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Pension funds / Insurance companies

The purpose of this paper, presented by several Member States to the Working Party on Tax Questions (Indirect Taxation), is to allow for an integrated technical exploration of issues that need to be considered when designing a FTT. The paper is based on individual contributions from Member States and, thus, it does not reflect, in any way, the position of any Member State or group of Member States. The document also suggests a number of questions, that the Presidency could put forward in the meeting of the WPTQ.

The intent of this document is to provide a neutral and objective view on different possibilities available to avoid negative impacts of a FTT on retirement schemes.

A. Pension funds

1. Definition

As provided for in Article 2.1 (8), point (f) of the Commission FTT proposal financial institutions include "a pension fund or an institution for occupational retirement provision as defined in Article 6(a) of Directive 2003/41/EC of the European Parliament and of the Council, an investment manager of such fund or institution".

For a definition of institutions for occupational retirement provision reference is thus made in particular to Art 6(a) of Directive 2003/41/EC on activities and supervision of institutions for occupational retirement provision (IORP Directive). On 27 March 2014 the Commission proposed a recast of the IORP Directive but without impact on the definition. The Council reached a general approach in December 2014 and the European Parliament is expected to adopt a report in November this year.

In the IORP Directive (occupational) pension funds are defined as follows:

"Article 6
Definitions
For the purposes of this Directive:
(a) 'institution for occupational retirement provision', or 'institution', means an institution, irrespective of its legal form, operating on a funded basis, established separately from any sponsoring undertaking or trade for the purpose of providing retirement benefits in the context of an occupational activity on the basis of an agreement or a contract agreed:

–individually or collectively between the employer(s) and the employee(s) or their respective representatives, or
–with self-employed persons, in compliance with the legislation of the home and host Member States, and which carries out activities directly arising therefrom;"

Occupational pensions, which include an employer contribution, are known as the "second pillar" of pension systems, the "first pillar" being state-based social security pensions, and the "third pillar" being non-compulsory but typically Government-sponsored private pension savings by individuals[1].

In the European Economic Area (EEA) Pillar 3 pension products are primarily offered by insurance undertakings or by investment funds under national law. It is to be noted in this context that the European Insurance and Occupational Pensions Authority (EIOPA) on 3 July 2015 launched a Consultation Paper on the creation of a standardised Pan-European Personal Pension product (PEPP)[2].

These pillar 3 pension funds are also included in Art. 2.1.(8) point (f) of the FTT proposal as it refers to the generic term "pension funds". As a matter of fact, the wording pension fund represents a "catch-all provision" and thus also includes other forms of funded pension provision systems. On the other hand, insurance and reinsurance undertakings that frequently also offer pension-like products are included in Art. 2.1.(8) point (d) of the FTT proposal and are now regulated (in the EEA) by the Solvency II Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance, applicable as of 1 January 2016.

Pension funds (autonomous) are defined as the pool of assets forming an independent legal entity that are bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. The plan/fund members have a legal or beneficial right or some other contractual claim against the assets of the pension fund. Pension funds take the form of either a special purpose entity with legal personality (such as a trust, foundation, or corporate entity) or a legally separated fund without legal personality managed by a dedicated provider (pension fund management company) or other financial institution on behalf of the plan/fund members.

The OECD[3] defines *occupational pension* plans, i.e. so-called "pillar 2 pension plans" as plans the access to which is linked to an employment or professional relationship between the plan member and the entity that establishes the plan (the plan sponsor). Occupational plans may be established by employers or groups thereof (e.g. industry associations) and labour or professional associations, jointly or separately. The plan may be administered directly by the plan sponsor or by an independent entity (a pension fund or a financial institution acting as pension provider). In the latter case, the plan sponsor may still have oversight responsibilities over the operation of the plan.

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[1] European Commission - PRESS RELEASES - Press release - Revision of the Occupational Pension Funds Directive – frequently asked questions.

