Taming pension fund capitalism in Europe: collective and state regulation in times of crisis

Bernhard Ebbinghaus and Tobias Wiß

*Transfer: European Review of Labour and Research* 2011 17: 15
DOI: 10.1177/1024258910390840

The online version of this article can be found at:
http://trs.sagepub.com/content/17/1/15

Published by:

SAGE

http://www.sagepublications.com

On behalf of:

ETUI

European Trade Union Institute

Additional services and information for *Transfer: European Review of Labour and Research* can be found at:

Email Alerts: http://trs.sagepub.com/cgi/alerts

Subscriptions: http://trs.sagepub.com/subscriptions

Reprints: http://www.sagepub.com/journalsReprints.nav

Permissions: http://www.sagepub.com/journalsPermissions.nav

Citations: http://trs.sagepub.com/content/17/1/15.refs.html
Taming pension fund capitalism in Europe: collective and state regulation in times of crisis

Bernhard Ebbinghaus
Professor of Sociology, University of Mannheim

Tobias Wiß
Researcher, Mannheim Centre for European Social Research (MZES)

Summary
The recent financial crisis has led to major losses among many pension funds across Europe, showing the problems in shifting responsibility for old-age income to private actors without sufficient regulation. The impact of the crisis on pension funds and future retirement benefits depends on good governance and effective regulation. There is a large cross-national variation in pension fund capitalism and its regulation across Europe. We compare private supplementary pensions in six countries (Denmark, Germany, the Netherlands, Sweden, Switzerland and the UK) and analyse how these different systems have reacted to the crisis. Whereas higher contributions and delayed indexation may be temporary measures, more important are the long-term consequences for individuals, in particular the diminished rates of return leading to lower pensions. The sponsoring firms, pension funds, the social partners and the state therefore need to adapt investment strategies and strengthen the supervisory mechanisms.

Résumé
La crise financière récente a provoqué des pertes majeures pour beaucoup de fonds de pension à travers l’Europe, en mettant en lumière les problèmes posés par le transfert aux acteurs privés de la responsabilité du revenu de vieillesse sans une réglementation suffisante. L’impact de la crise sur les fonds de pension et les revenus futurs de retraite dépend de la bonne gouvernance et d’une réglementation efficace. Il existe une grande variété en matière de développement et de réglementation des fonds de pension privés à travers l’Europe. Nous comparons les systèmes de pension complémentaire privée dans six pays (le Danemark, l’Allemagne, le Royaume-Uni, les Pays-Bas, la Suède et la Suisse) et nous analysons comment ces différents systèmes ont réagi à la crise. Si une augmentation des cotisations et un report de l’indexation peuvent être des mesures temporaires, les conséquences à long terme pour les individus sont plus importantes, en particulier...
l’abaissement du rendement sur le capital qui conduit à des retraites plus basses. Par conséquent, les entreprises, les caisses de retraite, les partenaires sociaux et l’Etat doivent adapter les stratégies d’investissement et renforcer les mécanismes de supervision.

**Zusammenfassung**


**Keywords**
Pension policy, pension fund capitalism, welfare state reform, financial crisis, social partners

**Introduction**

For more than two decades, the financial sustainability of public pensions has been questioned, while the privatization of pre-funded supplementary pensions has been advocated. The recent financial crisis, however, has challenged the merits of private pension fund capitalism as assets of such funds experienced substantial decline. Moreover, trust in the expected returns has been shattered, and calls upon the state and social partners have re-emerged to regulate better private pensions. The privatization of responsibility for old-age income, and the shift towards more funded pensions, raises major questions with respect to governance and regulation. In line with the importance of private pensions and their modes of governance, better regulation is needed to protect the interests of employees and pensioners against undue financial risks.

In a comparative analysis of selected western European countries, we will focus on the role of collective actors and the state in regulating and governing private pensions. Although the state seems to be retreating from former commitments to guarantee secure and adequate public pensions, the need for public regulation has increased – rather than diminished. Moreover, the social partners – employers and workers’ representatives – often also have an important role in regulating and governing such private pensions. We ask to what extent the beneficiaries of such arrangements – the current and future retirees – have any participatory and social rights in the decisions concerning their occupational or personal pension plans.

Drawing on the experience of several countries with developed or expanding multi-pillar systems (see Ebbinghaus, 2011), we focus in this article on six countries with different forms of supplementary pension systems. We include the UK as a prime case of an Anglophone Liberal Market Economy (LME) and advanced pension privatization but also look at two cases of a Coordinated Market Economy (CME) with rather exceptionally developed pension fund capitalism: the Netherlands and Switzerland. In addition, we analyse the growth of funded pensions in
Scandinavian welfare states, taking Denmark and Sweden as examples, and we include Germany as a major CME with a slowly privatizing pension system.

In this article, we first discuss the conflicts of interest among stakeholders in private pensions, including vertical principal-agent and horizontal capital-labour relations. We then map the supplementary pension landscape for the six European countries under consideration. Thereafter, we analyse the importance of financial markets for occupational pensions and the scope of pension fund capitalisms together with the inclusiveness of private pensions. The following sections discuss the stakeholders’ participatory rights (especially the involvement of social partners) and the scope of state supervision. Next, we review investment regulations that limit the financial risks for beneficiaries. Before concluding, we discuss the short-term and long-term consequences of the financial market crises in the 2000s for both sponsors and beneficiaries.

