

Feasibility Study for a EU Pension Fund for Researchers

**European Commission
Research Directorate-General**

Executive Summary

n°RTD/DirC/C4/2009/026879



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This report covers the main results of the "*Feasibility study of a pan-European pension fund for EU researchers*", carried out by Hewitt Associates on behalf of the European Commission - Research Directorate-General- over the period June 2009 – April 2010.

Within this project, Hewitt Associates has examined the legal, technical and financial terms and requirements that should be considered for setting up a viable pan-European framework for occupational pension arrangements that could match the needs of researchers in the European Economic Area.

We conclude that there is demand for a cross-border pension fund for EEA based researchers, and that it is now possible to establish such an arrangement. This project has shown that:

- The opportunity to establish cross-border arrangements is considered relevant and valuable by a large majority of surveyed organisations;
- European organisations consider that occupational pension benefits will become more important in the near future;
- Multinational companies are already establishing EU cross-border pension funds;
- Financial service providers are entering the market and are establishing new products;
- It is preferable to use the legal framework provided by the European Directive on the Institution for Occupational Retirement Provision (IORP);
- There appear to be no insurmountable barriers to implementation, although it will be difficult to include public sector researchers from a number of countries unless national authorities authorise additional contributions to the new fund or allow the possibility to opt-out from the current national system;
- To improve the cost-effectiveness of the fund, it would be preferable to have benefits and reporting structures that are standardised within each country.

The results of the study should help to raise the awareness of a wide range of stakeholders about possible practical solutions covering supplementary pension rights which overcome one of the barriers to the mobility of researchers. The study may also encourage the establishment of targeted pan-European pension arrangements that could benefit researchers, and more generally employees at large. Ultimately these developments will be instrumental in making the European Research Area more open, competitive and attractive.

The study shows that there is wide support by employers in favour of a cross-border pension fund for EEA based researchers, and that it is now possible to establish such a single arrangement covering researchers in a majority of EEA countries. In some countries, especially for researchers with a public sector contract, there are local restrictions and specific conditions that effectively limit cross-border affiliation to a non-domestic pension fund.

From a market perspective, on the demand side, multinational organisations are already establishing EU cross-border pension funds.

The willingness of a larger number of organisations to follow such a path is likely to increase in conjunction with the more generalised availability of accurate and user-friendly information on local statutory requirements underpinning employment contracts, labour law and social security conditions. The increasing co-operation among national authorities, the availability of new frameworks and tools for the exchange of information and best practices among these authorities will have a positive impact on the predictability and user-friendliness of administrative procedures necessary to operate such funds. Meanwhile on the supply-side, activities being undertaken by financial service providers and pension advisors towards the provision of pension related services and of new products that respond to cross-border client needs are growing steadily. Although offers on the market are limited in scope at present, its gradual acceleration should take place over the coming years.

In terms of cost-effectiveness of pension fund set-up and administration, the standardisation of benefits and reporting structures within each participating country is strongly recommended.

The wide diversity of pension regimes and of potential sponsor undertakings requires the design of a thorough system of project management and governance throughout the whole process of implementation. For this purpose an ad hoc task-force involving representatives of the promoting organisations could be set up.

In addition to the benefit structure, on the basis of the number, diversity and scope of sponsor undertakings interested in setting up a common cross-border framework for occupational pensions, the promoting organisations should consider whether to set-up a cross-border pension fund or use a cross-border product developed and delivered by a financial services provider or a consortium of such providers responding to agreed and well defined specific terms of reference. The strategic implementation path chosen by the promoting organisations and the founding sponsors will determine the depth into which to consider issues such as such as location, vehicle, administration and investment policies.

The study has focused on the following areas of investigation, namely:

- Best market practice already in place or under development;
- Employers' practices and willingness to establish pan-European pension arrangements;
- Possible systems of governance in line with the EU directive on IORP (Directive 2003/41/EC);
- Benchmark analysis and considerations for geographic location of a pan-European IORP;
- Cost structure and estimate of financial implication for pension arrangements;
- National labour law, social security and tax conditions applicable to employees;
- Impact assessment of pension benefits rights for researchers moving across countries; and
- Possible follow-up actions.

