# Chapter 18
# Pension funds and the European Union: Anatomy of an encounter

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## Introduction

The nation state is the prime locus for social protection, social services, and redistribution (Daly, 2019). EU budgets for interpersonal redistribution pale in comparison to national ones (Schmidt, 2021). The Stability and Growth Pact puts limits on public debt, and member states are subject to the EU system of socio-economic governance. But compliance with the pact and the economic governance recommendations have been weak, at best (Efstathiou and Wolff, 2018). The EU has limited leverage in this area, except for domestic adjustment pressures for some member states after the 2008 financial crisis caused by bail-out conditionalities, and, potentially, through the linkage of country-specific recommendations to the recently adopted Recovery and Resilience Facility (Heins and de la Porte, 2015; Vanhercke and Verdun 2022). Direct legislative social policy powers are typically linked to the internal market. Yet, even despite new areas entering in the last two decades, such as poverty and social inclusion, the system is 'lacking in depths, focusing on a range of areas around a core that looks hollow when compared to member state policies' (Daly, 2019: 2). The factors that hold back the development of an EU welfare state are well understood and include the variety of national welfare regimes with their legacies and vested interests (Esping-Andersen, 1990); the electoral incentives, in particular for social democratic and Christian democratic parties, to keep competencies of the generally popular social policies on the national level (van Kersbergen and Verbeek, 1997); and the high institutional threshold of unanimity among member states to transfer new competencies to the EU level, providing each of them with a veto.

However, national preferences for keeping the status quo, or at least autonomy, might conflict with supranational actors' attempts of harmonization. This contribution lays out such an encounter, an initiative by the EU Commission that, if successful, would have had large welfare consequences for countries such as the Netherlands and the UK. This failed initiative is still worth presenting as an example of how well vested interests in national welfare states can defend against intrusion when the stakes are high.

The focus is on pensions, occupational pensions in particular. As Esping-Anderson wrote in his classic *Three worlds of welfare capitalism,* a study on pensions may 'appear somewhat narrow and pedestrian' (1990: 79), but as he has emphasized, pensions account for a considerable share of the GDP and 'constitute a central link between work and leisure, between earned income and redistribution, between individualism and solidarity, [and] between the cash nexus and social rights' (1990: 80). The contribution further zooms in on something that might look particularly pedestrian at first sight: solvency margins for pension funds. The solvency margin denotes the amount of capital a pension fund is obliged to hold against unforeseen events. The higher the margins the higher the income security for scheme members. At the same time, increasing margins or keeping them at the same level in adverse circumstances implies higher contributions by sponsors (companies) and scheme members (workers) and, hence, lower net salaries and potentially less profits and/or less investments and less economic growth.

In the remainder of the contribution, I will first sketch out the cross-national diversity of pension systems and the variety in the importance of occupational pensions and pension funds therein. I will then outline the Commission's motivation to include harmonized solvency requirements for pension funds in planned revisions of the existing pension funds directive (IORP), and finally, I will describe which groups mobilized and how effectively vested interests were able to put this issue off the agenda for the revision of the directive, even before the Commission adopted its official proposal for the revised directive (IORP II) in 2013.

## Diversity of pension systems

Esping-Andersen (1990) distinguishes between (a) state-dominated, status-maintaining, and earnings-related social insurance systems, (b) universalistic state-dominated systems, and (c) residual systems. Since his research, the universalistic systems have made quite a transformation, at least in their financing structure, as the state-sponsored universal flat-rate schemes (first pillar) did not keep up with the retirement income needs for the better well off and, hence, created an incentive for supplementary occupational pensions (second pillar) that, in contrast to the first-pillar pensions, were mostly capital market funded (Bonoli, 2003; Myles and Pierson, 2001). In this financing system, contributions by sponsors (companies) and scheme members are invested into assets, and benefits are paid out of the interests the investments generate and the selling of assets. In Denmark, the Netherlands, and Sweden, these occupational pensions are quasi-mandatory and based on collective, typically sector-wide, agreements, which leads to coverage rates above 90% among employees (OECD, 2023). In addition to providing income security after retirement, these arrangements also cover risks such as longevity and often also disability, becoming a surviving dependent, and interrupted careers (Haverland, 2011; Mabbett, 2009). Flat-rate pensions in the UK and Ireland also created incentives for occupational pensions. They typically took the form of company schemes and to a lesser extent covered additional social risks. Coverage rates are about 50% (OECD, 2023). The earnings-related character of the state-dominated social insurance systems provided less incentive for occupational pensions. However, retrenchment in this pillar in Germany led to an increasing importance for company schemes as well as for some sector schemes, governed jointly by employers and employees. This led to a coverage rate of roughly 50% among employees (OECD, 2023), although only a part of these schemes are capital funded. Other countries that belong to this regime type, such as Italy and Spain, largely rely on the first pillar (Pavolini and Seeleib-Kaiser, 2018).