The stakeholders in private pension governance

Conflicts of interest over supplementary pensions occur due to the complex principal-agent relations between beneficiary and sponsor, and between sponsor and financial agent. In the case of an occupational pension, employees rely on their employers who (co)sponsor the pension contribution; they also have to trust the pension funds that pool these resources and the financial managers investing on their behalf for their future pension (Besley and Prat, 2005: 121). As a consequence problems arise due to asymmetric information and ‘hidden’ knowledge on the part of the agent(s) vis-à-vis the principal (see McCarthy, 2006). Particularly in the context of highly complex benefit calculations and investment decisions in volatile financial markets, the principals are incapable of fully controlling their agents who may act in their own interests. Moreover, supplementary pensions differ in which actors decide on pension arrangements (the initiators), stipulate the governance rules and control these schemes (the overseers), pay into these supplementary schemes (the sponsors) and eventually benefit from them (the beneficiaries). In the case of a firm’s pension commitment to its employees, the employer may be initiator, overseer and sponsor, while in other cases some of these tasks are taken on by other actors, for instance, the social partners.

Given information asymmetries to the detriment of principals, trust plays a crucial role, but so does good governance and foresighted regulation. Further difficulties arise because agents can be principals at the same time or vice versa. Thus pension funds create multi-level principal-agent problems where the trustees are agents of the beneficiaries as well as principals vis-à-vis the managers of pension fund portfolios (Lakonishok et al., 1992). The EU, OECD and other international organizations have suggested a range of institutional arrangements and instruments to reduce the risk of mismanagement and fraud: supervisory agencies, whistle-blowing procedures, codes of good practice, dissemination of ‘best practice’ models and information rights.1

We distinguish three governance modes of supplementary pensions based on the sponsor and beneficiary (see also Ebbinghaus and Wiß, 2011): the collective occupational pensions decided by the social partners, the employer-sponsored occupational pensions and the individual decision to save for personal pensions (see Table 1). Economic theory assumes the importance of ‘exit’ as a market force, while we will focus here more on the ‘voice’ mechanism: the participatory rights and regulatory rules in favour of current and future beneficiaries. Institutional complementarities between corporate governance traditions and pension fund governance can be expected since

1 See also OECD and EU reports on private pensions (OECD, 2001; OECD, 2002; OECD, 2004; OECD, 2005; SPC, 2005).
principal-agent relations between investors and investment funds are embedded in more or less contentious labour relations – either the relationship between employer (sponsor) and employees as well as retirees (beneficiaries) or between employer associations and trade unions (the initiators and overseers). This adds an additional horizontal ‘class’ conflict: the negotiations between employers and employees on occupational benefits as part of the individual employment contracts or as part of the collective bargaining on (social) wages.

In the case of collective schemes employer and unions agree on jointly managed pension schemes, usually external to the firm and covering several firms. These agreements usually allow for broader coverage and risk pooling, while limiting the voice of stakeholders (sponsors and beneficiaries) to indirect representation through employer and worker representatives. Advantages are the better information capacity and economies of scale of collective schemes in comparison to a single-employer scheme, particularly for a small firm, or an individual, especially one without adequate financial knowledge. Collective schemes provide better portfolio management and lower administrative costs than single-employer or individual schemes (Trampusch, 2009). Nation-wide or sector-wide schemes cover a large proportion of, if not all, employers or workers; they also allow workers to move between firms without loss of, or disadvantages in, former benefits. Collective schemes, self-administered by the social partners, assume an important second-tier function in Denmark, the Netherlands and Switzerland, while negotiated occupational pensions are also nation-wide ‘top-up’ benefits in Sweden and are gaining in importance in some sectors in Germany. Decentralized labour relations and the absence of state intervention prevented the development of sector- or nation-wide schemes in the UK.

In the second governance mode – employer-sponsored pension plans – firms might be willing to provide defined benefit (DB) pensions as part of human resource strategies to bind qualified workers to the firm (Lazear, 1990). Benefits can be at risk when an employee moves to another company, depending on so-called ‘vesting rights’. These pensions could be financed by book reserves (directly by the firm), by a trust fund independent of the firm, or by a contract with an insurance company. Employers as sponsors mainly control these plans, while the employees as future beneficiaries have often only indirectly a voice through the trustees picked by the sponsor. These firm-sponsored occupational schemes (whether pension funds or book reserves) may have higher administrative costs than collective plans. The employer can use these plans for human resource management strategies in order to bind employees to the firm. Depending on the context of corporate governance (e.g. German co-determination), employees and their representatives may have only limited influence on employer-sponsored plans. Employer-sponsored occupational pensions that contract-out of the second state pension play an important role in the UK. Employer-specific occupational pensions are also a preferred form for Dutch and Swiss larger firms, and German firms provide these as voluntary fringe benefits.

