We should also bear in mind that taxes to pay for investors could be potentially even higher, as:

- Due to this big capital accumulation, it is very likely that a higher tax threshold is charged when withdrawing the capital from the pension fund as opposed to investing in the pension funds (e.g. higher tax threshold).
- A net returns rate of 1% has been assumed (3% investment returns and 2% inflation). This is not a very realistic assumption, as Spanish pension funds have proved not to succeed in beating inflation rates and protecting the real value of the money of investors.

Pension Returns

Private pension products are relatively young in Spain. The obligation to publish the information of private pension fund returns began with the publication of the Pension Plans and Funds Regulation, approved by the Royal Decree 1684/2007, which transposed the IORP Directive into Spanish law.

According to INVERCO¹¹⁸, the average annual returns of Spanish pension funds (by category) were as displayed in Table 98. Better Finance could not find any consolidated data on the returns of other private pension savings products such as life insurance.

¹¹⁸ INVERCO, Asociación de Instituciones de Inversión Colectiva y Fondos de Pensiones http://www.inverco.es/novedadesEstFPensT.do?id=1206_Junio%202012





Table 98. Returns on Spanish private pension funds [%]

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2000 - 2013 avege.	
Non-mandatory 2nd Pillar Pension Fund from associations or worker unions to members															
-	-0.64	-3.72	6.73	5.52	8.39	5.36	2.44	-10.5	9.28	2.01	0	6.94	9.51	0.4726	0.0302
Non-mandatory 2nd Pillar Pension Funds from firms to employees															
-	-0.1	-3.84	5.61	6.56	9.49	8.16	3.05	-11.1	9.23	0.95	-1.11	8.04	7.7	0.4881	0.031
3rd Pillar Pension Funds – Fixed returns (short term)															
3.83	3.64	3.83	1.95	1.77	1.04	1.26	1.94	2.13	1.8	-0.64	1.38	3.47	2.08	33.74%	2.09%
3rd Pillar Pension Funds – Fixed returns (long term)															
0.68	0.62	-0.73	2.62	1.92	1.78	0.34	0.75	2.03	3.96	-0.47	1.39	4.79	4.66	27.04%	1.72%
3rd Pillar Pension Funds – Fixed returns (mixed)															
-2.2	-2.41	-5.15	3.92	3.15	5.33	3.58	1.32	-8.79	6.05	-1.54	-2.21	5.41	6.11	11.74%	0.79%
3rd Pillar Pension Funds – Variable Returns – mixed															
-4.97	-7.73	-17.2	8.7	5.6	12.16	10.09	2.96	-23.8	14.21	-0.82	-7.01	8.62	12.51	3.92%	0.27%
3rd Pillar Pension Funds – Variable Returns															
-10.6	-16.3	-30.1	16.18	8.88	18.73	18.3	3.93	-38.4	27.2	1.63	-10.4	10.43	22.19	-7.01%	-0.51%
3rd Pillar Pension Funds – Guaranteed Capital Pension Funds (either fixed or variable returns)															
-	-	-	-	4.66	4.64	1.44	1.48	-0.68	3.77	-3.96	1.15	5.48	9.41	30.26%	2.67%
WEIGHTED AVERAGED ANNUAL RETURNS, BEFORE INFLATION AND TAXES															
-1.85	-1.64	-4.4	5.42	4.46	7.22%	5.23	2.08	-8.07	7.7	-0.13	-0.76	6.59	8.36	23.82%	1.53%
Inflation – CPI Spain, Eurostat															
4	2.7	3.94	2.65	3.22	3.66	2.71	4.15	1.49	0.84	2.82	2.34	2.9	0.2	44.82%	2.68%
ANNUAL RETURNS, AFTER INFLATION AND BEFORE TAXES															
-5.85	-4.34	-8.34	2.77	1.24	3.56	2.52	-2.07	-9.56	6.86	-2.95	-3.1	3.69	8.16	-8.97%	-0.66%
ANNUAL RETURNS, AFTER INFLATION AND AFTER TAXES (see Table 36)															
-6.35	-4.84	-8.84	2.27	0.74	3.06	2.02	-2.57	-10.06	6.36	-3.45	-3.6	3.19	7.66	-15.19%	-1.17%

Source: INVERCO and Better Finance Research

Our previous analysis identified that the composite real annualised tax return for Spanish pension funds from 2002 to 2011 was, before taxes but after inflation, -9.88% over these 10 years).

Having extended the period of time considered in our analysis, once taking into account the good results of the two last years but also the early 2000's stock markets crash, the yearly 14-year long term overall results remain significantly negative (-1.17%).

Aguirreamalloa, Corres and Fernández (2012) consider that, besides high fees the other main cause for the poor returns of Spanish pension funds was inadequate portfolio composition. The OECD data confirms that Spanish funds have increasingly weighted their portfolios towards debt assets. While this has been a mixed benefit during the current financial crisis, in the long term the weighting towards debt securities will be a substantial impediment to the ability of these funds to generate real returns for their savers.