[2] https://eiopa.europa.eu/Publications/Consultations/EIOPA-CP-15-006-Consultation-paper-Standardised-Pan-European-Personal-Pension-product.pdf (see graph 1)

[3] Pension Markets in Focus (table 6), 2014, OECD: http://www.oecd.org/daf/fin/private-pensions/Pension-Markets-in-Focus-2014.pdf

Personal pension plans, i.e. so-called “pillar 3 pension plans” are defined by the OECD as plans the access to which does not have to be linked to an employment relationship. The plans are established and administered directly by a pension fund or a financial institution acting as pension provider without any intervention of employers. Individuals independently purchase and select material aspects of the arrangements. The employer may nonetheless make contributions to personal pension plans. So do typically those Member States that aim at financially promoting such non-compulsory but fully-funded pension plans (products). Some personal plans may have restricted membership.

This paper will only deal with pillar 2 and 3 pension funds.

2. Some figures[4]

When assessing the economic importance of pillar 2 and pillar 3 pension plans one might want to analyse both the asset structure and the investment strategy of those funds, as they typically differ significantly amongst suppliers and products and as these two parameters largely determine the potential burden national FTTs could exert on the relative and absolute performance of different actors / products.

Assets – volumes and portfolio composition

Assets accumulated by the main *institutional investors* in the OECD, including investment funds, insurance companies and pension funds, grew in 2013.

Institutional investors totalled USD 92.6 trillion in 2013, with USD 34.9 trillion coming from investment funds, USD 26.1 trillion from insurance companies, USD 24.7 trillion from pension funds, USD 5.1 trillion from public pension reserve funds and USD 1.8 trillion from other investors. In 2013, pension funds confirmed their growing prominence among institutional investors, with a share of 26.7% in terms of total assets held by institutional investors. At the end of 2013, all private pension assets, including both occupational (workplace-related) and personal arrangements, were valued at USD 36 trillion.

Pension funds remained the main financing vehicle for private pension plans, with USD 24.7 trillion of assets under management representing 68% of the total private pension assets. Bank or investment companies managed funds or other entities accounted for one fifth of the market with USD 7.1 trillion, followed by insurance companies having USD 4.2 trillion (12% of private pension assets) in the form of pension insurance contracts .

Among the twenty-eight countries for which information was available, assets in occupational pension plans offered through autonomous pension funds remained predominant in 2013 in nineteen OECD countries compared to personal pension plans.

[4] Ibidem, respectively p. 9, 10, 11, 13 and 20.

The relative importance of (funded) pension funds is very different across the European Union. It is the highest in the Netherlands (166,3% of its GDP or around EUR 1002 bn. in 2013) followed by the UK (100,7% of its GDP), Ireland (55,8%), Finland (50,8%) and Denmark (42,8%) In countries like Estonia, Sweden, Portugal and Spain it reaches around 9% of GDP, whereas in Germany, Austria, Italy, Belgium and Slovenia it is in the range of 4 to 6% of GDP. Finally, in France and Greece it is less than 0,5% of GDP.

Pension funds generally have a diversified portfolio of assets and invest their money in financial instruments, mainly bonds, but also in cash and currencies, deposits, real estate, loans, gold and silver.

In most OECD countries for which 2013 asset allocation figures were available, bonds and equities remained the two most important asset classes in which pension funds were investing in 2013.Twenty-one OECD countries invested more than 70% of their portfolio into these two asset classes at the end of 2013. The United States was the country where pension funds allocated the biggest share of their portfolios in shares in 2013, followed by Australia, Chile and Poland. In these four countries, pension funds' equity allocations were above the OECD weighted average of 40.3% of total investments.

In half of the OECD countries, pension funds invested more than 50% of their assets in bills and bonds in 2013. The proportion of bills and bonds in pension fund portfolios was over 80% in two countries, namely the Czech Republic (86.5%) and Hungary (83.1%). Bills and bonds were more than 50% of the portfolio in 2013 in a further fifteen OECD countries: Chile, Denmark, Germany, Greece, Iceland, Israel, Luxembourg, Mexico, Norway, Poland, Slovak Republic, Slovenia, Spain, Sweden and Turkey.

In Belgium the pension funds' investment in financial instruments is as follows: Bonds: 46 %;
Shares: 32 %; Real Estate: 5 %; Cash: 3 %; Others (including derivatives): 12 %. As regard the derivatives, the largest part is invested in currency and interest rates derivatives. Equity, credit and commodity derivatives are also used but in a limited proportion.