<table>
<thead>
<tr>
<th>Collective occupational pension</th>
<th>Employer-sponsored occupational pension</th>
<th>Personal pension</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sector-wide:</strong> Netherlands, Denmark, Sweden, Switzerland, Germany</td>
<td><strong>Pension fund:</strong> Netherlands Switzerland Germany (also book reserve)</td>
<td><strong>Mandatory public pension:</strong> Swedish Premium P. Danish Special Savings P. Voluntary Germany (Riester) Opt-out: UK (Personal, Stakeholder)</td>
</tr>
<tr>
<td>Opt-out: UK: pension fund trusts</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Main systems underlined.
In the case of individual decisions, there might be a collective action problem of individuals that do not have much power (‘voice’) vis-à-vis the investment fund manager, as they might only be able to vote with their feet (‘exit’) by switching to a different fund. Here the responsibility remains solely with the individual, though the state as regulator sets the legal framework and standards, particularly through tax codes and rules for tax subsidies. An advantage of personal pensions that are commonly defined contribution (DC) schemes is their portability. Besides the two mandatory personal pensions in Denmark and Sweden, voluntary personal pensions are particularly common in Germany thanks to tax subsidies (since 2001) and in the UK since an option to opt-out was granted (in 1986).

Varieties of pension fund capitalism

There are different worlds of supplementary pension systems, varying from mature multi-pillar systems to those where occupational and personal pensions play a rather limited role. Among the more mature multi-pillar cases, the UK has a long tradition of pension fund ‘trusts’. Employers have been able to decide to contract-out from contributions to the mandatory state second pension since 1978. Since 1986 individuals could also opt out by choosing a personal pension. However, recent pension acts (2007/08) have limited the possibility in the future to contract-out of the state second pension into DC plans, and require employers to provide access to a supplementary pension by 2012 (auto-enrolment). In the Netherlands, occupational pensions are mainly sector-wide schemes that are negotiated by the social partners and can be made mandatory by the ministry, and there are also some larger company pension funds. In Switzerland, occupational pensions are mandatory since 1985 but take different forms: the joint foundations are administered by the social partners for a sector, in group (multi-firm) foundations conditions vary across firms, and single-firm plans also exist.

Among the intermediate group in the trend towards pension privatization, the Scandinavian countries, Denmark was a laggard until the ‘labour market pensions’ were developed as sector-wide collective agreements from the 1990s (similar schemes already existed in the public sector) and a mandatory personal pension was introduced (suspended since 2004). In Sweden, there are four main nation-wide negotiated supplementary occupational schemes: two for public employees and two for private employees that provide a ‘top up’ benefit. Following the 1994/98 reform, a funded DC personal pension is part of mandatory public pension contributions, but individuals have the choice of their investment portfolio (including union-run schemes). Finally, Germany remains less developed but occupational and personal pensions have become more important in recent years, while public pensions are being cut back. Depending on the scheme, German employers are more or less solely responsible for the administration in the case of the ‘on-the-books reserves’ and support funds. Large German companies have their own occupational schemes, although employers are typically bound to sector-wide collective agreements. The 2001 reform introduced the voluntary personal Riester plan (subsidized for low income groups).

Whether funded pensions are invested in shares, bonds or other financial instruments have major implications. Pension investment, in particular by larger pension funds, can have a major impact on financial markets and corporate governance nationally and internationally. Today’s level of pension fund assets indicates the importance of funded supplementary pensions for later old-age income among the elderly but also their importance for financial markets. Based on the ‘varieties of capitalism’ approach (Hall and Soskice, 2001) we would expect there to be a relationship between the importance of financial markets in Liberal Market Economies (LME) and a reliance on private funded pensions, while in Coordinated Market Economies (CME) there might be
more reliance on pay-as-you-go (PAYG) occupational pensions in the public sector and on unfunded ‘book reserves’ of private sector firms (Jackson and Vitols, 2001).

The variations in pension fund assets, financing vehicles and asset allocation reflect the differences in the design and maturity of funded pensions, including pension funds, personal DC pensions and public reserve funds (see Table 2). The potential impact of pension systems on financial markets is very high for the liberal UK due to the funded occupational and personal pensions that are allowed to contract-out of the (unfunded) state second pension. Also in accordance with expectations, pension fund capitalism in coordinated Germany is still relatively low, although pension assets are growing at average annual growth rates of some 15 percent. However, Switzerland and the Netherlands, both considered to be CME, also rank high in funded capitalism, channelling substantial investments through the Dutch collectively negotiated and the Swiss mandatory pension funds. Moreover, the Nordic CMEs (Denmark and Sweden) also now have substantial pension fund capitalism, as part of both public and private pensions.

The scope of pension fund capitalism is measured in the investment of supplementary pensions, thus it is central whether or not pensions are fully funded. In funded systems contributions are invested in capital markets, in the expectation of higher returns. In DB pension funds, the employer has the main responsibility to provide for underfunding of pension liabilities, while they may profit from contribution ‘holidays’ in times of overfunding. In funded DC schemes, administrative costs and financial charges for investments are higher, while the financial market risks are completely individualized. All occupational pension plans are funded in Switzerland and the Netherlands. In the United Kingdom, Sweden and Denmark all plans in the private sector are funded; the same holds for most of the new German private pensions while many older ones still have book reserve liabilities.