This trend towards greater debt weighting is mostly noticeable in the life insurance sector. There is anecdotal evidence to suggest that positioning ahead of the pending Solvency II Directive is the factor driving this trend. Solvency II has a low tolerance to volatile assets, such as unlisted or private equity (for such assets, even lower than for other equities). The draft Directive obliges insurance companies to conserve shareholder capital by investing in supposedly low volatility debt instruments (such as sovereign debt), which historically have relatively low rates of real return in comparison to real assets.

With respect to legislation governing the asset allocation of pension funds, the Royal Decree 304/2004, Articles 69 to 77 establish the requirements for asset allocation of pension funds in Spain. The Decree is prescriptive in that it details where portfolio managers can invest pension assets. Article 69.5 established that pension fund portfolios should be mostly invested in securities and financial instruments traded in regulated markets. Those securities and financial instruments traded in unregulated markets should have a relative low weight in the pension fund's portfolio. Article 70 comprises an exhaustive list of eligible investment instruments. Article 72 establishes very detailed requirements on portfolio allocation on the different types of assets for pension funds, according to investment coherence and diversification criteria. Article 73 establishes liquidity requirements, and Article 75 establishes investment valuation criteria.





Conclusion

On average the real returns of pension plans in Spain for the last 14 years have been globally negative.

Disclosure to individual savers of pension products is poor, according to research by Aguirreamalloa, Corres and Fernández, though fees are capped.

The taxation regime in Spain encourages personal pension provision, with tax deductibility on contributions and tax exemption through the investment period. Pension funds do not pay tax on capital gains or dividends received, nor corporation tax or VAT on management and depository fees. The tax burden of pay-out falls on the saver, usually having to pay much higher income tax marginal rates if capital is recovered through a lump sum creating an incentive for converting capital into an annuity and therefore taxes on a deferred basis.

Private Pensions: The Real Returns

2014 Edition

Country Case: United Kingdom

Introduction

The pension system in the UK is based on three pillars:

- **Pillar 1** is a social insurance program consisting of two elements:
 - The Basic State Pension: Every employee or self-employed person is required to contribute to this plan and each person can receive their basic pension upon attaining the age of retirement (State pension age). The legal age of retirement is 65 years for men. Since April 2010, the statutory retirement age for women has gradually increased from 60 to 65. The statutory retirement age will gradually increase from 2018 to be fixed at 66 years in 2020 for both men and women. The basic pension depends on the number of years of contributions to National Insurance. To qualify for a full pension, thirty years of contributions are necessary. The perceived pension at the full rate in 2014 for a single person amounts to £110.15 per week. It increases every year according to the following components, with the largest figure being taken into account:
 - the average percentage growth in wages;
 - the Consumer Price Index increase;
 - 2.5%.
 - Employees (and not the self-employed) who earn more than £5,668 per year contribute to the Additional State Pension system and receive an income in addition to the Basic State





Pension. The Additional State Pension depends on the number of years of contribution and earnings. Anyone wishing to save for retirement under pillar 2 or 3 may leave the State Second Pension. If the employee opts out in favour of an occupational scheme, the employer and the employee pay lower contributions and the employee cannot qualify for the State Second Pension.

- **Pillar 2** is a system of occupational/company pension plans. There are two categories of schemes:
 - Salary-related schemes (Defined benefit);
 - Money purchase schemes (Defined contribution).

The number of employees saving in a workplace pension plan has declined from 12.9 million in 1997 to 12.1 million in 2012.¹¹⁹ If employers do not offer a company scheme, they have the opportunity to contribute to an individual retirement savings plan contracted by the employee. In this case, contributions must be at least equal to 3% of salary paid.

Automatic enrolment

Public Authorities sought to ensure that part of the population does not fall into poverty in retirement by establishing a safety net at the professional level. The Pension Act of 2008 aims to solve the pension problem facing people whose savings are not enough to ensure a decent retirement¹²⁰. The purpose of this legislation is to protect the 13.5 million UK employees who are not affiliated to any pension plan (other than the basic plan that offers a very low level pension).

Employers are required to automatically enrol all employees whose annual income is more than £8,105 to a basic scheme to which they contribute. Employees have to explicitly opt out of if they do not wish to contribute. Contributions amount to at least 8% of their salary, of which 3% is paid by the employer. This requirement currently applies to only the largest

¹¹⁹ Department for Work and Pensions, 2013.

¹²⁰ According to the Department for Work and Pensions (2013) 12 million people are not saving enough to ensure an adequate income in retirement.

employers and will progressively extend to the smaller ones by 2017. In practice, most employers use defined-contribution schemes for this purpose. British employers who don't have their own scheme will have to join a national multi-employer scheme.