Besides, especially in smaller countries, a large part of the investment is made in non-domestic products, ranging from shares of 40 % (NL) to shares of 75 % (EE)5.

Turnover of assets and risk and performance management strategies

For the importance of their financial transactions made it has to be noted that pension funds approximately account for 10 % of turnover on secondary markets in securities, 1 % of turnover in other transactions (in units/shares of UCITS/AIF share based repos) and <0,1 % of turnover in derivatives.

[5] OECD Pension market in progress 2014.

In order to manage risk as prudent investors, many pension funds opt also for a strategic asset allocation policy by means of which they periodically rebalance their portfolios, either through activities on primary or on secondary markets or a combination thereof.

3. Treatment of pension funds in the Commission's proposal

(a) Option 1 (Commission's proposal) and its effects

Taxable financial transactions made by (liable) pension funds as a consequence of their asset management are proposed by the Commission to be taxed at each side of the transaction, at least if at the other side of a transaction a (taxable) financial institution is involved (i.e. acting as a party to the transaction, either for its own account or for the account of another person, or is acting in the name of a party to the transaction). The taxable pension fund (meaning deemed to be established in a participating Member State) is primary liable to pay the proposed FTT at its side of the transaction, whereas the other taxable financial institution is primary liable to pay the proposed FTT on its side. The actual FTT charge taken by the pension fund would depend on the contractual relationships and market circumstances.

The impact of the proposed FTT on pension funds will depend on both the asset allocation and on the investment strategy of the individual funds6.

First, most financial transactions relating to the assets of pension funds will not be taxable:

- Primary market transactions carried out in shares and bonds are excluded from the taxation scope.
- Primary market transactions in shares and units in collective investment undertakings are also excluded; moreover, the extent of primary market transactions in this context is still under discussion.
- Secondary market transactions relating to bonds and other debt instruments will most probably not constitute taxable transactions either, at least not those relating to government debt. These instruments represent a significant part of the assets of pension funds.
- Secondary market transactions relating to shares not issued in a participating Member State might be excluded, as well as unlisted shares or shares of low capitalized companies.
- Repurchase agreements and reverse repurchase agreements will most probably not be taxed. According to information from the Dutch pension fund industry, it seems that around 50% of the estimated tax bill would stem from the tax on such agreements and 37% from taxing investment in equities and bonds (Impact Assessment (second) FTT proposal, p.38)

[6] See Impact Assessment accompanying the (second) FTT proposal, p 36-38; http://ec.europa.eu/taxation_customs/resources/documents/taxation/swd_2013_28_en.pdf
and FTT – additional analysis of impacts and further clarification of practical functioning. Technical fiche on: Pension funds in the context of the FTT proposal, p. 39-49.

- Transactions relating to cash, currencies, deposits, real estate, commodities (such as gold and silver) are not in the scope of the proposed FTT.
- Transactions in derivatives made by pension funds seem to be relatively limited; moreover, most probably not all derivatives' transactions will be subject to FTT (in particular those directly relating to "government debt").

All in all, it could be that only a very limited part of transactions made by pension funds would be subject to FTT also depending on the decisions on the final FTT design.

Obviously, the more frequent taxable transactions are carried out by the pension fund the higher the FTT burden could be, and the impact will depend on whether they pursue more of a "buy and hold" strategy, which also requires less risk hedging or an "activist management" strategy that also requires more risk hedging and typically comes with much higher administration and management costs. The proposed FTT could "encourage" a passive "buy and hold strategy" and to act as an institutional investor on primary markets, while it would "discourage" an active "beat the market" strategy. This is illustrated in the following box.

"Buy and hold" versus "active management" strategies

Example 1:

A Belgian pension fund has invested its assets of EUR 10 bn. the following way: 30% in shares, 5% in real-estate funds, 50% in bills and bonds, and 15% in other (such as cash or deposits or real estate). The Fund follows a passive "buy and hold" strategy, i.e. it shadows the relevant indices for shares, it purchases bills and bonds when they are issued and holds them until maturity. Pay-outs (to pensioners) and pay-ins (from contributors) are balanced. ***Due to changes in the composition of the stock-market indices, it has to turn over (buy and sell) on average 10% of its shares and real-estate funds each year. None of the new purchases are purchases on primary markets.***

- The turning over of the shares and real-estate funds on secondary markets carries Belgian FTT. Investing as "institutional investor" on primary markets carries no Belgian FTT.