Some public sector occupational pensions are PAYG systems (Denmark, Germany, the UK and Sweden), that is, current contributions are rechannelled to pay benefits of current pensioners. In so far as they face the same demographic and sustainability problems as public pensions, the state (including public sector companies) therefore has to guarantee long-term sustainability. Increasingly, reserve funds are devised or new entrants are insured by partly funded schemes. Many larger German private firms profited from on-the-book reserves of their occupational pensions (Jackson and Vitols, 2001; Vitols, 2003), but, with the increased importance of shareholder value, a reorientation from DB schemes towards funded DC schemes has occurred.

Table 2. Pension fund capitalism, Europe 2001–2008

<table>
<thead>
<tr>
<th>Funds</th>
<th>Funds, etc.</th>
<th>Financial assets</th>
<th>Contributions</th>
<th>Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of GDP</td>
<td>% of GDP</td>
<td>million US dollar</td>
<td>% of GDP</td>
<td>% of GDP</td>
</tr>
<tr>
<td>(a) 2008</td>
<td>(b) 2007</td>
<td>(a) 2008 2001–08</td>
<td>(b) 2008</td>
<td>(b) 2008</td>
</tr>
<tr>
<td>Netherlands</td>
<td>113.2</td>
<td>(149.1)</td>
<td>988.1 +13.4%</td>
<td>4.0</td>
</tr>
<tr>
<td>Switzerland</td>
<td>99.3</td>
<td>(151.9)</td>
<td>496.6 +9.6%</td>
<td>8.7</td>
</tr>
<tr>
<td>UK</td>
<td>61.8</td>
<td>(96.4)</td>
<td>1 644.8 +6.8%</td>
<td>2.8</td>
</tr>
<tr>
<td>Denmark</td>
<td>47.4</td>
<td>(140.6)</td>
<td>161.7 +20.6%</td>
<td>0.5</td>
</tr>
<tr>
<td>Sweden</td>
<td>39.1</td>
<td>(57.4)</td>
<td>35.3 +9.9%</td>
<td>-</td>
</tr>
<tr>
<td>Germany</td>
<td>4.7</td>
<td>(17.9)</td>
<td>172.4 +14.9%</td>
<td>0.3</td>
</tr>
</tbody>
</table>

Notes: (a) Funds: private pension fund investments (% of GDP); (b) Funds etc.: total private pensions, including also insurances and book reserves (% of GDP); Germany: excl. book reserves; Denmark and Sweden: incl. funded public pension. Source: OECD (2009a; 2009b).
Private pension governance and stakeholders’ participatory rights

The participatory rights of employees and beneficiaries, but also the way in which the principal-agent problem applies, can vary substantially. On the one hand, pension schemes that are internally organized such as public sector PAYG schemes and employer commitments (book reserves) depend on the trust in the financial sustainability of current and promised future benefits. On the other hand, the pension contributions may be invested by the principal (sponsor) in an external independent fund (agent) which is sheltered from the risk of bankruptcy by the sponsoring firm. Internal governance prevails among those public sector schemes with PAYG financing and those employer commitments that are directly financed from a company’s balance sheet. The public sector schemes are state guaranteed, but in the case of book reserves of commercial firms, future liabilities (for defined benefits) are funded through future returns on reinvestment into the company. In terms of liabilities, such direct employer commitments are still the most important occupational pension form in Germany. They are governed by codetermination in the case of listed companies: a supervisory board with bipartite labour-employer representatives oversees the company. Otherwise only weak rights for works councils exist. The Swedish occupational scheme for private employees also uses book reserves (closed since 2007); employers have to register with a bipartite agency that manages benefits and pays out pensions.

Most occupational pensions, however, are sponsored by employers and organized externally. This means that pension funds are independent of company balance sheets and shielded from the risk of bankruptcy. In many countries it is possible for employers to participate in multi-firm or open pension funds. In addition, employers, particularly small firms, might choose to pay into life or group insurances, even though they have higher administrative costs per insured. In the case of pension funds set up by employers, the administration and supervision is decided by the sponsor according to trust law, whereas in the case of insurance contracts the administration and supervision is outsourced, hence the sponsor and beneficiary need to rely on public supervision and regulation of financial agents to be ensured of their rights.

External employer-led pension funds dominate in the mature UK multi-pillar system. Boards of Directors of UK companies are not legally required to have any employee representatives, and pension funds are overseen by trustees appointed by the sponsoring company. However, by law the trustee must act in the interests of the beneficiaries, one-third of trustees must be member-nominated (employees and retired beneficiaries) and there is pressure to increase the share of member-nominated trustee seats. Pension funds are also increasingly common in German larger firms instead of book reserves following the externalization of liabilities.

Collectively negotiated pension schemes with joint administration exist in nearly all multi-pillar systems, except the UK. They are very common in the Netherlands and Switzerland, but also in Denmark and Sweden. All Dutch pension funds are managed by a bipartite governing board, representing employers and members (employees and pensioners). On request by either side an advisory board has to be established which holds decision-making power for contributions and benefits. Mandatory Swiss occupational pensions are strictly regulated: almost all take the form of corporate (firm-based), group (multi-firm based) or joint foundations (sector-wide). By law these are supervised by bipartite committees but in smaller companies representative rights are not always taken up. Assets are either administered by the bipartite committee or contracted-out to financial institutions, though the bipartite committee remains responsible for investment guidelines. In Danish pension funds, half of the board representatives (mainly nominated by unions) are elected by plan members. Since the 1990s, German superannuation funds and pension funds must
follow the two-tier, bipartite board structure, while collective pension schemes (e.g. Metallrente) are administered jointly by the social partners.

