DEFINED CONTRIBUTION ARRANGEMENTS IN EUROPE

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Defined contribution arrangements in Europe

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* Not in the European Union

Introduction

1

1.1 The purpose of this report is to summarise the form and structure of defined contribution retirement benefit arrangements within Europe. The intention is to focus on occupational retirement benefit programmes, although reference will be made to private provision. The term 'second pillar' is used to mean occupational pension arrangements whilst 'third pillar' refers to privately transacted arrangements.

1.2 The last decade has seen a greatly increased interest in defined contribution arrangements, although the detail of what represents a defined contribution arrangement can differ between different countries.

1.3 The information in this report was provided by the Pensions Committee of the Groupe Consultatif and edited by David Collinson.

Summary

2

2.1 Traditionally the most common form for occupational retirement benefits across Europe has been the defined benefit scheme. Over the past decade there has been an increasing interest among employers in defined contribution arrangements. The primary driver behind this trend have been the desire from employers to seek a greater stability of costs from year to year and the increasing complexity of the legislation and supervision of defined benefit arrangements.

2.2 The only country where defined contribution arrangements dominate occupational pensions is Denmark. Defined contribution plans are also common in Switzerland.

2.3 Defined contribution arrangements have reached a significant proportion of company pension arrangements in the UK for smaller employers, with the use of unit-linked insurance products being prevalent.

2.4 In most other countries defined contribution arrangements are still very much in the minority but are becoming increasingly popular, particularly with multinational employers and for new arrangements for new employees.

2.5 In many cases the new defined contribution arrangements are funded through traditional insurance with-profit endowment insurance products with an interest rate guarantee. In some countries such as Italy, recent legislation has enabled pure defined contribution arrangements without guarantees to be introduced.

3

The role of defined contribution arrangements

Second Pillar

3.1 Complementary occupational pension plans were in the past not particularly widespread in Austria, as the Austrian social security system provides generous benefits. This means that supplementary benefits tend to be provided only for individuals in high salary brackets ie above the earnings limit for social security (ATS 588,000 in 1998). Where additional benefits are provided, they have tended to be defined benefit and linked to final salary rather than of a defined contribution nature.

3.2 In 1990, the Pension Fund Act was introduced. The Act defined the framework for single employer or multi-employer Pensionskassen (pension funds). The benefit structure of a Pensionskassen can be either defined benefit or defined contribution. Since 1995, most of the new arrangements established through Pensionskassen have been on a defined contribution basis. Occasionally, defined contribution plans are financed through book reserves or direct insurance.

3.3 Some defined benefit plans funded through a Pensionskassen are called "defined contribution plans with additional payment". They tend to be found where a defined benefit plan was financed by building up book reserves and has been transferred to a Pensionskassen contract. The balance of the cost of such plans has to be met by the employer if necessary.

3.4 Contribution rates are normally specified as a percentage of salary, usually with a lower contribution rate applying to earnings up to the social security ceiling (up to 5%) and a higher contribution rate on earnings above the ceiling (10% - 15%). Some plans use a fixed rate for all employees.

Third Pillar

3.5 Some employees make additional voluntary contributions to the state pension scheme. Tax-deductible contributions are allowable up to a maximum of ATS 40,000 for an individual (doubled for a married couple) (1998) but only a maximum of 25% of the contribution will be tax-deductible. These contributions purchase a fixed amount of additional pension, regardless of the individual's age.

3.6 Insurance contracts can also be used to provide additional retirement income. In the overwhelming majority of cases these are set up as endowment insurance contracts with the possibility to purchase a pension at retirement.

3.7 There are new special investment saving funds that have been established for private pension savings. They are called "Pensions Investmentfonds".

Legal/tax framework

3.8 Company pension funds in Austria are influenced by two laws, the Company Pensions Act, and the Pension Fund Act 1990 ("PKG").

3.9 The law allows employers to pay tax-deductible contributions to finance pension plans or to build up book reserves within certain limits. The limit for tax-deductible contributions from an employer to Pensionskassen is 10% of salary (this limit applies to the total contribution paid by employers and employees ie the limit for the tax deductible employer contribuitons is 10% of salary **less** the employee contributions). Contributions above these limits made by the employer to a Pensionskasse are not tax-deductible. The maximum tax efficient contribution to a direct insurance arrangement is ATS 4,000 per year. Contributions above this amount are tax-deductible for the employer but represent a taxable benefit-in-kind for the employee. The maximum contribution to a book reserve is calculated in accordance with specified actuarial methods set out in the Austrian tax code.

3.10 An employee can also contribute to a Pensionskasse, but these contributions cannot exceed the level of contribution made by the employer.

3.11 Employee contributions under second pillar arrangements to either Pensionskassen or direct insurance are partially tax-deductible in accordance with the requirements mentioned in Section 3.5 above.

3.12 A Pensionskassen must take the legal form of a joint stock company. There are specific minimum requirements on the amount of paid up share capital and the ratio of equity to technical reserves etc.

Product structure and providers

3.13 A Pensionskasse must hold a separate account in respect of each individual beneficiary. The amounts financed by the employer and the employee are recorded separately.

3.14 The assets of the Pensionskassen must be held with a local deposit administration bank licensed to trade in securities. There are limits on what assets can be held, in particular not less than 40% of the assets can be held in local bonds.

3.15 The investment are held in separate funds for large employers or groups of smaller employers ("VRGs"). The mortality risk and investment experience is spread across the members of each VRG.

3.16 The stockholders of Pensionskassen are mainly insurance companies and banks.

4

The role of defined contribution arrangements

Second Pillar

4.1 Although defined benefits plans still predominate, there has been a trend towards defined contribution arrangements particularly in respect of additional benefits for specific categories of employees. By the mid 1990's, it was estimated that 7% of all funds were of a defined contribution nature.