However, among those targeted by the reform (that is, people whose savings are insufficient to cover their needs at retirement), 4.5 million are not automatically enrolled in the new system. This includes young employees, employees too close to retirement and those whose annual income is less than £8,105. Employees may also request to opt out of the system. Occupational schemes are subject to the same limitations in terms of contributions and capital as individual savings plans (see below).

- **Pillar 3** consists of individual retirement savings plans.

Anyone participating in pillar 1 State Pension scheme has the opportunity to leave the State Second Pension and subscribe to a Personal Pension Plan with a bank, an insurance company, a building society or other financial intermediaries. The offer of individual retirement savings products in the UK is highly standardized and controlled by the State. There are two types of Personal Pension Plans: Stakeholder Plans and Self-Invested Personal Plans (see below for more details.)

A Personal Pension Plan is a defined contribution scheme. The accumulated savings can be withdrawn at any age between 55 and 75, even though the beneficiary is still employed.

The savers normally convert the accumulated rights into an annuity for life, which is subject to taxation. However they may withdraw from the scheme a non-taxable lump sum of a maximum of 25% of the accumulated savings.¹²¹ Another alternative to the annuity is for the subscribers to quit their retirement savings plan and to receive taxable income from it (called Unsecured Pension, USP). After turning 75 years old, they are able to make annual withdrawals. USP can be transmitted to heirs.

¹²¹ From April 2015, retirees will have more flexibility to withdraw their defined contribution pension savings. They will be able to withdraw a lump sum beyond 25%, subject to income tax at their income tax marginal rate, while they were previously taxed at the rate of 55%.





As the retirement system in the United Kingdom is predominantly a pre-funded one, life insurance and pension funds represent the majority of total assets held by UK households.

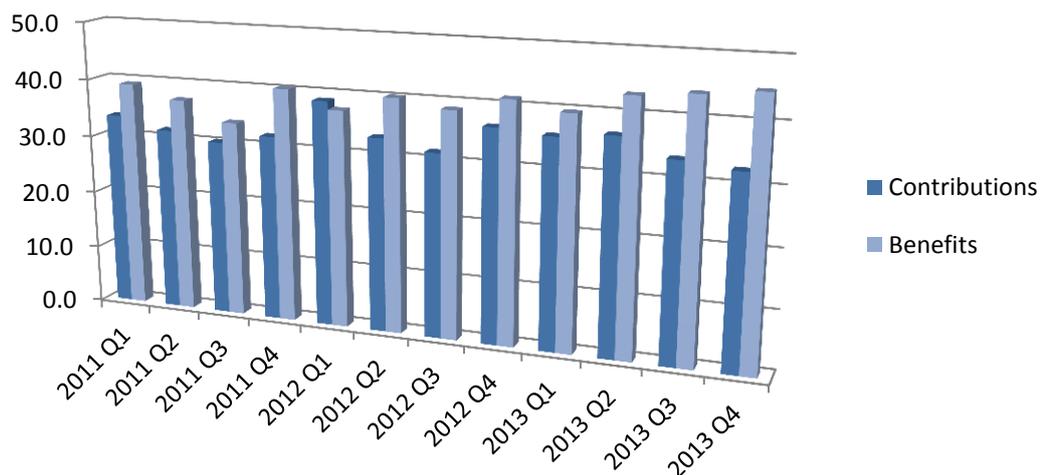
Table 99. Financial Savings of UK Households at the end of 2013 (non-real estate)

	% of total assets	2013/2012
Currency and bank deposits	29.0%	4.0%
Investment funds	2.2%	5.0%
Pension funds and life insurance ¹²²	58.0%	10.8%
Direct investments (debt products, shares and other equity)	10.8%	9.0%
Total	100.0%	8.4%

Source: Office for National Statistics

Since 2013, benefits paid by pension funds have increased consistently while contributions remain stable and inferior to benefits. This reflects that pension funds in the United Kingdom are increasingly mature as many people who were born after World War II retire. However, income from rents, interest and dividends allow pension funds to honour their commitments, with two-thirds of them still being invested in the framework of defined-benefit schemes.

Graph 11. Contributions and benefits of pension funds in the United Kingdom (£bn)



Source: Office for National Statistics. Data include self-administered pension funds and pension funds managed by insurance companies (seasonally adjusted data)

¹²² Life insurance represents just a small portion of it.

Pension Vehicles

Pillar 2

There are many types of pension schemes, including defined contribution schemes and defined benefit schemes.

Defined benefit schemes

Defined benefit schemes are protected by the Pension Protection Fund (PPF). PPF pays some compensation to scheme members whose employers become insolvent and where the scheme doesn't have enough funds to pay members' benefits. The compensation may not be the full amount and the level of protection varies between members already receiving benefits and those who are still contributing to the scheme.

- Final salary schemes

Trustees are responsible for paying retirement and death benefits. The pension depends on the number of years the employee belonged to the scheme (pensionable service), the final pensioner salary and the scheme's accrual rate.