Pension funds as institutional investors can use their voice as shareholders to influence management. For instance, Danish pension fund administrators have been criticizing companies for insufficient profits, bad management and scarce information. In particular, collective pension funds, which are administered equally by employers and unions, can exert pressure on firms and promote social, employment and environmental standards (see Clark and Hebb, 2004). In addition, new ‘ecological’ or ‘social’ pension funds might be established in the future for socially and environmentally oriented investment strategies (as is already the case in the field of banks).

Further external modes of governance are group or individual insurance contracts underwritten by the employer. Personal pensions in the UK allow individuals choice of fund but no further influence. Direct insurances are common for German small and medium-sized firms due to lower costs for employers. In Denmark, two-thirds of the sector-wide pension plans are contracts with life insurance companies, though these are governed by a bipartite board which administers contributions and benefits. The mandatory Special Pensions Savings are administered by a bipartite fund, but the individual is able to choose their own fund manager and portfolio. The Swedish pension foundations for white-collar private sector workers have a governing board with an equal number of employers’ and employees’ representatives. In the case of insurance plans special institutions administered by social partners act as intermediaries. A public authority administers the mandatory Premium Pension but individuals can choose the mutual funds in which they invest their mandatory contributions.

The role of the state in supervising pension funds

In addition to governance by social partners, supervision is crucial for the protection of beneficiaries from non-prudent investment strategies. More effective supervision is possible in the case of collective schemes in continental Europe than for single-employer pension funds in the UK (Laboul and Yermo, 2006: 517), though much depends on additional state regulation. The Dutch collective and Swiss mandatory schemes have substantial supervision, while the UK exercises more restraint. The Dutch Central Bank supervises occupational pension funds (besides other financial institutions). Swiss occupational pensions are supervised by a federal agency that examines compliance with regulations and undertakes preventive measures against insufficient funding. UK regulation has been tightened: private schemes are certificated after passing reference scheme tests for DB and protected rights tests for DC schemes (including personal pensions), while the Pension Regulator is responsible for occupational pension supervision.

The Scandinavian countries have encompassing supervision for both quasi-public and private supplementary pensions. Danish occupational pension funds and insurances must be registered and are supervised by the Danish Financial Supervisory Authority that prescribes detailed procedures, including annual reporting by an approved actuary. The mandatory labour market pension fund (controlled by social partners) administers a part of the personal pension since individuals have been free to invest their contributions via financial institutions since 2005. The Swedish Financial Supervisory Authority supervises all financial institutions, while the new pension authority administers and manages the social insurances and the Premium Pension.

In Bismarckian systems, public pensions have often been self-administered and supervised by bipartite boards, while private pension institutions are supervised by supervisory authorities common for the financial sector. In Germany, the Federal Financial Supervisory Authority supervises banks, insurances and pension funds. Led by a board with state and fund representatives, it controls
the solvency, transparency, consumer protection and certification of private pensions (Riester pensions). In addition, European Union directives prescribe a supervisory framework for pension institutions and supervisory institutions. The payment of outstanding claims to employees in the event of their employers’ insolvency is to be guaranteed in line with Directive 80/897/EEC. In sum, in most of the countries there are state institutions that are responsible for the supervision of pension provider companies. These supervisors have powers to request information, are responsible for stress tests and are entitled to carry out on-site inspections. The main thrust behind these regulations is to ensure institutions’ financial sustainability and guarantee the underwritten liabilities; thus they are mainly concerned with financial sustainability, not social adequacy.

**Controlling investment strategies for the benefit of pensioners?**

Fundamental problems for funded pension schemes are posed by financial market downturns of the severity experienced in the early and late 2000s. These might reduce an individual’s expected DC pension, while in DB schemes it can lead to underfunding and increase liabilities for the sponsor. The low and partly negative rates of return after 2001 and again in 2008 point to this fact: Dutch pension funds lost 11.9 percent of their value in 2002 and again 16.9 percent in 2008, while the UK had even worse declines in real returns during 2008 of 17.4 percent (OECD, 2009a). Such a downturn may lead to severe underfunding of future pension liabilities and problems in guaranteeing minimum rates of return, depending on the statutory rules. For instance, Swiss pension institutions lobbied with success for a lower statutory minimum rate, given the financial market downturn in 2000/01, but the earlier high rates of return had often been used for lowering contributions of employers and not for savings during better years. Similarly, in the Netherlands the 1990s surpluses were used to reduce the contribution rates while the pension funds became severely underfunded during the subsequent financial market downturns. Regulation is appropriate in order to promote benefit security. Funded pensions institutions are subject to investment restrictions such as rules on currency matching, allocation of assets and investments in the sponsoring company (EU Directive 2003/41). In the field of life insurance several EU directives include amongst others investment rules and criteria about guarantee funds in the event of insurance companies’ insolvency (SPC, 2005: 33).