4.2 Defined contribution arrangements normally include employee contributions with an overall contribution rate of between 5% and 10%. Some plans include age related contribution rates. It is usual to find plans which provide for a lower contribution on earnings up to the social security ceiling (BF 1,386,533 or Euro 35,000 in 1998) and a higher rate above the ceiling. Most plans are funded through insurance contracts although a self-administered pension plan would be available to fund a defined contribution plan.

4.3 Defined contribution arrangements have often been used to top-up benefits for senior employees, high level managers and self-employed directors.

Third Pillar

4.4 Insurance contracts are widely used to provide additional retirement income. In the overwhelming majority of cases these are set up as capital insurance contracts on a traditional with-profit endowment basis.

Legal/tax framework

4.5 The Insurance Control Authority ('OCA/CDV') exercises control over both insurance companies and pension funds. The key laws regulating group life insurance are the Royal Decrees of 17 December 1992 and 5 July 1985. The Royal decrees of 14 and 15 May 1985 govern private pension funds in Belgium. Furthermore the benefits provided by company pension plans (whether secured through pension funds or insurance contracts) are impacted by the so-called Colla law of 6 April 1995.

4.6 Employer contributions to a pension fund/group insurance arrangement are tax deductible for the employer provided that state pensions and complimentary schemes do not exceed 80% of the last salary for a full career (the so-called 80% rule for defined benefit plans).

4.7 There is a special formula to calculate whether a defined contribution plan is within the 80% limit. Employer contributions are not considered a taxable income to the employees.

4.8 Employee contributions to a second pillar plan are tax deductible, again, provided the 80% limit is observed for both employee and employer contributions.

4.9 Employee contributions to a third pillar private arrangement can receive a tax credit up to the lesser of BF 66,000 per annum or 15% of taxable income up to BF 55,000 plus 6% of other taxable income (1998).

4.10 Benefits are normally taken in lump sum form reflecting the favourable tax treatment of lump sum benefits over pension benefits. All contributions to group insurance arrangements, private insured arrangements and self-administered pension funds are subject to a 4.4% insurance tax. Employer contributions to a group insurance arrangement or pension fund are subject to an 8.86% social security charge.

4.11 The assets of a self-administered pension fund are subject to an annual tax of 0.17%. Withholding taxes are also applied on dividends and income from investments.

Product structure and providers

4.12 The most popular form of defined contribution arrangement is through a group insurance contract. In this case with-profit deferred annuities are purchased with the investment return of 4.75% guaranteed. It is normal for the insurance contract to offer guaranteed factors to convert the annuity into a lump sum at retirement. These factors are typically based on the standard mortality tables and an interest rate of 4.75%.

Denmark

5

The role of defined contribution arrangements

Second Pillar

5.1 Second Pillar arrangements are very common in Denmark, either as industry-wide schemes or through company sponsored arrangements. Almost all schemes are on a defined contribution basis.

5.2 Many of the industry-wide schemes have been established within the last 5 years and contributions are only a small percentage of salary. Contributions often start at 0.9% of salary and will increase over time to 9% or more. In many of the older schemes, contributions are higher at 15% of the salary. Employee contributions are common, typically at ⅓ of the total contribution

5.3 Some arrangements are funded through a pension fund or "Pensionskassen", although the number of such funds has been in decline. In recent years, insurance arrangements have become the most popular method of funding for pension benefits.

5.4 Schemes funded through a pension fund tend to provide retirement pensions, disability pensions, spouse pension and children's pension and in some cases lump sum benefits. Life assurance arrangements normally provide annuities or lump sums or a combination of both.

Third Pillar

5.5 Third Pillar arrangements are established with life assurance companies as private pension schemes. One of the most popular arrangements is a capital pension scheme, where a lump sum is paid out at a date, defined by the insured person, between age 60 and 70.

Legal/tax framework

5.6 Contributions made to an occupational pension scheme by an employee are deductible from taxable income. Employer's contributions are also tax deductible. Payments into private schemes are tax deductible at the top income band (marginal rate), but from 1999 contributions into capital pension schemes are only deductible at the middle income band (average rate).

5.7 Pension benefits paid out are taxed as personal income. Tax on lump sum payments from a pension scheme is levied at the rate of 40%.

5.8 Occupational pension schemes require the employee to pay Labour Market Contributions (gross tax). This contribution/tax is 8% of pension contributions. The employer pays the total pension contributions to the insurance company or pension fund, and the insurance company or pension fund then has to withdraw the gross tax and pay it to the Taxation Authorities.

5.9 Under the Danish "Real Interest Taxation Law", tax is payable on the investment return from some forms of capital. The tax liability is imposed on the life insurance companies and pension funds. The tax is not applied to returns on equities, property and index-linked bonds, and applies only to the real return on pension capital over and above inflation and erosion of value. Up to 1998 the tax rate has been determined yearly in the light of price development and inflation. From 2000, the tax rate will be fixed at 26% in accordance with new legislation passed in June 1998. The same legislation implements a tax of 5% of the return on equities from June 1998.

Product type/structure

5.10 Unit-linked products are only a small part of the total market. The majority of arrangements are financed through with-profit deferred annuity contracts or pension funds. Under with-profit insurance contracts any surplus is paid back to the employer or employees as a reversionary bonus.

5.11 The products are based on a minimum guaranteed interest rate. This minimum interest rate is determined according to the Third EU Life Directive, and because of the real interest tax, 2.5% pa is the current rate. For contracts or pension schemes established with life assurance companies before July 1994 the interest rate is usually 4.5%. In pension schemes established before January 1996 with pension funds, the interest rate is usually between 4% and 4.5% but lower interest rates can be found.