The cross-national variation in incentives for creating and joining occupational pensions also translates in the variation of the importance of pension funds for income maintenance and the size of their assets. Concerning the latter, in the Netherlands and the UK, pension fund assets (more than) equal the countries' GDP. Figures in the period of this analysis are 161% for the Netherlands and 99% for the UK. Other countries with significant pension funds are Denmark (49%), Finland (46%), Ireland (59%), and Sweden (67%), while countries with earning-related first-pillar pensions, such as Germany, Italy, and Spain, trail with less than 10% (OECD, 2015).

## Enter the European Commission: Occupational pensions and the single market

The massive number of assets that pension funds have acquired implies that pension funds are not only a vehicle for income security for the elderly and for the pooling of social risks, but also formidable institutional investors and, hence, Janus-faced. It is particular the latter feature that drew the attention of the European Commission with its core mission to create and safeguard the internal market. This mission includes, but is not limited to, the free movement of (financial) services and capital. In line with its 'financial face', pension fund regulation became an issue for DG Internal Market and, later, the newly created DG Financial Markets, rather than the relevant social division, the DG Social Affairs. From the DG Internal Market perspective, pension funds are yet another type of financial institutions, which should be subject to financial internal market regulations in a similar vein as banks, investment funds, and (life) insurance companies.

Since at least the 1990s, the European Commission has aimed at creating a single market for occupational pensions. To improve the free movement of capital, the Commission sought to harmonize rules regarding pension funds investment behaviour, in particular, removing national barriers to investment. However, it was not until 2003 that the EU adopted the IORP directive, stipulating minimum standards for the operation and supervision of pension funds and for their investment policies. The directive was largely based on the least common denominator of national preferences and, therefore, had no significant effect on national welfare systems (Haverland, 2007; Hennessy, 2014).

The 2008 financial crisis provided a new impetus for regulation and an emphasis on increasing financial stability, making sure that financial institutions have sufficient capital to cover their risks and to meet their obligations also in adverse circumstances. The EU updated capital requirements for banks and investment firms in 2013 (CRD-IV package) and for insurances through the Solvency II directive (2009), amended by the Omnibus II directive (2014).

Although pension funds had no part in the financial crisis, they suffered from its effects. In an environment of crumbling stock markets and low interest rates, the value of pension fund assets dropped significantly, by 20% in 2008 alone, threatening their solvency and, hence, their ability to fulfil their commitments to scheme members.

The protection of scheme members was an important argument for the Commission to revise the existing pension fund directive. The template for the proposed solvency provisions as outlined in the Commission's Green Paper on pensions was provided by the then just adopted Solvency II directive (European Commission, 2010). Solvency II was informed by the Basel II rules of capital requirements for banks and has made the solvency rules for insurance, including life insurance, more stringent. In technical terms, Solvency II stipulated that (life) insurances should have enough capital that, with 99.5% confidence, the value of the assets would exceed the value of the liabilities over one year.

Hence, the Commission likened occupational pensions to insurances and aimed to impose the same relatively strict solvency standards on pension funds as they have on insurance companies. The strict standards were not only motivated by protecting the members of pension schemes, but also more generally to instill public trust in capital market pensions as part of the envisaged Capital Markets Union (CMU). The Commission wanted to decrease the reliance on bank-based finance, and strong(er) pension funds are an important element in that respect. In addition, the level playing field with other financial providers, in particular, life insurance companies, was also part of the argumentation (European Commission, 2010).