- The pension fund has to pay EUR 700.000 Belgian FTT annually for the turning over of 10% of its shares and real estate funds in case Belgium applied the minimum tax rates of 0.1%. This sum corresponds to 0.007% of all its assets.

- If these assets represented 20 years of savings / asset accumulation the annual figure of 0.007% of total assets translated into 0.14% of annual savings, i.e. a pensioner who has invested EUR 100/month would receive returns (after FTT) as if he had invested only EUR 99.86/month in case the fund managers passed these costs on fully to the pensioners and not to the borrowers of capital.

<u>Example 2:</u>

Same asset structure etc. as in the previous case, but this time the pension fund follows an "active" strategy, and ***turns over all its assets*** *except cash and deposits and other (such as real estate), i.e. 85%* ***twice a year****. It does <u>not</u> intervene on primary markets for bonds, bills and shares. Also, as it is more exposed to market volatility, it is assumed to* ***hedge all these assets four times a year against diverse risks****.*

<u>Case 1: the trading in (government) bonds and bills on secodary markets is taxable:</u>

- The turning over of assets carries FTT in case transactions in these assets fell in the scope of the directive, so do the hedging operations; thus transactions in 85% of all assets are taxable. Investing as "institutional investor" on primary markets carries no Belgian FTT.
- The pension fund has to pay EUR 36 mn. Belgian FTT annually for the turning over of its assets. Annual FTT for hedging would amount to EUR 3.6 mn. This corresponds in total to 0.396% of its assets.
- If these assets represented 20 years of savings / asset accumulation the annual figure of 0.396% of total assets translated into 7.92 % of annual savings, i.e. a pensioner who has invested EUR 100/month in such an activist fund would receive returns (after FTT) as if he had invested only EUR 92.08/month in case the fund managers passed these costs on fully to the pensioners and not to the borrowers of capital.

<u>Case 2: The trading on (Government) bonds and bills on secondary markets is **not** taxable:</u>

- In this case, transactions in (government) bonds and bills on secondary markets would not carry Belgian FTT.
- Thus, the pension fund would in this case have to pay EUR 14 mn. Belgian FTT (instead of EUR 36 mn) on its transactions in its assets. Annual FTT for hedging is assumed to remain unchanged, i.e. amount to EUR 3.6 mn. This corresponds in total to 0.176% of total assets.
- If these assets represented 20 years of savings / asset accumulation the annual figure of 0.176% of total assets translated into 3.52 % of annual savings, i.e. a pensioner who has invested EUR 100/month in such an activist fund would receive returns (after FTT) as if he had invested only EUR 96.48/month in case the fund managers passed these costs on fully to the pensioners and not to the borrowers of capital.

Thus, the investment strategy both with respect to the portfolio structure and the churning of financial assets has a very important influence on the impact of the FTT. Therefore, the FTT itself could influence the investment strategy itself, including e.g. the emphasis given on investing as an institutional investor in government bonds and bills on primary markets as this would not trigger taxable transactions, while buying and selling shares (and bonds) on secondary markets or investing in derivatives such as structured products would be taxable events.

Not taxing the issue of shares and units in UCITS and AIF together with not taxing primary markets for securities already covers a significant part of the financial market transactions typically undertaken by pillar II and pillar III pension funds, notably by the more "passive" ones. This, in combination with the assumed substantial fall in the turnover of derivatives contracts should effectively ring-fence these pension funds from the direct effects of the FTT.

The same mechanisms could be at work as regards the indirect effects, i.e. pension funds investing in financial institutions and funds (of funds) who themselves are then active on financial markets. The FTT could favour investments in more passive investment vehicles. Also, due to the assumption of reduced churning and hedging by these vehicles themselves the latter's substantial management fees could have a potential for being reduced. The partial crowding out of "spread internalisers" or high frequency traders could also help both pension funds themselves and the vehicles in which they invest to get better deals on financial markets.