- Career Average Revalued Earnings (CARE) schemes

CARE schemes are similar to final salary schemes, apart from the fact that pensions depend on the employee averaged earnings over their career (the pensionable earning) instead of the last salary before retirement. Pensions are indexed on price inflation.

Defined contribution schemes

The amount of pension depends on contributions paid by the employer and the employee, the fees charged for the management of the scheme and the performance of investments.





Small self-administered pension schemes (SSAS)

SSASs are pension schemes whose members are normally company directors or key staff. The investment policy of SSASs is more flexible than the common law system. The fund may lend money to the employer and it may borrow and invest in a broad range of products, including the employer's shares.

SSASs are managed by insurance companies, pension consultants and fund managers.

Hybrid schemes

The sponsor of a hybrid scheme commits on a minimum pension amount. The pension can be higher depending on the outcome of the investment policy of the fund.

Cash balance plans

In cash balance schemes, the employer is committed to a minimum amount of pension savings from the scheme for each period of service of his/her employees. At retirement, the accumulated capital is converted into an annuity.

Multi-employer schemes

Multi-employer schemes have been around for a long time and are common in the public sector.

The National Employment Savings Trust (NEST), established in 2011 by the government, is one of the schemes complying with the legislation on auto-enrolment (see above). It is a low-cost pension scheme and is required to accept membership from any employer. Contributions may reach £4,200 per year.

Since the implementation of the auto-enrolment legislation, other inter-fund companies have been created and are in competition with NEST, namely NOW and "The People's Pension".

Pillar 3

Self-invested personal pensions

Self-invested personal pension plans are a type of Personal Pension Plan where the subscriber decides its own investment strategy or appoints a fund manager or a broker to manage investments. A large range of investments are allowed, although some of them (notably residential property) support heavy tax penalties and are therefore excluded in practice.

Stakeholder pension schemes

Stakeholder pension schemes were created in 2001 to broaden the range of investment choices and facilitate access to individual savings plans for anyone wishing to save for retirement.

Stakeholder pension schemes are Personal Pension Plans that are regulated in terms of charges and in terms of contributions that the provider must accept; management fees must not exceed 1.5% per year for the first ten years and 1% thereafter. Stakeholder pension plans must accept any contribution of more than £20 and any transfer from other pension schemes.

Group personal pension plans

Group personal pension plans are like Personal Pension Plans but they are arranged by the employer. The liability lies on an independent pension provider, usually an insurance company

Enhanced annuities

Products for certain categories of people whose life expectancy is lower, such as smokers or people with serious diseases, are proposed by pension providers. In this case, the benefit is "enhanced" (Enhanced Annuities) and distributed over a much shorter period of time.





Charges

A recent report by the Office of Fair Trading (OFT) highlighted the lack of transparency and comparability on fees charged to members of UK pension funds.¹²³ This is the case especially for trust-based schemes where there is no requirement to disclose charges.

Annual Management Charges (AMC) are usually the main charges levied on pension funds. However, some schemes charge additional fees such as, for example, a contribution charge or a flat fee. In some cases audit, legal, custodial or consultancy fees are added to the AMC and deducted from members' pension pot.¹²⁴ OFT's report also showed that some providers do not include the costs of administering schemes, of IT systems or of "investment management services" in AMC. Moreover, transaction costs are never included in the AMC, but this latter practice can be justified by the fact that a major part of trading costs is the bid-ask spread of quotes or orders in order-driven markets, a cost that should be considered as an inherent component of investment returns.

To summarize, there are some operational expenses that are not included in AMC, but to which extent is unknown. As a reference, operational expenses of pension funds in the United Kingdom vary between 0.25% and 0.30% of assets.

Table 100. Pension funds in the United Kingdom: Operating expenses (% of total assets)

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
0.279	0.264	0.304	0.217	0.239	0.238	0.319	0.262	0.270	0.260	0.270

Source: Office for National Statistics, IODS calculation¹²⁵

Fees charged to members may be significantly higher than the average, depending, among other things, on the size of the scheme. It has also been noted by OFT that some providers recently charged higher AMC to deferred members than active members. In order to protect members of pension funds against the most abusive

¹²³ Office of Fair Trading (2013).

¹²⁴ Department for Work & Pensions (2013, 2).

¹²⁵ Operating expenses for 2012 are available from ONS but total assets in 2012 are not yet available. To calculate the percentage of operating expenses in total assets, we assumed that total assets grew in 2012 at the same rate as those of self-administered funds which are available and represented 71% of assets of all pension funds in 2011.

practices, a stakeholder pension scheme cannot charge an AMC superior to 1.5% and it cannot charge its members for starting, changing or stopping contributions, nor for transferring funds. There is currently a project of new regulation of the Department for Work and Pensions to impose a cap of 1% or 0.75% to Annual Management Charges charged by workplace default funds in the framework of the automatic enrolment regulation.