A prudent management can reduce the risk by shifting assets of people nearing retirement into less volatile investments (SPC, 2005: 22 ff). But additional quantitative restrictions that balance portfolios with risky equities and more secure bonds are needed, as well as minimum return rates to protect individuals from undue financial risks. The less strict ‘prudent person’ rule which would allow more investment flexibility and higher return rates (Davis, 2003: 126), but also entails higher risks, is prevalent in the UK (and also the Netherlands), while the other countries considered here have more quantitative restrictions (Laboul and Yermo, 2006: 508).

Strict state restrictions for investments exist in some cases to more beneficial effects: in 2008 Swiss pension funds had only a 12.5 percent decline in returns and German funded schemes 8.5 percent (OECD, 2009a). Swiss mandatory funded schemes invest in different regions and economic sectors, the minimum interest rate was 2 percent in 2008 (compared to 4 percent in 2002), there is a maximum of 30 percent in foreign currencies or bonds as well as foreign equities, and a maximum of 50 percent may be equities and only 5 percent in the sponsoring firm (OECD, 2008a: 432).

---

2 For the limited application of the EU directive on institutions for occupational retirement provision (IORP) see Guardiancich and Natali (2009).
In Germany, restrictions for direct insurances and superannuation funds are a maximum of 50 percent in bonds, 35 percent in investment funds, 10 percent in shares of non-EU companies and a maximum of 5 percent in hedge funds. There are almost no quantitative constraints for pension funds, though there is a maximum investment of 5 percent of the assets in the sponsoring firm (OECD, 2008a: 227). The minimum interest rate for Riester plans based on insurance contracts is 2.25 percent per year, while the accumulated contributions are guaranteed by the financial service provider.

Less strict rules of investments exist in Denmark: at least 30 percent of assets must invest in low-risk investments, and a maximum of 70 percent may be placed in equities, though only 10 percent in shares issued outside the OECD (OECD, 2008a: 221). All Danish pension institutions offer a minimum rate of return. Thus the UK, the Netherlands and Sweden have the lowest investment regulation in line with the self-governing ‘prudent person’ rule. In the Netherlands and the UK the lowest investment regulation (with higher investment risks) exists along with funded-only occupational schemes (with the exception of the UK public sector).

### Short-term and long-term consequences of the financial crisis

The recent financial market crisis led to major losses among many pension funds across Europe. Funded pension systems in OECD countries lost US$5.4trn with an average reduction of 20–25 percent in the value of the assets (Eureport, 2010(1–2): 24). In contrast, in 2009 almost all countries had positive return rates but from a much lower starting point. These sudden losses affect employers as sponsors in the case of DB schemes, as well as future and particularly current pensioners relying on DB and DC schemes. The crisis highlights the problems of shifting responsibility to private actors without proper regulation. Even if pension funds have been partly recovering since 2008, the effects of the crisis are still present, undermining the expected long-term growth of, but also the trust in, funded pensions. In particular, those pension systems that are weakly regulated and where financial risks of funded pensions are shifted onto individuals (DC schemes) demand attention. In addition to the state, the social partners can function as mediators to address the consequences and face the reactions of firms and pension funds. Via collective bargaining and involvement in the operation and management processes of pension funds, burdens can be shared between employers (higher contributions) and employees/pensioners (lower or frozen indexations, higher contributions and lower benefits).

In Germany, restrictions for direct insurances and superannuation funds are a maximum of 50 percent in bonds, 35 percent in investment funds, 10 percent in shares of non-EU companies and a maximum of 5 percent in hedge funds. There are almost no quantitative constraints for pension funds, though there is a maximum investment of 5 percent of the assets in the sponsoring firm (OECD, 2008a: 227). The minimum interest rate for Riester plans based on insurance contracts is 2.25 percent per year, while the accumulated contributions are guaranteed by the financial service provider.

Less strict rules of investments exist in Denmark: at least 30 percent of assets must invest in low-risk investments, and a maximum of 70 percent may be placed in equities, though only 10 percent in shares issued outside the OECD (OECD, 2008a: 221). All Danish pension institutions offer a minimum rate of return. Thus the UK, the Netherlands and Sweden have the lowest investment regulation in line with the self-governing ‘prudent person’ rule. In the Netherlands and the UK the lowest investment regulation (with higher investment risks) exists along with funded-only occupational schemes (with the exception of the UK public sector).