In particular the following results emerged from the study.

1. Employers Practices and Interest for Pan-European Pension

The most important HR challenge indicated by participating organisations is to attract and retain key employees. 76% of employers believe that complementary pension benefits to R&D staff will be more important in the future to retain and attract key employees. The employer survey shows most employers perceive a potential EU cross-border pension arrangement to be relevant and valuable. The key drivers for such arrangements are: policy consistency, better managing employee mobility and meeting employee expectations.

Actual participation rates in new arrangements will be influenced where researchers are members of existing domestic retirement benefit arrangements. The survey showed that 42% of organisations currently operate complementary pension funds. The proportion is higher and reaches 55% when considering only the private sector.

The main reasons to provide occupational pension benefits beyond regulatory requirements indicated by survey participants are related to the need of being in line with market practices and attracting talent. In the majority of cases (53%) existing pension fund provisions are designed to cover all employees; while in 10% of cases these arrangements cover only senior R&D staff.

Where employers provide the same retirement benefits to all employees irrespective of their function, there may be some resistance for providing "special" benefits for researchers only. In addition, some researchers are in mandatory pension arrangements where, unless there is a change in national provisions, it is not possible to choose to participate in a cross border pension arrangement instead.

2. Market Practices

Cross-border retirement solutions can be established as IORPs and regulated under the EU Pension Directive, or otherwise using the 3rd Life Directive or simply grouping local retirement products.

We have concluded that the IORP framework would be preferable for the following reasons:

- There is more established market practice under this route (almost 80 registered cross-border IORPs), and expectations indicate it will continue;
- Financial service providers are developing new products in this area;
- There is the opportunity for full portability when researchers move cross-border;
- Tax equality and unlawful discriminatory national practices have been explicitly addressed by the European Commission and by the European Court of Justice and, accordingly, are leading to changes in legislation and practices.

3. Governance

The establishment of a best in class governance framework and the implementation and monitoring of related principles are the preconditions for efficient, reliable and sustainable private pension arrangements. This is even more important in the context of this project, given the diversity of nature, scope and location of potential sponsor organisations, and the different employment histories, statuses and locations of potential pension beneficiaries.

On the basis of the governance principles stated in the IORP EC Directive and best country specific practices of pension fund governance, the study reviewed the key possible options and examined the terms and conditions for a governance structure that can match the needs of both sponsor organisations and beneficiaries.

The analysis of possible options for a reliable, transparent and best in class governance structure is mainly a function of:

- The type of legal contractual vehicle that will be chosen to collect contributions/premiums and deliver benefits;
- The level of independence in terms of legal capacity that the sponsoring employers will wish to attribute to the chosen vehicle; and
- The location, in the case of a pension fund.

Two possible options of governance structure, which are function of the applicable legal framework in two different jurisdictions, have been presented in the study. The first is applicable in a common law context having the institution of the "trust" at the centre of the system of governance.

The second is applicable in a specific mainland European jurisdiction that relies on an ad hoc and autonomous legal framework designed to respond to the objectives and operations of pension funds, potentially irrespective of the status of affiliated members (employees and self-employed), of the nature of sponsor undertakings, of the scope, terms and conditions of pensions plan design.

Nevertheless the basic governance principles and the main tasks and goal of an IORP remain the same, ultimately to serve as a secure source of retirement income for its beneficiaries by administering and managing pension schemes rules in compliance with their fiduciary and biometric obligations.

4. Location and Vehicle

Considerations about location and choice of vehicle depend on whether the promoting organisation decides to set up a new cross-border IORP, or use a cross-border product developed by a financial services provider. By assuming that a new cross-border vehicle would be created, the analysis of different locations compared and contrasted ten retirement vehicles in six different EEA locations in terms of scope of benefits, governance, financing and a number of other characteristics. We concluded that the most attractive locations/vehicles are primarily in Belgium (OFP) that has adopted an ad hoc new vehicle, but also in Ireland (via a trust based arrangement), or in Luxembourg (SEPCAV -for DC plan only- and ASSEP).