There are various estimations available on the average weight of charges levied on pension funds in the UK.

- Charges are especially high in personal contracts other than Group personal plans. According to Oxera¹²⁶, there is a contribution charge of 0 to 1% and an average AMC of 0.95% in personal defined contribution schemes.
- The Association of British Insurers (ABI) found that schemes newly set-up for automatic enrolment supported a 0.52% Annual Management Charge on average, against 0.77% for pre-existing schemes. NEST AMC is around 0.5% of assets and administration fees charged by NOW amount to 0.3% of assets plus £1.50 per member per month.
- According to the Department for Work and Pensions¹²⁷, average charges were 0.71% in trust-based schemes and 0.95% in contract-based schemes in 2012.
- According to the Office of Fair Trading (OFT), the weighted average annual management charge for new contracts decreased from 0.79% in 2001 to 0.51% in 2012.

This latter source appears to be the most consistent and recent one and we use it below to calculate investment returns before and after charges, although taking into account only AMC underestimates the actual level of charges.

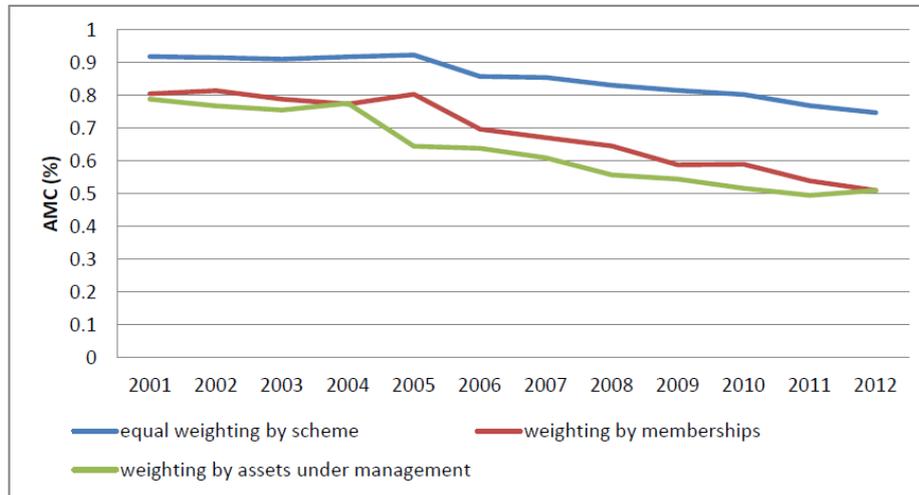
¹²⁶ Oxera (2013).

¹²⁷ Department of Work and Pensions (2013, 3).





Graph 12. Average AMC on schemes set up by new contract-based and bundled trust-based pension providers in each year



Source: OFT, based on data submitted by providers

The fall in average AMC is attributed to several factors by OFT:

- The growing size of assets under management generated economies of scale and increased the bargaining power of employers.
- The AMC cap on stakeholder pensions created a new competitive benchmark.
- Advisers' remuneration has been excluded from AMC by some providers ahead of the regulation preventing this method of adviser remuneration from January 2013 onwards (The Retail Distribution Review, RDR).

In order to calculate the average weight of charges in total outstanding assets over a ten year period, we used assumptions of OFT on the average annual rate of switching providers (6.7% of assets) and the average annual rate of successful re-negotiations (3.6% of assets). Since no data are available on average AMC in 2000, we assumed that average AMC represented 0.79% of managed assets in 2000, as in the following three years which are documented by OFT. According to these hypotheses, we find that the average AMC decreased from 0.79% until 2004 to 0.63% of the outstanding assets of pension funds in 2013. On average, AMC represented 0.74% of assets on the ten years from 2002 to 2012.

Table 101. Average AMC on schemes set up by existing contract-based and bundled trust-based pension providers in each year (%)

From 2000 to 2004	2005	2006	2007	2008	2009	2010	2011	2012	Annual average
0.79	0.77	0.76	0.75	0.73	0.71	0.69	0.67	0.65	0.74

We have added these levels of charges to investment returns each year to calculate investment returns before charges of the year.

Table 102. Impact of charges on annual rate of investment returns (%)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Annual average
Nominal return before charges, before inflation, before tax	-0.4	na	3.5	3.3	3.1	2.9	2.8	2.7	2.9	2.6	2.3	2.2	2.1	2.7
Nominal return after charges, before inflation, before tax	-1.2	na	2.7	2.5	2.3	2.1	2.0	1.9	2.2	1.9	1.6	1.6	1.4	1.9

Source: OFT, GAD, OECD, own calculation

Taxation

Tax relief on contributions

Contributions to personal pension plans allow for investor tax relief, which is subject to a maximum amount limited to either 100% of salary or an annual allowance of £50,000 (£40,000 from the tax year 2014-15); whichever is lower. The total contributions of the employee and his employers should be inferior to the annual allowance. The tax relief depends on the tax rate of the investor.