At the time of the proposal, the (accounting) rules calculating the solvency margin and the procedures to restore the solvency were determined nationally. For example, the Dutch regulator, the Dutch Central Bank, required a confidence level of only 97.5% (Koningkrijk der Nederlanden, 2006). An increase to 99.5% would have meant higher capital requirements, which would imply more contributions by sponsors (companies) and scheme members, increasing security to scheme members but negatively influencing companies' profits, scheme members' net salaries, and economic growth.

## The EU meets national vested interests

Strict and harmonized solvency margins in line with Solvency II became the core element of the Commission proposal to revise the IORP directive. Given the heterogeneity of national pension systems, it comes to no surprise that the proposed directive would have a differential impact on national systems, and the vested interests and stakes involved. Generally, member states with only a small occupational pension pillar, such as the welfare states of Southern, Central, and Eastern Europe, were only marginally affected. Also, occupational pension arrangements that are not capital funded at all, such as those financed through book reserves (as present in many German and Austrian schemes), fell outside the scope of this type of regulation. In addition, capital-funded pension arrangements where benefit levels purely depend on market performance, so-called defined contribution (DC) schemes, were not affected. Hence, the proposed regulation affects those arrangements that actually promise a certain level of benefits, so-called defined benefits (DB). Scheme members accrue entitlements, and the sponsors of the pension funds are responsible for a pre-defined benefit, typically calculated as a ratio of the final or average salary. These pension funds must have a sufficient solvency margin to make sure that the entitlements can be honoured. Countries with mature DB systems include the the UK, Ireland and to a very significant extent, the Netherlands, though the 2023 pension reform puts this country on a path towards a DC systems (Cumbo 2023). The proposed directive also indirectly affects a member state such as France because life insurance companies are the most prominent vehicles of occupational pensions in this member state. These companies fall under the Solvency II directive; hence, they must obey to relatively strict solvency standards and, therefore, might have a competitive disadvantage if laxer rules are adopted for pension funds.

While financial regulation often stays in the confines of venues populated by government and Commission officials and interest group representatives, the link to the welfare state makes pension fund regulation a potentially salient topic for the public. Hence, the Commission's ideas occasionally received media attention in the most affected member states, and in a particularly negative way. Already the announcement in the Commission's 2010 Green Paper on

Pensions that the solvency requirements for insurance companies would be a good starting point for discussing solvency requirements for pensions led to media outcries. The British tabloid and Eurosceptic Daily Mail ran two stories. One had the headline, 'EU 'puts final nail in coffin' of our gold-plated pensions', arguing that the proposals would increase the costs of running defined benefit schemes by up to 90% (Grover, 2010).

As a next step in the policy process, the European Commission tasked the relevant financial regulator, the European Insurance and Pension Authority (EIOPA), with providing advice, who in turn set out two rounds of consultation with interest groups. The strong mobilization of interest groups skeptical of, if not outright opposing, a harmonized approach to solvency requirements was evident from the beginning (EIOPA, 2011; 2012). The consultation was dominated by interest groups from member states that have mature defined benefit schemes. Looking at the second, more comprehensive consultation, 94 of the 138 contributions by interest groups that have origins in a specific country rather than at the EU level stemmed from just three of the then 27 member states, Germany, the UK, and the Netherlands. Within these countries, those groups mobilized that have a strong vested interests in keeping their national systems.

### Pension funds

Pension funds and their sponsors and scheme members were the dominant actors. The mobilization pattern neatly reflected the nature of the existing national arrangements. As occupational pensions in the UK are typically organized on the company level, not only the pension funds (i.e., trustees) were well represented, but also many large companies who sponsor these funds, including, for instance, British Petrol, British Telecom, and Tesco. The mobilization pattern of Dutch interest groups largely reflected the dominance of sector-wide schemes and the co-administration of employer organizations and employees' organizations. The sector-wide pension funds were well represented through their federation and three important sector-wide schemes. The major Dutch bipartite corporatist forum (Stichting van der Arbeid) submitted a contribution, as did the Dutch trade union federation and no less than six trade unions, together covering almost all Dutch trade union members.