Finland

6

Second Pillar

6.1 The majority of pension benefits in Finland are provided under the compulsory TEL system which is a defined benefit arrangement. The TEL system is not considered further in this report. Some companies provide supplementary private arrangements to top up the benefits provided under the TEL system. Such arrangements are typically established on a defined benefit basis. Legislation also allows profit-sharing plans to be introduced whereby benefits are payable on retirement. The contributions in this context are determined in the framework of the profit-sharing arrangement.

Third Pillar

6.2 Insurance arrangements are typically used to fund third pillar defined contribution arrangements.

Legal tax framework

6.3 Supplementary occupational arrangements (ie those in addition to the TEL plan) are typically financed through the appropriate institution providing the statutory TEL benefit, ie an approved insurance company or a self-administered pension fund. Employer contributions to a voluntary plan are fully tax deductible and are not taxed as a benefit-in-kind to the employee provided the certain limits are met. Employee contributions to voluntary pension arrangements are fully tax-deductible. Pension benefits are taxed as income.

Product structure and providers

6.4 Covered in the above.

France

7

The role of defined contribution arrangements

Second Pillar

7.1 In France the combined social security and unfunded compulsory plans provide generous benefits meaning that company sponsored supplementary plans are not common. Where such plans do exist they are typically on a defined contribution basis (referred to as Article 83- of the Tax Code-plans) because defined benefit arrangements must only pay a benefit on normal retirement if they are to receive favourable tax treatment. Thus defined contribution arrangements form a significant share of company specific supplementary retirement benefit plans. The benefits payable from an Article 83 plan must be in a pension form. Lump sum payments are forbidden.

7.2 Plans to allow more tax-efficient defined contribution arrangements with voluntary membership have recently been put on hold. Whether such plans will be revived will depend heavily on economic and political environment.

Third Pillar

7.3 Life insurance contracts are used widely to top-up employees mandatory retirement schemes. Favoured company savings plans are increasingly being provided by employers for employees.

Legal tax framework for defined contribution arrangements

7.4 A defined contribution arrangement can be established under Article 83 of the tax code. Contributions to Article 83 plans from both the employee and the employer are tax-deductible up to certain specified limits. As noted above benefits must be paid in pension form.

Product structure and providers

7.5 Under a defined contribution Article 83 plan typical practice is to define the contribution as a fixed percentage of salary with the contribution often differentiating between different levels of salary eg it is common to pay a higher rate of contributions on earnings lying between different tranches of income reflecting the tranches operating in the compulsory system (tranche A, tranche B, tranche C).

7.6 Article 83 plans must be arranged through group insurance with an insurance company. Contributions are paid into an individual account allocated to each employee. The individual account is either awarded with interest under a capitalisation system with revaluation according to a defined interest rate or by the income earned on the investments as stipulated in the contract conditions. Otherwise the contributions can be used to purchase units in investment funds whereby the holding of each employee in respect of each employee will then reflect the value of those investment fund units.

Germany

8

The role of defined contribution arrangements

Second Pillar

8.1 The overwhelming majority of occupational pension plans in Germany are on a defined benefit basis, although there is a small and growing interest in the establishment of defined contribution arrangements. Those defined contribution plans that do exist are either funded through Pensionskassen, direct insurance or re-insured support funds (a special kind of German pension fund). Companies may provide defined contribution book reserve plans (cash balance plans), although these are in reality defined benefit arrangements with a minimum return and hence the final benefit is guaranteed by the employer.

8.2 Under salary sacrifice arrangements a portion of salary may be foregone by the employee in exchange for either a contribution to a direct insurance/Pensionskasse or additional benefits promised under a book reserve or re-insured support fund arrangement.

Third Pillar

8.3 Insurance contracts are used widely to provide for additional retirement income. In the overwhelming majority of cases a traditional with-profit endowment structure is used.

8.4 The possibility of establishing special investment saving funds for individuals became effective on 1 April 1998 in Germany; these funds are not providing life pensions, but lump sum benefits.

Legal/tax framework

8.5 Defined contribution arrangements funded through direct insurance, Pensionskassen, or re-insured support funds must comply with the Occupational Pension Act in Germany.

8.6 Contributions to direct insurance and Pensionskassen are tax-deductible for the employer but are regarded as taxable income for the employee. Contributions up to DM3,408 per annum are taxed at a special flat-rate rather than the marginal tax-rate. The flat-rate equals 20% plus Church taxes etc which usually amounts to 23%. Benefits are tax free if paid in lump sum form (subject to certain restrictions). Pension benefits are partially taxable.

8.7 Contributions to a re-insured support fund are tax-deductible for the employer and are not taxed as income for the employee. The benefits when payable are taxed as normal income. If the support fund is to maintain its tax-free status various conditions are put upon the payment of contributions and on the level of benefits.

8.8 Under 'defined contribution' book reserve arrangements, the company is allowed to accrue a tax-deductible provision in its balance sheet subject to a maximum calculated in accordance with the relevant tax code, paragraph 6A EStG. The benefits, when payable, represent taxable income for the employees.