In sum, the impact of the common system of FTT as proposed by the Commission can be expected to have a rather limited impact on the more “passive” pillar II and pillar III pension funds and their beneficiaries and that aim at following the trend instead of beating it. This effect would become even smaller in case the trading in certain products, such as (government) bonds and bills remained out of scope of the directive or in case tax rates were to be reduced even further.

(b) Options 2 and 3 (exclusions)

Despite these limited effects, notably on pension funds following a more conservative “buy and hold” strategy, it could be argued that the old-age provision is an important issue and therefore pension funds might not be liable to the tax at all, and this independent of the investment strategy pursued by individual funds. This idea could avoid an increase of social costs (even if the FTT impact would be limited) that could be borne by the pension beneficiaries in terms of higher contributions or reduced benefits.

If further exclusions of pension funds from the scope of the FTT were to be considered, two options could be possible:

- Either, excluding from the scope only the side of the pension fund of a (taxable) transaction (unilateral exclusion; **option 2**) or
- entirely excluding transactions involving a pillar II or pillar III pension fund (i.e. both sides, bilateral exclusion; option 3) i

Option 2 would require deletion of pension funds from Art. 2.1(8) point (f) and their inclusion in Art.3.2 of the FTT proposal, whereas option 3 would require deletion from Art. 2.1(8) point (f) and inclusion of their transactions in Art.3.4.

In case one wanted to exclude transactions of and / or involving pension funds, it would need to be discussed whether the above exclusions might be granted to all pillar II and pillar III pension funds (and their vehicles) or only to an institution for occupational retirement provision as defined in Article 6(a) of Directive 2003/41/EC of the European Parliament and of the Council, and investment manager of such fund or institution.

Revenue implications would largely be determined by the scope and coverage of the exemption. Putting out of scope transactions of pension funds would notably be beneficial for those funds that pursue an activist strategy with a lot of churning of their assets and investing in leveraged synthetic ETFs etc. while pension funds pursuing a conservative strategy and mainly acting as "institutional investor" would hardly benefit from this privileged treatment.

(c) Option 4(compensation of retail investors)

It can be also argued that stabilizing or increasing old-age income with the help of fully-funded occupational or private pension schemes should be considered as merit products to be privileged typically also provide fiscal incentives to incite employees or private households to invest in such pension schemes. This is e.g. done by providing cash subsidies (up to a certain threshold) as a proportion of individual (monthly) savings or by a generous treatment in personal income tax rules.
Thus, instead of exempting the transactions of pillar II and pillar III pension schemes Member States concerned by the impact of an FTT on old-age pensions could also consider not exempting the schemes or funds but increasing the fiscal incentives for saving in first place. This could e.g. be done by increasing for each EUR 100/month of saving the premium / fiscal incentive by XX eurocent.

Questions to Commission and delegations:

What is the view of delegates on the different options presented above?

B. Insurance companies and other pension scheme arrangements

Despite the specifics of pension funds, there are equivalent products available on the markets, such as various types of bonds, collective investment funds and life insurance contracts (unit-linked insurance plans) and there are others and different entities operating pension scheme arrangements of which the primary purpose is to provide benefits upon retirement. Usually this is done in the form of payments for life, but also as payments made for a temporary period or as a lump sum. These arrangements typically minimise their allocation to cash in order to maximise the efficiency and the return for their policy holders. Hence, a tax burden from FTT would also decrease the income or the ability to manage appropriately these funds.

As provided for by Article 2 paragraph 8 (d) financial institutions include "an insurance and reinsurance undertaking as defined in Article 13 of Directive 2009/138/EC of the European Parliament and the Council". As a consequence of this definition, FTT covers the transactions related to the asset management of insurance and reinsurance undertakings, typically at both sides of the transaction.
In several Member States, life insurance companies account for a significant part of the pillar III pension schemes, reaching up to a market share of 90% in some countries.
Taking into consideration the role of insurance undertaking in non-compulsory and non-occupational private pension provision, it could be appropriate to make considerations similar to the ones made for pension funds, although it should be noted that there is no specific regulation of this matter comparable to the regulation of pension plans.