It is interesting to note that quite some contributions came from Germany. Although the pension funds sector is relatively small, many large German companies do have capital-funded defined benefit systems. The two major national associations for occupational pensions took part. Besides that, the peak association of German employers (BDA) wrote a contribution as well as the federal employer association of the chemical sector and the metal and electrical engineering industry. In addition, large employers were also well represented on the company level, with entries by BASF, Bayer, Bosch, Deutsche Post, MAN, RWE, and Siemens. For some companies, the associated company pension funds wrote contributions as well.

The pension funds, their sponsors (employers), and the organizations representing the scheme members (trade unions) were all very skeptical about the need for a new directive. Regardless of the member state they came from, they stressed the unique character of occupational pensions as social rather than financial institutions, emphasizing in this context the unique set up, such as the sponsor-trustee relation (e.g., UK) and the involvement of the social partners (e.g., NL), and emphasized the cross-national diversity sustained by its links to national social and labor law, which, according to them, limits harmonization. While being opposed to harmonization in general, they also strongly objected to follow the lead of Solvency II, since, according to them, occupational pensions are too different from life insurance products (e.g., aba in EIOPA, 2011: 13).

## The insurance industry

Insurance companies compete with pension funds as they also provide occupational pensions as well as individual (third-pillar) retirement saving products. As stated above, insurance companies are an important vehicle for occupational pensions in France, and French mobilization patterns reflected this. With two associations of insurance companies and six individual companies, the degree of mobilization of the French insurance sector almost equaled the mobilization of the insurance sector of all other European member states combined. However, compared to the pension fund interests, the insurance sector was much less represented.

As the insurance industry must comply with relatively strict solvency requirements established by the Solvency II directive, this sector sought a system for pension funds that was a close as possible to the Solvency II regime to create a level playing field and to allow insurance companies to play a larger role in the pensions market. Accordingly, they framed an occupational pension product as just another financial product and the organization offering it as just another financial institution. For instance, the European peak association of the national insurance industry associations (CEA) 'strongly supports the application of the "same risks, same rules, same capital" principle to all financial institutions providing occupational pension products' and argued that 'Solvency II should serve as a benchmark for the regulatory treatment of all financial institutions offering occupational pension products, including pension funds' (EIOPA, 2011: 34). The Pan-European Insurance Forum (PEIF), which is comprised of the CEOs of major European insurance companies, also stressed the similarities between different providers and emphasized that the same rules should apply 'to prevent the opportunity of regulatory arbitrage' (EIOPA, 2011: 65-66).

### Other financial services

In addition to pension funds and insurance companies, investment and asset management firms were also present. Rather than seeing pension funds as competitors that should be subject to strict regulation (as the insurance industry argued), the asset management firms shared the pension funds interest in preventing strong solvency requirements. BlackRock, the world's largest asset management firm, argued that 'the proposed measures do not take into account the different mechanisms that already exist in a number of Member States', that the 'administrative burden and financial costs would also impact significantly investment performance', and that 'the application of solvency II to pension funds would discourage pension schemes to invest in equities making it harder for European companies to raise capital' (EIOPA, 2012a: 69-70).

This position reflects the economic relationship between both industries. As pension funds have matured over the last decades, they increasingly search for relatively more risky investments to secure the high returns on their investments needed to match their liabilities. For doing so, they increasingly rely on the specialized expertise of the asset management industry (Engelen, 2003).

## Dead on arrival

The consultations demonstrated a considerable opposition by most interest groups to the Commission's plan to harmonize the solvency requirements for pension funds. However, in its advice to the Commission, EIOPA stuck to its idea. It kept the philosophy of Solvency II but proposed a new method, the Holistic Balance Sheet, which, in the view of EIOPA, would allow to take the specific character of pension funds and the national diversity into account (EIOPA, 2012b). In the 2012 Commission's white paper entitled 'Adequate, Safe and Sustainable Pensions', published just one day after EIOPA's advice, the Commission sided with EIOPA and announced that it would present a legislative proposal for a revised IORP directive and explicitly stated the aim to 'maintain a level playing field with Solvency II …' (European Commission 2012: 17).