Product structures and providers

Defined contribution direct insurance arrangements

8.9 Under a defined contribution direct insurance arrangement contributions are paid to an insurance contract held with an insurance company. The level of contribution is typically specified as a Deutschmark amount although some arrangements are found whereby a percentage of salary is paid. It is common practice to limit the amount of the contribution to that which applies for flat-rate tax purposes ie DM3,408 per annum. In the overwhelming majority of cases contributions are paid to a with-profit endowment contract paying lump sum or pension benefits. In such cases contributions are awarded a guaranteed rate of return (usually in the range of 3% to 4%) but with the benefits payable on retirement or death being regularly increased due to profit-sharing on investment return and other experience earned over and above that guaranteed in the relatively conservative premium basis calculation. The guarantees are given by the insurance company rather than the employer and hence, although under most of these arrangements a benefit is defined for the employee in terms of a minimum retirement benefit and a minimum benefit on death, the underlying obligation of the employer is to pay a fixed level of contribution.

Pensionskasse

8.10 A Pensionskasse can be seen as a form of insurance company sponsored by a single employer or group of employers. Where a Pensionskasse is used to provide a defined contribution arrangement the structure is typically similar to that described above for direct insurance. Typically, contributions are defined either as a Deutschmark amount or as a percentage of pay.

Re-insured support funds

8.11 Under a re-insured support fund contributions are paid by the employer to a support fund and then immediately paid on to and invested in a group insurance contract. The group insurance contract in this case will consist of a with-profit endowment or deferred annuity contract similar to that described above for direct insurance. Contributions are generally specified as a percentage of salary or as a Deutschmark amount. The insurer under the with-profit contract will guarantee a minimum level of return but will usually enhance the benefits through profit-sharing. Unit-linked insurances can be used under certain conditions for re-insured support funds.

Defined contribution book reserve schemes

8.12 Under these type of arrangements each year a notional contribution is awarded to an employee's notional account held with the company or converted into pension benefit. This notional contribution may be defined as a Deutschmark amount or as a fixed percentage of salary with differing rates applying above and below the social security ceiling. The notional account may then either be awarded an addition of interest each year which may be at a fixed rate or at a variable rate with a certain minimum applying. The employer will also specify the rate at which the accumulated employee notional fund is converted into pension benefit. In reality these arrangements are defined benefit arrangements since in order to obtain a deduction for the book reserve a benefit needs to be specified in advance.

Greece

9

The role of defined contribution arrangements

Second Pillar

9.1 At present, pension plans are not as widespread in Greece as in many other European countries. However, pension plans are becoming more popular and the number of plans has increased over the last few years.

9.2 Following the growth of pension arrangements, defined contribution plans are also gaining in popularity and for some insurance company providers the proportion of defined contribution schemes is as high as 50 percent.

9.3 Plans typically define the contribution rate as a percentage of pay, with different rates often applying above and below the social security (IKA) ceiling.

Legal/tax framework

9.4 As yet, no major legal or regulatory controls are in place for defined contribution arrangements. This is partly because almost all of the existing plans are classified by the regulatory authorities as defined benefit deposit administration funds.

9.5 Investment decisions for defined contribution arrangements are usually arrived at jointly by the contract holder and the investment company. Their popularity is largely due to their transparency.

9.6 Employer contributions are tax deductible subject to a limit of the lesser of 5% of pay or GRD 150,000 (1998). Employer contributions are not considered a benefit-in-kind for employees up to the limits described above.

9.7 Employee contributions to second pillar schemes and private life assurance plans are tax deductible up to 4% of taxable income subject to a maximum of GRD 200,000 pa (1998).

9.8 Pension benefits are taxed as income. Lump sum benefits from insured plans are tax free but subject to a stamp duty tax of 3.6%.

Product structures and providers

9.9 Defined contribution arrangements are typically funded through deposit administration insurance contracts.

Ireland

10

The role of defined contribution arrangements

Second Pillar

10.1 The overwhelming majority of occupational pension plans in Ireland operate on a defined benefit basis although there is an increasing interest in the establishment of defined contribution arrangements particularly amongst new employers and American multinationals establishing in Ireland. The annual benefit survey undertaken by the Irish Association of Pension Funds indicated that only 7% of pension schemes were operated on a defined contribution basis in 1991 whilst by 1997 that percentage had increased to 15%. Additional voluntary contributions by members of defined benefit schemes are, however, invariably managed on defined contribution lines.

10.2 Defined contribution schemes normally require a contribution from the member with the employer paying either a fixed contribution expressed as a percentage of pensionable salary or a tiered percentage contribution which increases with age. Concern has been expressed at the relatively low level of aggregate contribution being paid to new defined contributions schemes. It seems unlikely, in the absence of continuing exceptional investment returns, that the level of pensions delivered from the schemes at retirement will match those traditionally provided under defined benefit schemes.

10.3 The joint contributions to defined contributions schemes are directed to individual retirement accounts under the umbrella of a separate trust established by the employer. The individual retirement accounts are invested in unitised managed fund contracts offered by the insurance companies/investment managers or smoothed with profit contracts offered exclusively by the insurance companies.

10.4 The self-employed and employees in non-pensionable employment save for retirement through retirement annuity contracts. Retirement annuity contracts operate exclusively on defined contribution lines with the investment options similar to those available to occupational pension schemes.

Third Pillar

10.5 Life insurance contracts are used widely to top-up employee savings for retirement. Investment is invariably directed to a unitised managed fund type contract.

Legal/tax framework

10.6 Defined contribution schemes established by employers are set up under trust and must be approved under the provisions of the Irish Finance Act of 1972. Contributions paid by both employees and employers to the schemes are treated as an expense for income tax purposes whilst no income/capital gains tax is levied on the accumulating retirement accounts. On retirement a proportion of the accumulated sum standing to the credit of the member can be taken by way of a tax free lump sum whilst the balance

of the account proceeds must be converted into taxable pension by reference to annuity rates ruling at the date of retirement. The ultimate benefits payable cannot exceed those set down by the Revenue Commissioners. These benefit levels are identical to those that apply to defined benefit schemes.