All three countries have been positioning themselves as locations of choice.

5. Benefit Structure

In terms of benefit structure, a preference emerged for a defined contribution plan, potentially with some form of investment guarantee options where this is required or desirable. We fully support this direction given that:

- Most new retirement arrangements in the EEA are now defined contribution in nature and hence market competitive and attractive to employers; and
- Employers typically prefer arrangements which avoid the need for cross-subsidies between themselves and other employers; defined contribution arrangements typically meet this need if any investment guarantees are implicit within the investment funds offered.

The host country analysis shows that it should be possible to provide a defined contribution type benefit from a cross-border pension fund for researchers. It will be necessary to establish different country sections to ensure compliance with the different specific social and labour law requirements of various EEA member states.

These differ in several ways including:

- Permitted contribution structure (flat rate, age-related);
- Maximum legally permitted contribution amounts;
- Maximum tax-effective contributions;
- Ability of members to make additional voluntary contributions to the same pension fund;
- The range of investment options required (for example the need for any investment guarantees) and the right for individual members to determine how their contributions are invested;
- Flexibility in benefit payment form – pension and or lump sum;
- Indexation requirements;
- Eligibility conditions;
- Minimum/maximum retirement age;

- Provision of additional risk benefits;
- Language and information requirements; or
- Member representation.

In terms of the overall design, it is possible to design a common overall structure which has the ability to meet all requirements, and then make those parts available or mandatory on a country specific basis to comply with the social and labour law requirements.

Contribution levels will need to differ by country taking into account existing levels of local social security and other mandatory retirement arrangements.

There needs to be an appropriate balance between flexibility and administrative efficiency. Each country should have a common benefit design to facilitate cost-effective administration. However, even within the common country design, there can be some variability (such as contribution level) as far as this variability is supported automatically in the administration system.

Flexibility in contribution design will also be important where certain groups of researchers are covered under existing local pension arrangements and either choose or are required to remain in these arrangements. In these cases, it may be desirable to offer researchers the opportunity to contribute to the cross-border pension fund to enable them to make additional retirement saving where this is possible.

A common theme emerging from our analysis is that legislation may need to be addressed in some countries where it appears impossible to provide researchers with access to a different pension arrangement that other employees working within the same organisation or sector of economic activity.

6. Investment

The cross-border pension fund will need to offer a range of investment funds to support the defined contribution structure and be capable of meeting local investment requirements in terms of the required currencies and guarantees. These will be made available to each country section depending on local requirements, and should be offered in as consistent a manner as possible.

For those countries requiring all members to invest contributions in the same investment fund, it will be necessary to develop a suitable common investment strategy. There are a variety of approaches possible ranging in complexity and cost.

Some countries require a minimum investment guarantee. We recommend that such guarantees should be provided directly through the investment options rather than as a guarantee from the sponsoring entity. This will result in a lower expected investment return as the guarantees have a cost. However, it is considerably administratively simpler and takes account of the need to avoid cross-subsidies between sponsoring entities.

Some countries permit members to choose how to invest their contributions on an individual basis. For these countries, it will be necessary to offer a reasonable choice of investment options and decide on an appropriate default strategy. Members who do not wish to be invested into the default strategy should be able to elect to move existing holdings, future contributions or both.

Further thought should also be given to appropriate member education so they appreciate the potential impact of different investment choices.

Once the design of the cross-border framework has been finalised, it will be necessary to decide the most appropriate balance of segregated and pooled investment approaches.

Finally, the investment approach will need to be multi-currency notably to reduce currency risk exposure and to reflect the different currencies in operation within the EEA.

7. Administration and Cost

The optimal delivery model for administration will need to be structured in a tiered approach. Members should have access through an on-line portal where information is provided, where they are able to make standard selections. The next level is a member service centre which covers queries which are not resolved in the on-line system, and the final tier is the system and administrators who deal with complex queries and have interfaces with employers, investment administrators, accounting and pensioner payroll.