0According to the Belgian insurance sector an insurance company has to manage its activities in life insurance separately from those in non-life insurance. It also means a separate management of the assets portfolio which is also addressed in the REGULATION (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR).[7] The intention of taking pension scheme arrangement into consideration under EMIR is to exempt these arrangements from the clearing obligations of derivatives contracts which lead to significant additional costs.

According to Article 2 No. 10 EMIR pension scheme arrangement means

(a) institutions for occupational retirement provision within the meaning of Article 6(a) of Directive 2003/41/EC, including any authorised entity responsible for managing such an institution and acting on its behalf as referred to in Article 2(1) of that Directive as well as any legal entity set up for the purpose of investment of such institutions, acting solely and exclusively in their interest;

(b) occupational retirement provision businesses of institutions referred to in Article 3 of Directive 2003/41/EC;

(c) occupational retirement provision businesses of life insurance undertakings covered by Directive 2002/83/EC, provided that all assets and liabilities corresponding to the business are ring-fenced, managed and organised separately from the other activities of the insurance undertaking, without any possibility of transfer;

(d) any other authorised and supervised entities, or arrangements, operating on a national basis, provided that:

(i) they are recognised under national law; and

(ii) their primary purpose is to provide retirement benefits;

[7] REGULATION (EU) No 648/2012 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

According to EMIR legislative procedure it is important to ensure that only appropriate entities and arrangements receive special treatment as well as to take into account the diversity of pension systems across the Union, while also to provide for a level playing field for all pension scheme arrangements. Therefore, the temporary derogation should only apply to arrangements which fulfill the mentioned criteria.[8]

Questions to Commission and delegations:
Do Member States believe that the guidelines in the EMIR regulation for a special treatment of old-age systems could provide valid ideas for the FTT Directive?
Do Member States believe that EMIR provides valid ideas of how to distinguish and separate appropriate pension scheme arrangements?
Are there any other regulations which should be taken into consideration?

[8] REGULATION (EU) No 648/2012 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 4 July 2012 on OTC derivatives, central counterparties and trade repositories: legislative procedure.
Recital (27): *It is important to ensure that only appropriate entities and arrangements receive special treatment as well as to take into account the diversity of pension systems across the Union, while also to provide for a level playing field for all pension scheme arrangements. Therefore, the temporary derogation should apply to institutions for occupational retirement provision registered in accordance with Directive 2003/41/EC, including any authorised entity responsible for managing such an institution and acting on its behalf as referred to in Article 2(1) of that Directive as well as any legal entity set up for the purpose of investment by such institutions, acting solely and exclusively in their interest, and to occupational retirement provision businesses of institutions referred to in Article 3 of Directive 2003/41/EC.*
Recital (28) *The temporary derogation should also apply to occupational retirement provision businesses of life insurance undertakings provided that all corresponding assets and liabilities are ring-fenced, managed and organised separately, without any possibility of transfer. It should also apply to any other authorised and supervised entities operating on a national basis only or arrangements that are provided mainly in the territory of one Member State, only if both of them are recognised by national law and their primary purpose is to provide benefits upon retirement. The entities and arrangements referred to in this recital should be subject to the decision of the relevant competent authority and in order to ensure consistency, remove possible misalignments and avoid any abuse, the opinion of ESMA, after consulting EIOPA. This could include entities and arrangements that are not necessarily linked to an employer pension programme but still have the primary purpose of providing income at retirement, either on a compulsory or on a voluntary basis. Examples could include legal entities operating pension schemes on a funded basis under national law, provided that they invest in accordance with the 'prudent person' principle, and pension arrangements taken up by individuals directly, which may also be provided by life insurers. The exemption in the case of pension arrangements taken up by individuals directly should not cover OTC derivative contracts relating to other life insurance products of the insurer which do not have the primary purpose of providing an income at retirement. Further examples might be retirement provision businesses of insurance undertakings covered by Directive 2002/83/EC, provided that all assets corresponding to the businesses are included in a special register in accordance with the Annex to Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings (1) as well as occupational retirement provision arrangements of insurance undertakings based on collective bargaining agreements. Institutions established for the purpose of providing compensation to members of pension scheme arrangements in the case of a default should also be treated as a pension scheme for the purpose of this Regulation.*