10.7 Contributions to retirement annuity contracts by the self-employed/employees in non-pensionable employment also qualify in full for tax relief and the investment earnings accumulate within the individual accounts on a tax free basis. On retirement 25% of the accumulated assets can be taken in the form of tax free cash with the balance being applied to purchase taxed pension by reference to then current immediate annuity rates. The Revenue Authorities impose a limit on the percentage of annual remuneration which can be paid to a retirement annuity contract - 15% up to age 55 and 20% thereafter but there is no monitoring of the ultimate level of retirement benefits secured.

National Pensions Policy Initiative

10.8 The Pensions Board has recently published its report on the National Pensions Policy Initiative (NPPI) - a comprehensive review of retirement provision in Ireland which received submissions and support from a very wide range of interested parties. The NPPI was prompted by a realisation that only about 50% of the employed/self-employed workforce was covered by second pillar pension schemes and, in particular, that the existing structures were failing atypical workers eg part-time, job sharers, etc. Recognising these problems one of the main proposals in the report is to introduce personal retirement savings accounts (PRSA) similar to personal pensions which have operated for some years in the UK.

10.9 The new product is intended to be attractive to atypical/mobile employees but would be available to employees generally and of most significance would be independent of their employment status. The PRSA could receive contributions both from the employee and his employers over time. The PRSA's would be operated on defined contribution lines and tax reliefs both on contributions paid and on investment income would be similar to those available under existing occupational pension schemes and retirement annuity contracts. Bearing in mind the mis-selling lessons of the UK the PRSA products offered by the insurance companies/investment managers would be required to meet prescribed criteria adopting a kite-marking process.

10.10 The hope would be to increase second pillar pension coverage from the existing 50% up to approximately 70% of the working population over age 30 within a reasonable period of time. Quite clearly if the PRSA concept is successful a very much higher proportion of the workforce in Ireland will look to defined contribution type pension arrangements for retirement provision than has been the case in the past.

Product structure and providers

10.11 Covered in the above text.

Italy

11

The role of defined contribution arrangements

Second Pillar

11.1 Traditionally the comprehensive nature of the social security system in Italy combined with the mandatory termination indemnity (TFR) meant that the scope for occupational pension arrangements was limited. Historically only a few companies set up pension arrangements for their employees and those pension funds that did exist were generally defined benefit in nature. The possibility for defined contribution arrangements will emerge in 1998 following the pension law of April 1993 which was recently enacted. This is leading to the establishment of industry-wide schemes or regional schemes.

Third Pillar

11.2 Under the new pensions law it will be possible to have open pension funds which can be set up to allow employees not in a specific company or industry-wide scheme to participate in a third pillar pension arrangement on a defined contribution basis.

Legal/tax framework

11.3 Defined contribution pension arrangements set up under the new law will allow contributions per person that are tax deductible up to the lower of 2% of salary or Lit 2.5 million per annum from each of the employee and the employer. The TFR accrual can also be contributed. The allowable contribution is limited to the amount of TFR accrual that is contributed. Twelve percent of the eventual pension payments will be tax-free and the rest will be taxed as income. Any lump sum benefits will be taxed at a rate equivalent to slightly less than the individual's marginal rate. Pension funds set up under the new law have to meet numerous requirements with regard to their structure and management.

Product structure and providers

11.4 It is envisaged that the arrangements that will be established under the new law are likely to be on a regional or industry basis. Contributions are likely to be fixed as a percentage of an employee's income and will be invested in unit-linked/individual accounts. It is not anticipated that there will be any form of guaranteed return on the investment of the contributions. The main administrators of the arrangement are likely to be banks and insurance companies.

Luxembourg

12

The role of defined contribution arrangements

Second Pillar

12.1 Although company sponsored arrangements are not widespread in Luxembourg, where they do exist they have traditionally been on a defined benefits basis through either final salary or career average plans. Defined contribution plans have been used to provide a top-up to the main benefits.

12.2 Some companies operating defined benefit plans are considering changing to a defined contribution arrangement.

Third Pillar

12.3 The main vehicle for providing third pillar retirement savings is through privately held insured annuity contracts which are usually on a with-profit basis.

Legal/tax framework

12.4 Defined contribution plans must comply with the legal tax framework. This requires them to be based on a pension promise in an employer/employee relationship.

12.5 Employer contributions to a defined contribution arrangement are tax-deductible on the basis that the requirements of the legal tax framework are met. Benefits can be payable as a lump sum or annuities. Employee contributions are fully tax-deductible up to a certain limit.

Product structure and providers

12.6 Defined contribution plans, where operated, are typically established with insurance companies. The typical product used is a with-profit deferred annuity with a guaranteed interest rate of 3.5%.

12.7 New legislation with respect to pension plans is being implemented.

Netherlands

13

The role of defined contribution arrangements

Second Pillar

13.1 Although second pillar arrangements are in general very widespread in the Netherlands, either through company sponsored arrangements or industry-wide schemes, these have traditionally been overwhelmingly on a defined benefit basis through either final salary or career average plans. Defined contribution plans are however enjoying increasing popularity and are being used to:

- provide a top-up to the group plan benefits
- as a separate plan to finance early retirement benefits as a replacement for VUT schemes
- as a comprehensive main plan to replace an old defined benefit plan
- as the main plan for new companies or for new employees.

13.2 Some companies operating defined benefit plans are considering changing to a defined contribution arrangement.

Third Pillar

13.3 The main vehicle for providing third pillar retirement savings is through privately held insured annuity contracts which are usually on a with-profit basis.