Table 103. Tax relief on contributions

Income Tax Rate	Tax Relief
20%	25% of contributions
40%	2/3 of contributions

Non-taxable persons benefit from a subsidy of a maximum of £2,880 of individual contributions per year (subsidy of £720.)

A third person may contribute and benefit from the tax relief for contributions up to £2,880.

Moreover, there is a lifetime allowance of £1.5 million (£1.25 million from the tax year 2014-2015). Pension savings are tested against the lifetime allowance when the beneficiaries receive their pension benefits. The charge is paid on any excess over the lifetime allowance limit. If the amount over the lifetime allowance is paid as a lump sum, the rate is 55 %¹²⁸. If it is paid as a pension, the rate is 25%.

Taxation of the funds

Pension funds do not pay any tax on the income of their assets (interest, dividends, and rents) nor on capital gains.

Taxation of pensions

Pensions are included in the income tax base. There are currently three marginal rates in the UK: 20% for an annual income of up to £32,011, 40% for up to £150,000 and 45% for annual income above. There are income tax allowances of £9,440¹²⁹ in favour of taxpayers with an income inferior to £100,000.

Pension Returns

When looking into Pension Returns, we will consider the returns of private pension

¹²⁸ From 2015, the applicable tax rate will be the marginal rate applicable to the beneficiary, see note ¹²² above.

¹²⁹ This amount applies to people born after 5 April, 1948.

funds as the most descriptive proxy, since other options such as life insurance have a lower weight in the British market. As for other instruments such as shares, bonds and packaged products we do not have statistics that show in which proportions these products are used for purely private pension provision.

Asset allocation

Pension fund returns depend on their asset allocation.

Table 104. Breakdown of self-administered pension fund asset holdings (%)										
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Public sector securities	16	15	12	12	13	14	14	13	16	17
Shares	46	43	43	41	33	29	29	26	22	21
Corporate bonds	7	8	8	9	10	12	13	11	10	10
Mutual funds	17	19	21	22	26	25	30	34	33	34
Other	13	15	16	17	18	19	15	16	18	18
Total assets	100	100	100	100	100	100	100	100	100	100

Source: ONS, "MQ5: Investment by Insurance Companies, Pension Funds and Trusts", various years

The share of direct holdings of corporate securities (shares and bonds) consistently decreased from 53% in 2003 to 31% in 2012. British pension funds remain among the most exposed to the stock market, either directly or through investment funds¹³⁰. However, faced with the uncertainty of returns achieved by the stock market and the weak performance of government bonds, managers reallocated part of their investments to alternative asset classes.

The UK pension funds have suffered relatively little from the crisis of sovereign debts in the euro zone; their bond portfolios are mainly composed of British government bonds (48%) and corporate bonds (46%), and foreign government securities have a much lower weight (6%) (Source: Office for National Statistics).

It is worth mentioning the investment policy of NEST. One of the objectives of NEST is to encourage individuals to save and it was, therefore, considered necessary to avoid any financial risk in the first few years. Until the age of around 30 years, the return of managed funds will be limited to inflation, that is to say a zero real interest rate. Unlike traditional allocations that gradually decrease market risks

¹³⁰ Equity funds assets represent more than two thirds of total UCITS assets in the United Kingdom.





when approaching the retirement age, higher risks can be taken in the second savings phase, with a target performance of 3% plus inflation. Employees may also choose to allocate their contributions to the fund "NEST Higher Risk", which will be composed of shares up to 75% of its assets.

Since 2005, investment returns of pension funds have been inferior to the sum of charges and expenses, resulting in negative investment returns. Returns were slightly positive before 2005, however, over a 10-year period the performance is negative (-6%), with an annual average of -0.6%.

However, the nominal returns (after charges and before inflation) are positive and retirees pay the income tax on their pension, a part of it being composed of the nominal investment returns.

The amount of tax depends on the income tax rate of each retiree. We assume that the pensioner withdraws the maximum tax-free lump sum: 25% of the accumulated savings. In other words, we multiply the applicable tax rate by 0.75. The retiree will pay an amount of income tax on their nominal investment return, which depends on their applicable marginal tax rate and their tax allowance, in relation to their total income.

We calculated the real investment return for four cases:

Table 105. Case description				
	Tax allowance (£)	Marginal Tax rate	Income tax	Average tax rate
Case 1: An annual income of £10,000	9,440	20%	-	0%
Case 2: An annual income of £20,000	9,440	20%	-	0%
Case 3: An annual income of £50,000	9,440	40%	4,158	8%
Case 4: An annual income of £150,001	-	45%	53,598	36%

Option 1

We apply the average tax rate to the nominal investment return and calculate the resulting real investment return after taxes. In the most favourable case, the negative return rises to -0.7% per year. Assuming that the employee and the employer contributed in total an equal amount of money each during the employee's 40 year career, the total puncture represents 12% of the accumulated savings coming from employer contributions and their own contributions.