### Table 3. Pension fund portfolio allocation (in % of investments) 2007/2008

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Bonds</th>
<th>Loans</th>
<th>Equities</th>
<th>Buildings</th>
<th>Private funds</th>
<th>Other investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK (2007)</td>
<td>3.7</td>
<td>27.1</td>
<td>1.2</td>
<td>45.8</td>
<td>2.8</td>
<td>–</td>
<td>19.4</td>
</tr>
<tr>
<td>Denmark (2007)</td>
<td>0.8</td>
<td>57.2</td>
<td>1.5</td>
<td>14.6</td>
<td>2.8</td>
<td>–</td>
<td>24.8</td>
</tr>
<tr>
<td>Germany (2008)</td>
<td>5.3</td>
<td>38.3</td>
<td>29.3</td>
<td>6.1</td>
<td>2.4</td>
<td>1.0</td>
<td>18.6</td>
</tr>
<tr>
<td>Netherlands (2008)</td>
<td>4.8</td>
<td>37.5</td>
<td>3.7</td>
<td>37.3</td>
<td>2.7</td>
<td>–</td>
<td>14.1</td>
</tr>
<tr>
<td>Sweden (2007)</td>
<td>2.2</td>
<td>53.6</td>
<td>0.0</td>
<td>36.5</td>
<td>3.4</td>
<td>–</td>
<td>4.2</td>
</tr>
<tr>
<td>Switzerland (2007)</td>
<td>9.1</td>
<td>38.9</td>
<td>4.6</td>
<td>32.7</td>
<td>9.4</td>
<td>4.5</td>
<td>0.7</td>
</tr>
</tbody>
</table>

Source: OECD Global Pension Statistics.

Municipalities in the UK ‘borrowed’ €3.12bn (at only 0.33 percent interest far below the market rate) from their pension funds, but after union protests, the UK government enacted that as of 2011 such borrowing will be ruled out, while the government called upon pension funds to invest more in domestic infrastructure (Eureport, 2010(1–2): 35). The value of the Swedish Premium Pension assets decreased by 34.5 percent in 2008 together with deficits of the buffer fund in the first pillar...
(Eureport, 2009(4–5)), thus affecting the public pensions of everyone. After a referendum, the Swiss government plans to increase VAT from 7.6 to 8.0 percent in order to channel SFr5bn to the public pension reserve fund (Eureport, 2010(1–2): 34).

The consequences for individuals depend on private pension plan designs. Workers might possibly have to postpone retirement (longer working life) or pay higher contributions in the event that their pension fund is not applying life-cycle investments which shift assets to more secure investments as retirement approaches. Employees in DC schemes who are close to retirement are harder hit (decline of asset values means lower pension benefits) than younger employees for whom financial markets and thus rates of return can recover over the next decades. Pensioners covered by DB schemes are less affected but their benefits could decrease in real value in the event of suspended pension indexation as is the case in the Netherlands (OECD, 2008b: 6). However, DB schemes place particular strains on the sponsors – the employer.

In the event of bankruptcy of sponsoring firms, pension benefits from DB pensions (or book reserves) are protected in Germany, the UK, Switzerland and Sweden via safety funds. With a growing number of firm insolvencies the contributions to the UK Pension Protection Fund will probably be raised from 2012 onwards (Eureport, 2009(7–8): 23). In Germany, contributions (per €1 000 in liabilities) to the Pension Protection Fund PSV will increase by nearly ten times from €1.8 in 2009 to some €16.5 in 2010, while the payments by the PSV skyrocketed from €140m to almost €4bn in 2010, the highest level in the history of the fund (Bora, 2009). These examples show how important protection mechanisms are, even if combined with higher contributions (to be paid by employers).

Perversely, the financial crises have been accelerating the shift from DB to DC benefits, that is, from a more buffered to a more individualized exposure to financial market risks. For example, the financial requirements for Dutch pension funds are such that turbulences are covered once in 40 years, although two financial market crises have already taken place within the last decade. The reaction to the first crisis was a shift from final-salary to average-career-salary DB schemes, while the second crisis of 2007/08 led to a further step: a more radical shift from DB to DC schemes or a decrease of DB benefits as well as an increase in the retirement age (Eureport, 2009(7–8): 24). As a long-term consequence, the European Commission’s Green Paper is discussing the introduction of minimum return guarantees in DC schemes and new mixed DB/DC pension plans as well as more life-cycle portfolio management. These measures aim to reduce short-term volatility in returns but they also have long-term consequences for future pension benefits (European Commission, 2010: 14).

Whilst no additional employer contributions due to financial shortfalls are needed in DC schemes, employers with DB schemes are faced with higher contributions or lower benefits for younger employees in order to reduce deficits and re-establish a sustainable funding ratio. In the Netherlands the funding ratio in most pension funds has fallen below 95 percent, though the required critical minimum funding ratio is 105 percent. In the Netherlands, the government extended the period for recovery from three to five years together with the requirement to submit recovery plans to the national supervisory authorities (Eureport, 2009(3): 21). The UK average funding ratio has dropped from 94 percent in 2007 to 85 percent in 2008 (Antolin and Stewart, 2009: 128). The same holds true for Switzerland, where the funding ratio in the private sector was 96.5 percent in 2008, while 60 percent of all funds were underfunded. To balance the funding ratio, pension funds suspended pension indexation and increased contributions (Eureport, 2009(3): 21). The Dutch telecom company TNT, for instance, increased the employer contributions from 20.8 to 39.2 percent (Eureport, 2009(7–8)), while British-Dutch multinational Shell increased the employer contributions from 5 to 23 percent in early 2009 and to 32.1 percent in June 2009 (Eureport, 2009(6): 25). The Dutch pension fund for public employees, one of the
biggest worldwide, temporarily raised the contributions by 1 percent and from January 2010 onwards by 2 to then 23.3 percent of salary (Eureport, 2009(4–5): 27). In contrast, American Express is not paying employer contributions for DB and DC pensions in the UK and the US for 18 months (Eureport, 2009(7–8)). Such short-term contribution ‘holidays’ have long-term consequences for future benefits as the returns on forgone investments will be missing.