Legal/tax framework

13.4 Defined contribution plans must comply with the Pension and Savings Fund Act. This requires them to be based on a pension promise in an employer/employee relationship and to be insured with an approved insurer or pension fund.

13.5 Employer contributions to a defined contribution arrangement are tax deductible on the basis that the requirements of the Pension and Savings Fund Act are met. Benefits must be payable in pension form. Employee contributions are fully tax deductible.

13.6 The contribution levels allowable under defined contribution schemes have to be approved by the tax authorities. This is to avoid excessive benefits being provided through defined contribution plans. The maximum allowable contributions are based on a target of 70% of final pay not being exceeded after a career of 40 years.

Product type/structure

13.7 Most defined contribution arrangements are currently invested through group pension insurance contracts. The contributions are usually specified as a percentage of salary

often with a salary offset to allow for the State benefits. Plans where a fixed contribution rate is applied to all employees are found as well as those where contribution rates vary with, for example, increasing age of the employee. The contributions are invested either in unit-linked arrangements with no investment guarantee or a traditional with-profit endowment/deferred annuity contract whereby the insurance company will guarantee a certain minimum return (usually 4%) with bonuses being awarded to reflect returns over and above the guaranteed amount, in the latter case there is usually no influence from the member on the investment policy.

Norway

14

The role of defined contribution arrangements

Second Pillar

14.1 Company sponsored pension arrangements are quite widespread in Norway, but traditionally they have been almost exclusively organised on a defined benefit basis, usually through final salary plans. This is primarily due to the tax regulations, since it is a requirement for a plan to be tax exempt that it provides pensions on a defined benefit basis.

14.2 Based on an increased demand in the market and on signals from the Parliament and from the Government, it is now expected that the legislation will change within the next few years to allow for defined contribution plans under the same tax regime as for defined benefits plans.

14.3 Although there are no special tax incentives in place, some employers are considering a partial change to defined contribution arrangements, and the providers are also looking at this market with increased interest.

Third Pillar

14.4 The main vehicle for providing individual retirement savings has traditionally been through privately held annuity contracts. Mutual fund savings arrangements and pension savings through banks has now been place on the same footing as savings through life insurance with respect to tax treatment. At the same time life insurance companies are gradually introducing more flexible products. It is therefore expected that the market for individual retirement savings will gradually become more sophisticated.

Legal/tax framework

14.5 As a main rule, contributions to a defined contribution arrangement will not be tax-deductible for the employer, while the benefits will be fully taxed as they fall due. However, since there is no overriding legal structure in place in respect of defined contribution plans, the actual taxable treatment will depend on the specific terms of the plan and other concrete circumstances.

Product structure and providers

14.6 No comment possible at the present time.

Portugal

15

The role of defined contribution arrangements

Second Pillar

15.1 Until recently supplementary pension plans were not widespread. Due to cutbacks in State benefits there has been an increasing interest in company sponsored pension arrangements. Some of these newer arrangements have been established on a defined contribution basis. Defined contribution plans are established either through direct insurance or through pension funds which are established on the basis of "open" pension funds (pooled pension funds) or "closed" pension funds (pension funds restricted to a single employer or employer group).

15.2 It is expected that as State benefits are cut back further there will be an increasing role for occupational pension arrangements and that a proportion of new arrangements will be implemented on a defined contribution basis.

Third Pillar

15.3 Employees typically use insurance arrangements to supplement their retirement income. Individual pension arrangements exist, referred to as PPRs.

Legal/tax framework

15.4 Pension funds are regulated by the Insurance Supervisory Body, the ISP. The ISP impose restrictions on the investments held by pension funds and life companies. Employer contributions to pension funds and insurance contracts are tax deductible up to a maximum of 15% of payroll provided certain conditions are met, in particular that the benefits are paid as pensions not lump sums (up to 1/3 of the pension can be converted to a lump sum), there is no early retirement, the plan is extended to all employees on a non-discriminatory basis, and the retirement benefits are not vested.

15.5 The employer contributions to such plans are not considered as taxable income for the employees. If the plan offers vested benefits the employer contributions are considered a taxable benefit-in-kind in the hands of the employee and the employer can deduct contributions for corporate income tax purposes. Special arrangements apply to banking sector employees. If the plan provides vested benefits but complies with all the other conditions then the employee may deduct the employer contributions from their taxable income up to 15% of their annual gross pay. Employee contributions to company sponsored arrangements are deductible up to certain very low limits (Pte 36,000 for a single employee - 1997).

15.6 Contributions towards individual pension plans (PPRs) are deductible up to the lesser of 20% of annual income and Pte 418,000.

15.7 Pensions from private pension plans, where the income from both the pension plan and the social security arrangement exceeds an income tax threshold (Pte 1,420,000), are fully taxable as personal income.

Product structure and providers

15.8 Defined contribution arrangements are typically provided by insurance companies or pension funds.

Spain

16

The role of defined contribution arrangements

Second Pillar

16.1 Until the early 1990's, most Spanish company sponsored pension arrangements were defined benefit arrangements. Sometimes these are funded through book reserves, but frequently they were unfunded and dealt with on a pay as you go basis.

16.2 The introduction of accounting legislation in 1990 requires the recognition of the cost of providing pension arrangements in a company's balance sheet. This caused many plans to be terminated or, more frequently, substituted by defined contribution plans.

16.3 Under the Law of Pension Plans and Pension Funds of 1987 (Law 8/87), a defined contribution pension plan is a pure savings arrangement under which the benefit cover arising from any event (death, disability and retirement) can only be the lump sum resulting from the accumulation of the contributions made and their yield (this lump sum can then be used to buy an annuity, usually from an insurance company). The Law establishes that in a defined contribution plan, during the period before benefit payment, no guarantee can be provided at all, not even a minimum interest guarantee. Under such plans all risks (mortality, disability, death and the financial-risk resulting from the volatility of the market) have to be taken by the participant, with no possibility of insuring them.