Table 106. Pension fund average annual rate of investment returns (%)															
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Annual average	
Nominal return before charges, before inflation, before tax	-0.4	na	3.5	3.3	3.1	2.9	2.8	2.7	2.9	2.6	2.3	2.2	2.1	2.5	
Nominal return after charges before inflation, before tax	-1.2	na	2.7	2.5	2.3	2.1	2.0	1.9	2.2	1.9	1.6	1.6	1.4	1.7	
Real return after charges, after inflation, before tax	-2.0	na	0.9	1.2	0.6	0.2	-0.9	-0.2	-0.9	-0.9	-2.1	-2.5	-1.2	-0.7	
Real return after charges, after inflation, after tax															
Case 1									-0.7						
Case 2									-0.7						
Case 3									-0.8						
Case 4									-1.1						

Sources: GAD (nominal returns in 2000), OECD (real returns other years), ONS, OFT, IODS calculation

Option 2

We apply the marginal tax rate to the nominal investment return and calculate the resulting real investment return after taxes. In the most favourable case, the average annual return is -0.9%. Assuming that the employee contributed an equal amount of money during each of their 40 year career, the total puncture from negative real investment returns represents 17% of the accumulated savings in the most favourable case.

Table 107. Pension fund average annual rate of investment returns (%)															
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Annual average	
Nominal return before charges, before inflation, before tax	-0.4	na	3.5	3.3	3.1	2.9	2.8	2.7	2.9	2.6	2.3	2.2	2.1	2.5	
Nominal return after charges before inflation, before tax	-1.2	na	2.7	2.5	2.3	2.1	2.0	1.9	2.2	1.9	1.6	1.6	1.4	1.7	
Real return after charges, after inflation, before tax	-2.0	na	0.9	1.2	0.6	0.2	-0.9	-0.2	-0.9	-0.9	-2.1	-2.5	-1.2	-0.7	
Real return after charges, after inflation, after tax															
Case 1									-0.9						
Case 2									-0.9						
Case 3									-1.2						
Case 4									-1.2						





Conclusions

The United Kingdom is one of the European countries with the most developed and mature pension funds. Workers in the UK cannot rely on the social insurance program (pillar 1) that provides only a very limited income. On the other hand, British households save less than other Europeans on average and they do not rely much on alternative assets as a means to prepare for their retirement. Hence, the government has implemented a compulsory framework of “auto-enrolment” in occupational schemes that should, in theory, extend the safety net to most employees.

But these initiatives can only be positive if the new money channelled to pension funds is efficiently managed and generates significant and sustainable revenues. The issue of the real returns of private pensions is thus crucial in the UK.

However, and surprisingly in a country which has been experiencing pre-funded retirement schemes for a long time, it is not easy to calculate these returns and identify its positive/negative (managers’ skills and asset allocation) or purely negative components (charges and taxation).

As in other countries, the financial crisis that started in 2008 resulted in changes in asset allocation that are probably generating lower returns, with more cash and less corporate equity.

Charges negotiated by employers with pension providers in the framework of new contracts or re-negotiations decreased on average since 2005. But there is a lack of transparency and comparability of charges disclosed by pension providers. Public authorities are currently taking initiatives to standardise and limit the fees paid to pension providers to avoid abusive practices. The Annual Management Charges, which are the main focus in the public debate, decreased from 0.79% in 2001 to 0.51% in 2012, but this indicator does not reflect all charges and its coverage varies from one fund to another or even from one member to another in any given fund.

Another negative factor is the inflation rate, which is higher in the UK than in the Euro Area, especially in 2012 and 2013.

In total, the nominal average annual performance of employees’ and employers’ contributions to pension funds from year 2000 to 2012 was positive by 2.5% but it

was negative – in the best case – by -0.7% (and up to -1.2%) when taking into account inflation, charges and taxes.