We believe that this approach will conform (broadly, accepting that different potential providers might draw or express the model differently) with modern technological design and be capable of accommodating the complexities of operating a pension fund covering a variety of jurisdictions throughout the EEA. We also believe that integrating the functionality in this way will be likely to keep the cost of running the fund to a reasonable level.

The costs of administering a pension fund are influenced by a number of different factors. These factors include the number of members, the number of participating employers, the volume of cash flows in and out of the plan, the number of plan and member "events", the complexity of compliance with local Host state social, labour and tax legislation, the design of the benefits and the degree of standardisation within country sections.

The cost of administration is usually met by a fixed charge per member, an asset management charge (AMC) expressed as a % of assets under management, or a combination of both; different providers have different models. A key difference between a member-based charge and the AMC approach is who meets the cost. Generally speaking, fees associated with a delivery model as set out above are usually met by the sponsoring employer(s). By contrast, the AMC will have the effect of reducing the rate of return on the investment fund(s) and so the members' accounts: in other words the members bear the costs.

Irrespective of the charging basis, the degree of standardisation will have a key impact on the overall cost of administration. The model we have developed allows for a certain amount of variability is available at the individual member level through the self-service functionality including member choice of investment fund and choice of level of contribution. However, other features which individual employers might like to choose on an individual basis should be standardised to reduce overall administration expenses. These include features such as customised reporting to members, different range of investment funds on offer, different additional benefits and a number of others such as frequency of paying contributions. Even if particular employers are willing to pay for additional features, this functionality increases the cost for all employers.

8. Impact Assessment of Pension Benefits Rights for Researchers Moving Across Countries

A modeller was prepared to estimate the expected replacement income from Social Security and statutory programmes for researchers with an international career in the six countries programmed. These countries are: France, Germany, Italy, Poland, Spain and the UK.

The expected replacement income was expressed in percentage of the career average revalued earnings. The difference with career average earnings is that the earnings of past years are revalued in accordance with inflation.

The prepared estimates demonstrate varying levels of replacement incomes and needs for supplementary benefits. The outcome of the calculations is closely related to the level of salaries used.

To ensure coherent results, salary variations when moving from one country to another or from public to private sector needed to be checked and be within certain limits. The salary scales developed are built around average salaries on the basis of the results provided in the context of another EC study focusing on salary scales by country and by job status (public/private sector). The levels of salaries in the Research Directorate's 2007 study are relatively low. These salaries are in some cases below the maximum salaries applied by some Social Security systems.

This explains why on average high replacement incomes are obtained. If the salaries of reference had been 20 percent higher, the replacement incomes obtained would reduce materially as salaries valued would start exceeding the applied salary ceilings.

At a subsequent stage the study determined the pension contributions needed from the supplementary plan to ensure an adequate aggregate replacement income.

The adequate replacement income, payable at age 65, was defined as 70 percent of the career average revalued earnings. The calculations assumed the provided future pension would be indexed with inflation.

The other assumptions for the calculations were as follows:

- Salary increase of 0.5 percent points in excess of inflation;
- Investment returns obtained on the supplementary contributions are 2 percent in excess of inflation; and
- A full career of 40 years.

The conclusion of the calculation shows that for a salary in excess of the maximum amount covered by Social Security a contribution of 18 percent would be required.

The contributions needed on the salary up to the maximum amount applied vary from one situation to another depending on the generosity of the underlying Social Security system.

For example, in the case of Germany the proposed contributions amount to 7% of salary up to this ceiling (2010: 66.000€) and 18% of the salary in excess of this ceiling.

In the case of Italy the proposed contributions amount to 2% of salary up to this ceiling (2010: 92.400€) and 18% of the salary in excess of this ceiling.

In the case of UK, the proposed contributions amount to 0% of salary up to this ceiling (2010: 5.600€) and 18% of the salary in excess of this ceiling.