16.4 However, if the plan corresponds to the second pillar (sponsored by the employer) then the defined contribution plan can be combined with some guaranteed coverages (the plan is then called "mixed plan"). Many of these second pillar plans guarantee a minimum coverage in case of death or disability of an active employee if the accumulated fund, at the moment of death or disability, has not reached yet that floor.

16.5 In 1994, the rise of interest rates produced an important decrease in the value of the assets of most of the funds backing this type of plan. This created a great confusion among the participants, as they saw that at the end of the year their rights were lower than those at the beginning of the year plus the annual contribution. Since then many managers of such funds invest at a relatively short term in order to reduce volatility. This investment policy is negatively affecting the final results obtainable in many cases, especially for young participants.

Third Pillar

16.6 Beyond the first two pillars, individuals may decide to save in order to improve their retirement income. One method of saving is through individual pension plans established under the Law 8/87. These plans are required to be of a "pure" defined contribution nature. Contributions have a maximum limit and are deducted from taxable income. Benefits when received will be treated as taxable income.

Legal and tax framework

16.7 Defined contribution pension plans are regulated by the Law 8/87. They can be used for the Second Pillar as well as for the Third Pillar arrangements. There is a maximum annual contribution, which in 1998 was the lower of Pts 1,100,000, or 20% of net taxable income. If a participant had contributed to more than one plan the limit has to be applied jointly to all amounts contributed to all plans.

16.8 The contributions paid to these plans are deducted from the taxable income and the benefits will be taxed when received.

16.9 Plans established under the Law 8/87 cannot be surrendered. The amount accumulated at any time can be transferred to another plan, but cash can only be received by the participant, or the beneficiary, when a contingency occurs (death, retirement or disability, recently extended to unemployment and dread diseases).

16.10 Alternatively insurance products and mutual funds do not attract any deduction in the taxable income from the amounts allocated to these products, but the benefits will be taxed only on amounts exceeding the contributions paid. These products offer early cash payout (through surrender in the case of insurance) when the participant requires it even if no contingency has occurred.

Product structure and providers

16.11 Covered in the above text.

Sweden

17

The role of defined contribution arrangements

Second Pillar

17.1 Second pillar arrangements are very wide-spread in Sweden. Most individuals are a member of one of the two nationwide pension plans; the one for the blue-collar workers (Avtal pension SAF-LO) or the one for the white collar-workers (ITP). These pension schemes came into force following a collective agreement between the parties of the labour market. These two big pension plans (together with some other pension plans for specific professions) cover most people employed by private companies in Sweden.

17.2 Over a period of four years from 1996, the plan for the blue-collar workers (Avtal pension SAF-LO) will be changed from a defined benefit arrangement to a defined contribution plan.

17.3 For the white-collar workers, the existing plan is mainly a defined benefit scheme, although one third of the premium goes to a defined contribution scheme. There have been discussions going on for several years for changing the existing pension scheme; the negotiating parties believe that they will end these discussions soon. The employers organisation want a defined contribution plan, but the employees organisation would like to retain a modified version of the defined benefit plan.

17.4 White-collar employees earning above 10 times the base amount (SEK 36,400 in 1998) may opt out of the defined benefit ITP plan and take out pension insurance on a defined contribution basis.

Third Pillar

17.5 It is common in Sweden to have private savings in insurance companies, either a deferred annuity contract or a unit-linked contract. Other vehicles used for saving are bank accounts or unit trust funds.

Legal tax framework

17.6 For occupational pensions, the premiums paid to an insurance company are normally tax deductible. There has been new legislation in 1998, which will simplify the tax rules. Generally, the employer is allowed to pay premiums up to 35% of the salary to a pension arrangement, which can be either a defined benefit or a defined contribution plan. For early retirement arrangements, the tax-deductible premium can be higher.

17.7 Contributions are subject to a special social security tax (approximately 24%).

17.8 Swedish company sponsored pension arrangements do not require the employee to contribute. As a result, there are no special tax arrangements for employee contributions.

17.9 Premiums paid to privately held pension insurances are tax deductible up to a limit of 0.5 Base Amounts plus 5% of income between 10 and 20 Base Amounts.

17.10 Benefits paid from occupational schemes represent taxable income.

17.11 Investment income on pension assets is taxed at 15%.

Product structure and providers

17.12 Under the defined contribution arrangements recently established for blue-collar workers, contributions are made at the rate of 2% of pensionable earnings. Contributions are paid either to deferred annuity with-profit contracts in an insurance company or to unit-linked contracts. Where a unit-linked fund is chosen, the employee is able to choose the type of fund the money is invested in. There are however no guarantees within the unit-linked business. For the deferred annuity with-profit contacts there is a guaranteed interest rate (max 4%). Bonuses are normally paid to reflect excess investment returns.

17.13 The ITP over 10 base amount opt out arrangements are usually established using with-profit deferred annuity contracts.

Switzerland

18

The role of defined contribution arrangements

Second Pillar

18.1 The provision of an occupational pension scheme has been mandatory in Switzerland since the enactment of the Federal Law on occupational old age, survivors and disability benefits in 1985 (referred to as the BVG).

18.2 The minimum pension to be provided is of a defined contribution nature and the BVG prescribes minimum employer and employee contributions. The employer must contribute at least 50% of the overall contribution. Each year the assets held in respect of the mandatory BVG minimum contributions must be increased with a minimum rate of 4%. The actual return will depend on the funds' rules and the investment returns may be smoothed from year to year.