This insistence by the Commission did not go unnoticed by national media. The widely-read German tabloid Bild wrote, 'Eurokraten fordern mehr Eigenkapital – bis zu 45 Milliarden Zusatzkosten. Machen EU-Pläne deutsche Betriebs-Renten platt?' (Martens, 2012). Representatives of pension funds and their sponsors were also not pleased with this decision. Some particularly powerful actors resorted to outside lobbying. The chair of the German Employer Association of the Chemicals Industry, for example, wrote an op-ed for Bild entitled 'Stoppt den Angriff der EU auf unsere Betriebsrenten!' (Voscherau, 2012). The British tabloid and Eurosceptic Daily Mail ran a number of articles in which representatives of British pension funds were quoted with harsh critique of the Commission's plans.

The impact of the Commission's ideas for solvency standards became very concrete and specific in the quantitative impact study (QIS) that EIOPA carried out in 2013. QIS are obligatory prior to legislative proposals in the context of the EUs 'Better Regulation' framework. The QIS for the Commission's holistic balance sheet approach revealed serious underfunding of DB schemes in Ireland, The Netherlands, and the UK. In other words, other things being equal, if this approach would be included in the directive, then pension schemes in many member states would have to either increase contributions (by companies and/or employees) or reduce benefits to the extent possible in DB systems to regain solvency. Applied to the UK, while its defined benefit system was £300bn short of capital according to the British regulator's calculations, the HBS approach would, in a worst-case scenario, result in a shortage of £450bn (IPE, 2013a). This is about £12,500 more per person who accrues (or has accrued) entitlements in the system or draws a pension out of it. The results of the impact assessment were greeted by the Daily Mail with the headline 'Brussels red tape would blow a £150bn hole in UK pension funds' (Salmon, 2013).

The preferences of the member state governments of countries that run large DB occupational pension systems were aligned with those of their pension funds. This coalition of member state governments consisted of the British, Belgian, German, Irish, and Dutch governments and were close to convincing another member state to oppose solvency requirements (IPE, 2013b). If such a proposal would have been tabled by the Commission, these countries would have been able to form a blocking minority in the Council.

Considering the opposition of these member state governments, powerful domestic vested interests, and the potential of public politicization through unfavorable media coverage, the Commission decided to not include provisions for pension fund solvency in the official proposal for the directive published in 2013. At the same time, the Commission still wanted to do at least something 'to leave a legacy' (IPE, 2013b) and, hence, focused on two other elements: pension fund governance and transparency issues. In a press release, the UK minister for pensions, Walsh, welcomed the decision to drop solvency requirements and stated rather undiplomatically that he hoped that the Commissioner might 'eventually abandon his damaging and reckless plan altogether' (UK Department of Work and Pensions, 2013).

The IORP II directive was finally agreed on in 2016, carefully delaying the official confirmation until a week after the British membership referendum (IPE, 2016). Solvency requirements have not been reintroduced during the legislative process. Several attempts by the Commission to introduce solvency requirements 'through the back door' by including provisions that would task the Commission (and *de facto* EIOPA) with developing those on the basis of delegated acts were met with fierce opposition by governments and interest groups (IPE, 2014). Member states were so wary of EU involvement that the IORP II directive became the only financial service directive in this period without any delegated acts.

## Conclusion

This contribution laid out an encounter between national welfare states and the European Commission's attempt to harmonize regulation affecting some of those welfare states. It demonstrates that national heterogeneity translates into a differential potential impact of EU harmonization on national welfare systems. Domestic vested interests most affected are mobilized as result and forcefully defend their positions. Member state governments side with their domestic interest groups, and the link of financial regulatory issues to welfare issues make them potentially publicly salient. This combined force has been a formidable obstacle to EU-wide harmonization, at least in this case.

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