If the careers of researchers are expected to be shorter than 40 years, then the contributions required would increase proportionately.

9. Follow-up and Implementation

The practical implementation of the feasibility study will depend on the willingness of stakeholders concerned to operate cross-border pension arrangements for researchers. In the context of a common framework involving multiple employers, challenges arise because of the diversity in status and scope of potential sponsors that employ researchers in the EEA.

A group of employers interested in setting up such arrangements will need to decide whether to establish a cross-border IORP themselves, or use a cross-border product developed and delivered by a financial services provider or a consortium of such providers responding to agreed and well defined specific terms of reference. In addition, such a group could set up an intermediate body that represents the interest of the sponsoring undertakings and with the mission of defining and setting up pension arrangements in accordance with the mandate given by the sponsors. The European Commission could enable this open co-operation process among potential sponsor undertakings via the establishment of a dedicated task-force on occupational pension for researchers.

Meanwhile, provided that there is enough support from stakeholders - including a critical mass of potential sponsor undertakings and national authorities, a more immediate practical follow-up could be ensured by the European Commission by supporting, through a call for proposals one or more projects:

- Promoted by sponsors undertakings and aiming to establish cross-border IORP that covers researchers in Europe; or
- Promoted by pan-European service providers that fulfil minimum terms and conditions considered suitable for both employers and researchers.

Both approaches, which are neither without alternative nor do they exclude each other, would have the advantage to encourage cooperation and mobilise potential stakeholders and financial service providers towards the practical implementation of pension arrangements that improve pension benefits for researchers and are cost-effective for the employers.

They will require a well articulated and dedicated system of governance with specific funding, expertise and market knowledge to be available up-front for setting up and coordinating all the various aspects -from inception to daily management- and ensure every function operates in a smooth and coordinated manner.

When working with a single financial service provider, or a consortium, in some capacity, generally there are fewer direct implementation issues as the provider or providers would coordinate the majority of the implementation process. In this approach financial service providers (singly or as a consortium) would be called to develop an offer for the delivery of a full bundled common product for researchers leading to maximum geographical coverage and shared development costs.

If a fully bundled solution is adopted by the group of sponsor undertakings, these will need to define strict and transparent terms of reference with the potential providers. Typically administration is financed through internal charges on the investments. At first glance, this can appear "cheap". However the "price" is reduced investment performance and lower retirement benefit amounts for members. As such, it will be necessary to ensure full transparency in the charges applied in a fully bundled solution.

The most significant potential hurdle to widespread implementation is existing local coverage of researchers in second pillar occupational pension arrangements, and those in public sector pension arrangements. Membership in these arrangements can be mandatory in some cases, or even where there is flexibility in terms of membership, we believe a significant number of researchers are likely to choose to remain in domestic retirement arrangements, notably when they offer already a replacement rate of benefits at retirement that is considered satisfactory without additional costs or investment.

Membership in the cross-border pension fund can be maximised by ensuring the contribution design is as flexible as possible to permit smaller "top-up" contributions, and by considering whether any specific countries could be asked to review their eligibility requirements.

A further part of the implementation process will be the pace of geographical coverage. On one extreme, the cross-border fund could involve most EEA member states immediately. However, this may be less practical in terms of establishing efficient administration procedures. We would recommend focusing on a core of countries to be covered initially, and then build out and add further countries in a step-wise manner.

Other implementation issues will be to build in the facility for the cross-border fund to be able to receive assets in respect of past service pension rights where this is possible and tax-efficient. This will greatly increase the operating size of assets under management and improve the charging basis the fund will be able to negotiate. In addition, the fund should consider how to provide annuity benefits where these are required under local social and labour law. In particular whether these should be paid directly from the pension fund, or whether they should be provided by a financial service provider.

Finally, due consideration must be given to how researchers and their employers are informed about the cross-border pension fund and their opportunity to join such an arrangement. In this respect, the European Commission and European and national associations could play a critical role by deploying an information and communication campaign that target researchers and their employers with a view to raise their awareness on the benefits of occupational pension.