18.3 The employer is free to choose either a defined contribution or a defined benefit plan for the BVG benefits. Traditionally most second pillar arrangements were defined benefit final salary plans, especially for larger employers. In most cases the employer will provide benefits that are better than the minimum BVG benefits.

18.4 Defined contribution plans are enjoying increasing popularity and are being used as either main benefit plans or to provide additional benefits for management.

18.5 Contribution rates are normally specified as a percentage of salary with both fixed and age related contribution rates found. Salary is usually capped and an offset is generally made to allow for state pension benefits. Benefits are taken in either pension or lump sum form.

Third pillar

18.6 Individuals who wish to make third pillar additional savings for retirement can use special blocked bank accounts or insured annuity policies. The BVG prescribes the conditions for these contracts and limits the allowable contributions

Legal Tax Framework

18.7 To fulfil its legal obligation the employer must either set up its own pension foundation or participate in a collective foundation. The latter are often established by insurance companies. In each case the entity must be separate from the employer

18.8 The employer's contributions to defined contribution arrangements are tax-deductible if the pension scheme meets the requirements of the BVG. In addition, the contributions are not taxed as an employee benefit in kind. Employee contributions are also tax-deductible.

18.9 Benefits are taxable

Product structure and providers

18.10 Defined contribution plans for smaller employers are typically funded through traditional with-profit deferred annuity contracts with an interest rate guarantee of 4%. Larger plans are funded through self-administered pension funds. An employer specific foundation can hold investments directly or invest via insurance contracts.

United Kingdom

19

The role of defined contribution arrangements

Second Pillar

19.1 Although defined benefit plans are still dominant in the UK, defined contribution pension plans are becoming increasingly popular. One of the reasons for their increasing popularity is the increase in legislation governing defined benefit plans. Since 1995, many people have predicted a marked switch from defined benefit to defined contribution schemes, and although this has not happened as fast as might have been expected other than for smaller employers. Where new arrangements are set up they are often of a defined contribution nature. In addition, some larger employers are introducing defined contribution schemes for new employees whilst retaining the defined benefit plan for existing staff, and others have hybrid arrangements of some form.

19.2 A recent NAPF survey, indicated that in 1997 approximately 15% of occupational schemes were of a defined contribution nature. This represents an increase from 2% in 1991.

19.3 The contribution rates payable under defined contribution arrangements are often graded according to the age of the employee.

19.4 Typically, contributions are at a lower level than that implied by traditional defined benefit arrangements. Whilst company sponsored defined contribution arrangements are commonly found there has been an increasing interest among smaller employers to establish a group personal pension arrangement. A group personal pension plan is in reality a collection of individual personal pension plans set up with a single provider (see below).

Third Pillar

19.5 Members of company sponsored arrangements can make additional voluntary contributions in conjunction with their normal company scheme under an additional voluntary contribution arrangement either through the company pension arrangement or separately. Usually these arrangements are of a defined contribution nature with contributions payable to a building society account or an insurance policy, on a unit-linked or endowment basis.

19.6 Individuals may establish personal pension arrangements on a defined contribution basis usually with an insurance company, fund manager or bank. Personal pension arrangements are popular with self-employed individuals and those individuals whose employers do not operate a company pension arrangement. Personal pension arrangements may be used to contract out of the second tier of the UK State benefit (SERPS).

19.7 There are numerous vehicles for applying third pillar savings. In particular there are at present equity based savings vehicles referred to as PEPs (Personal Equity Plans) and building society account vehicles referred to as TESSAs. From 1999 these will be replaced by another vehicle referred to as ISA's (Individual Savings Accounts).

19.8 Outside of this vehicle third pillar savings will typically be through life assurance policies, either on a unit-linked or with-profits basis, or through banks/building societies.

Legal Tax Framework

19.9 Occupational pension schemes need to be approved by the Inland Revenue and set up under a trust in order to obtain tax relief. If approval is granted both the employer and employee can obtain some tax relief on contributions. Tax relief for employees is granted on contributions up to 15% of earnings subject to a maximum of £87,600 pa (1998/9). The contributions paid by the employer are allowable against company corporation tax and are not taxed as a benefit-in-kind for employees.

19.10 Benefits payable from approved company defined contribution schemes are restricted by the same limits as defined benefit schemes. In particular there are limits on the maximum salary and the maximum service that can be used to determine benefits. Part of the pension at retirement can be commuted for a tax free cash lump sum.

19.11 Pension benefits from defined contribution arrangements are taxed as income when they are paid.

19.12 Contributions to personal pension arrangements are tax-deductible up to certain limits. The tax-deductible limit for contributions is 17.5% at age 35 or less rising to 40% at age 61 or more. These contribution rates are applied to earnings subject to the earnings cap of £87,600 (in 1998/9). There is no limit on benefits from personal pension arrangements.

Product type structures

19.13 There is no single typical structure for a defined contribution arrangement, although most plans tend to require employee contributions of between 3% and 5%. Employer's contributions may be flat rate or age related and higher employer contributions are often paid for more senior employees. An alternative arrangement is sometimes found where the employer will pay double the level of contribution paid by the employee. Typically employer contributions are in the range of 4% to 10% of earnings.

19.14 Contributions will be paid into a trust and will accumulate in line with the investment return achieved by the assets backing the fund. In the past, the investment return added to the fund was free from tax. However, the July 1997 budget changed this so that schemes are no longer able to re-claim Advanced Corporation Tax paid on UK equity dividends.

19.15 Where insurance contracts are used as the investment vehicle the contracts may be on a with-profit, unitised with-profit or unit linked basis. The use of the latter two products is becoming increasingly dominant.