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Glossary

- **ABI** – Association of British Insurers
- **AFG** – Association Française de la Gestion financière
- **AGIPI** – Association d'assurés pour la Retraite, l'Épargne et la Prévoyance
- **AIFs** – Alternative Investment Funds
- **AMAP** – Association Médicale d'Assistance et de Prévoyance
- **AMC** – Annual Management Charges
- **AMIREP** – Association Moderne pour l'Information sur les Retraites, l'Épargne et la Prévoyance
- **ANCRE** – Association Nationale pour la Couverture des risques, la Retraite et l'Épargne
- **ARCAF** – Association Nationale des Fonctionnaires Épargnant pour la Retraite
- **ASAC – FAPES** – Association de Sécurité et d'Assistance Collective
- **ATP** – Arbejdsmarkedets Tillægspension (Danish Supplementary Pensions Scheme)
- **AuM** – Assets Under Management
- **BaFIN** – Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)
- **BAPI** – Association Belge des Institutions de Pension (Belgian Association of Pension Institutions)
- **BeAMA** – Belgian Asset Managers Association
- **BNB** – The National Bank of Belgium
- **CARE** – Career Average Revalued Earnings
- **COVIP** – Commissione di Vigilanza sui fondi Pensione (Commission of Vigilance on Individual Pension funds)
- **CPI** – Consumer Price Index
- **CRH** – Complémentaire Retraite des Hospitaliers (French Complementary Pension System for Health Workers)
- **CTA** – Contractual Trust Arrangement
- **DB** – Defined Benefit
- **DC** – Defined Contribution
- **DFE** – Dobrowolny Fundusz Emerytalny (Voluntary Pension Funds)
- **DKK** – Danish Krone
- **EEA** – European Economic Area
- **EET** – Exempt contributions, Exempt investment income and capital gains of the pension institution, Taxed benefits
- **EIOPA** – European Insurance and Occupational Pensions Authority
- **ESAs** – European Supervisory Authorities
- **ETF** – Exchange-Traded Fund
- **ETT** – Exempt contributions, Taxed investment income and capital gains of the pension institution, Taxed benefits





- **EU** – European Union
- **FCPE** – Fonds Commun de Placement d'Entreprise
- **FFSA** – Fédération Française des Sociétés d'Assurances
- **FSA** – Financial Supervisory Authority
- **FSMA** – Financial Services and Markets Authority
- **GAIPARE** – Groupement Associatif Interprofessionnel Pour l'Amélioration de la Retraite et de l'Épargne
- **GDP** – Gross domestic product
- **GDV** – Gesamtverband der Deutschen Versicherungswirtschaft e. V. (German Insurance Association)
- **HICP** – Harmonised Indices of Consumer Prices
- **IKE** – Indywidualne Konta Emerytalne (Individual Retirement Accounts)
- **IKZE** – Indywidualne Konta Zabezpieczenia Emerytalnego (Individual Retirement Savings Accounts)
- **INAMI** – Institut National d'Assurance Maladie-Invalidité (National Institute for Health and Disability Insurance)
- **INSEE** – Institut national de la statistique et des études économiques (French national Institute of Economic and Statistical information)
- **INVERCO** – Asociación de Instituciones de Inversión Colectiva y Fondos de Pensiones (Spanish Association of Investment and Pension Funds)
- **IODS** – INSEAD OEE Data Services
- **IORP** – Institutions for Occupational Retirement Provision
- **KID** – Key Information Document
- **KNF** – Komisja Nadzoru Finansowego (Polish Financial Supervision Authority)
- **LD** – Lønmodtagernes Dyrtdsfond (Danish Employees Capital Pension Fund)
- **LT** – Long-term
- **NDC** – Non-financial Defined Contribution
- **NEST** – National Employment Savings Trust
- **OECD** – The Organisation for Economic Co-operation and Development
- **OFEs** – Otwarte Fundusze Emerytalne (Open Pension Funds)
- **OFT** – Office of Fair Trading
- **OICR** – Organismi di Investimento Collettivo del Risparmio
- **ONS** – UK's Office for National Statistics
- **PAYG** – Pay-As-You-Go
- **PCLI** – Pension Complémentaire Libre des Indépendants (Private Supplementary Pensions for the Self-employed)
- **PERCO** – Plan d'épargne pour la retraite collectif (Corporate collective pension plans)
- **PERP** – Plan d'épargne retraite populaire (Personal pension plans)
- **PIAS** – Planes Individuales de Ahorro Sistemático (Individual Systematic Savings Plans)
- **PIP** – Piani Individuali Pensionistici (Individual Pension Plans)
- **PPAs** – Planes de Prevision Asegurados (Insured Prevision Plans)

- **PPE** – Pracownicze Programy Emerytalne (Employees’ Pension Programs)
- **PPF** – Pension Protection Fund
- **PPSE** – Planes de Prevision Social Empresarial (Social Entrepreneurial Prevision Plans)
- **PRIIPS** – Packaged Retail Investment and Insurance-based Investment Products
- **PSVaG** – Pensions-Sicherungs-Verein Versicherungsverein auf Gegenseitigkeit
- **PTE** – Powszechna Towarzystwa Emerytalne (Pension Societies)
- **SSAS** – Small Self-Administered pension Schemes
- **TER** – Total Expenses Ratio
- **TFI** – Towarzystwa Funduszy Inwestycyjnych (Investment societies)
- **TFR** - Trattamento di Fine Rapporto
- **UCITs** – Undertakings for Collective Investment in Transferable Securities
- **UNESPA** – Unión Española de Entidades Aseguradoras y Reaseguradoras es la Asociación Empresarial del Seguro (Spanish Insurance Industry Association)
- **ZEW** – Zentrum für Europäische Wirtschaftsforschung (The Centre for European Economic Research)
- **ZUS** – Zakład Ubezpieczeń Społecznych (Social Insurance Institution in Poland)



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