Another trend is a shift in the type of investments in time of crisis from equities to less risky (but also slower growing) investments such as bonds and loans, as well as more internationally diversified products (Antolin and Stewart, 2009). In Germany, for instance, fixed-interest securities have in general lower rates of return; these have been decreasing since the end of the 1980s. Insurance companies in particular use these types of investments. With the portfolio shift of financial institutions towards more bonds and loans, the demand for such financial instruments is increasing, but a higher demand caused by the crisis together with stable supply will lower the rates of return. Since a large proportion of German pension plans are insurance contracts, pensioners do not have to fear benefit losses but have to expect lower future rates of return.

The regulatory state is responding with higher supervision and stricter investment rules. The German supervisory authority BaFin, for instance, intensified stress tests of liquidity and solvency margins for the largest insurance companies and pension funds. Similarly, Sweden started more regular analyses of financial institutions’ solvency (Antolin and Stewart, 2009: 131). In the UK and Sweden, activities include more frequent coordination and communication between supervisory authorities, the financial sector and policy-makers (Antolin and Stewart, 2009: 131 ff). In addition, extended recovery periods for pension institutions and lower solvency margins are meant to reduce additional pressures for firms and funds to sell their underperforming equities. Reviews and revisions of the existing investment regulations (rules and decisions) such as in the UK (Antolin and Stewart, 2009: 138) could improve risk management and avoid future declines in assets. The European Commission is considering new regulation since the current EU framework does not cover financial accumulation (European Commission, 2010: 14). On the other hand, claims for a Dutch pension safety fund failed because it is not in the interest of the employers who would have to pay the bill with their contributions. Also, Swiss employers and financial institutions successfully lobbied for a reduction to 2 percent of the minimum return rate for occupational pensions.

**Conclusion: increased privatization and regulation**

Although we often speak of pension privatization, the historical evolution shows wide cross-national diversity with respect to the public regulation and governance of supplementary pensions. Whether occupational pensions are collectively negotiated, employer-provided or individual schemes has major consequences for the overall scope of private pensions and benefits in retirement. The more state or collective regulation intervenes, the larger the coverage of supplementary pensions and the larger is the scope to pool risks and guarantee rights (Bridgen and Meyer, 2009). Encompassing coverage and collective regulation depend on bargaining institutions, the willingness of employers to negotiate and the overall bargaining coverage as well as state support (*erga omnes* extension of collective agreements). In addition, coverage varies strongly by sector and size of firms due to the varying strength of unions and employers.

The more funded pensions grow the more importance they gain in financial markets including their ups and downs for pensions and old-age income. The sensitivity to financial market turbulences, however, depends largely on the scope and portfolio of asset investment. The countries with the largest losses have the highest percentage of equities in their portfolios (OECD, 2009a: 34). More risky investments, most notably in the United States and Ireland, but also in the United
Kingdom and the Netherlands, lead to higher negative investment returns (from −17 percent to −26 percent) than in countries like Switzerland and Germany (−8 percent to −13 percent) with more prudent investment in bonds. Overzealous expectations with respect to returns from capital vis-à-vis the low if not negative returns of PAYG public pensions have led to rather risky investments, particularly where individuals could choose without any further precautions. However, DB schemes have also come under pressure due to underfunding, though this has led to a further retreat by employers from underwriting promises of future pension benefits. Having profited from the advantages of the system during good years, they may now flee their responsibilities during bad times. Thus privatization of pensions has led to individualization of financial risks, and this tendency was augmented during the financial crises unless state or collective regulation intervened.

The main lessons from the two financial crises within the last decade are the need for stricter rules regarding public supervision (e.g. more regular stress tests), investment restrictions and partly new benefit protection mechanisms. This indicates that the role of private pension governance, including (state) regulation, continues to gain importance despite the claims of privatization and a retreat of the state. Furthermore, state regulation is complemented by social partners’ governance and regulation. The role of trade unions and employers’ associations for future old-age income is gaining in importance. In addition to their traditional functions in self-administered state pension institutions in Bismarckian countries, they are now and in the future faced with increasing needs for private pensions due to lower state pensions. Via collective agreements and jointly administered pension schemes the impact of pension finance decisions by employers, trade unions or the social partners together on financial markets is growing since almost all of the newly introduced supplementary pensions are funded. A stronger inclusion of unions and workers’ representatives in supplementary pensions may balance the interests and risks between employers (low administration costs), financial institutions (profit) and beneficiaries (high benefits). The retreat of the state from public pension commitments has not only increased the need to fill the retirement income gap by private funded pensions but has led to demands for better regulation of these pensions.

**Funding**

This work was supported by the German Research Foundation (DFG, grant EB 434/1–2), funding the Project ‘The Governance of Supplementary Pensions in Europe’ at the Mannheim Centre for European Social Research (MZES). An earlier version of this paper was discussed at the EU-funded GUSTO-project workshop organized by Noel Whiteside at the University of Warwick in May 2010.

**References**


