



European pensions:
Reform trends and growth opportunities.

1. Pension reform trends.

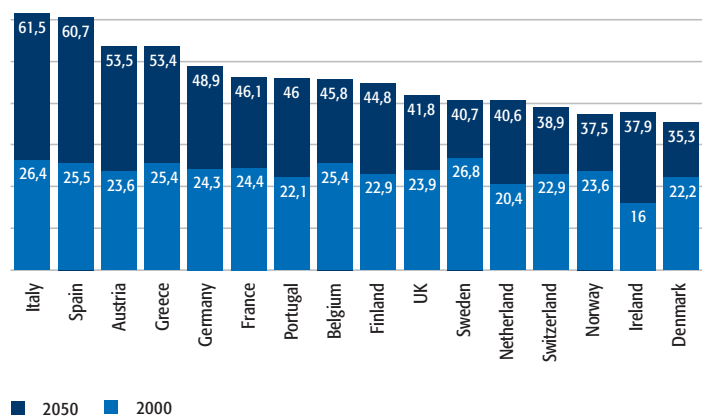
In most European countries, combating the effects of demographic change are very high on the political agenda. The impact of rising life expectancy and falling birth rates on the population's age structure is increasing.

While the number of elderly people continues to rise, the number of the young and employed will continue to fall (see “Old-age dependency ratios in Europe” chart). The repercussions of this change are many and diverse, and will be felt throughout almost all European States. The hardest hit by this change are the State, or first pillar, pension systems as their expenditure will rise due to the growing number of pensioners, so increasing the burden on public finances. (“Pension payments as a proportion of GDP”, source: EPC) However, public debt levels within the European Monetary Union are capped by the Stability and Growth Pact, making it almost impossible for countries to fund pensions by increasing national debt. This situation has prompted almost every European country to introduce pension reform, while at the same time attempting to reconcile the conflicting requirements of a supportable pension system whilst delivering an appropriate level of pension benefit.

The European Commission is predicting a 30% rise of pension payments in percent of GDP. This would indicate a rise from today's 10.5% to over 13% by 2030. These calculations take into account the reforms already introduced in many countries, many of which have taken insufficient measures to make the difference needed. Most national budgets and State pension systems will be unable to shoulder the burden of this increase, and higher GDP growth would not necessarily provide any noticeable relief either. This is why further reforms are likely to be necessary in order to slow the rise in pension spending. However politicians are unhappy about administering this bitter pill because it means interfering with living standards - sooner or later they may have no choice. Although each country's pension reform is different, they do have one thing in common: the goal of reduced pension benefits.

Demography: Old-age dependency ratio.

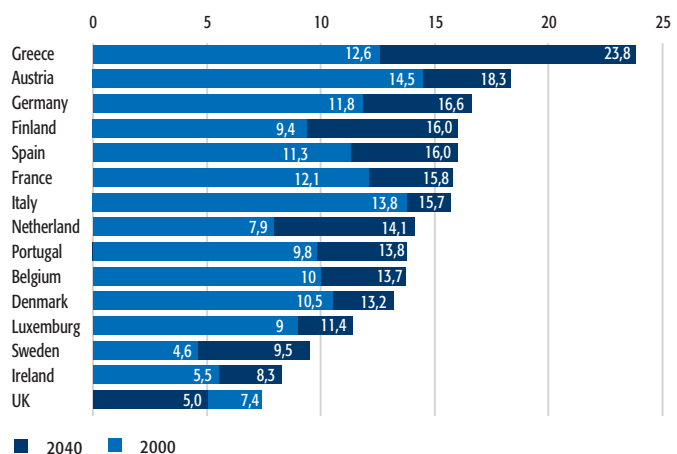
Ratio of 65 year-olds and older to 15 to 64 year-olds.



Source: Demographic forecast of EU Economic Policy Committee, 2001.

Pressure to reform 1st pillar pension systems.

Public pension expenditure as % of GDP.



Source: EU-Commission

1.2. Europe’s State pension systems.

1.2.1. Different types.

In principle, there are two different types of pension system: funded and pay-as-you-go (‘PAYG’). Under funded systems, capital accumulates during a person’s working life and when that person retires, is then paid out in the form of an annuity, together with interest and compound interest. In Europe, this type of system plays no significant role in State pension provision. ‘PAYG’ pension systems, on the other hand, collect receipts from general tax revenues or the employed and redistribute them straight back to pensioners in the same period. No capital fund is built up, apart from a small cushion to balance receipts and expenditure.

As mentioned, ‘PAYG’ systems can be financed either by general tax revenues or by contributions paid by the employed. Under pension systems financed by general taxation, a country usually pays pension benefits (which are often only a basic amount) to people who are nationals or residents of that country. This type of system is common in Scandinavian countries. Under pension systems financed by contributions, the level of benefits usually depends on a person’s employment history, so is earnings-related. Besides these ‘pure’ systems, there are also hybrids, where part of the expenditure is financed by contributions and part by taxation. A prominent example of this type of hybrid financing is the German pensions market.

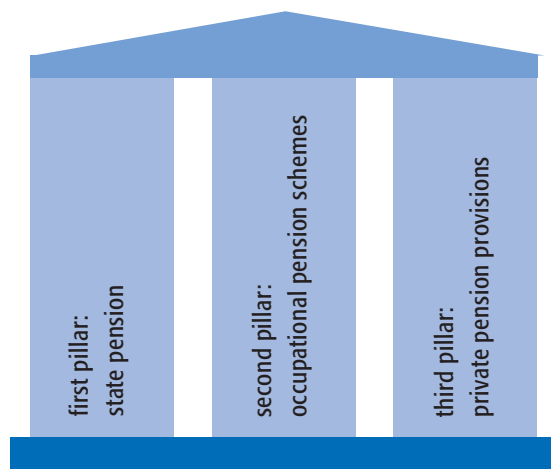
1.2.2. Methods of reform.

The purpose behind the reforms of the various ‘PAYG’ state pension systems is to soften the impact of demographic change. Since these ‘PAYG’ systems are based on the same design, the available methods of reforming them are, by and large, identical in all cases. On the income side are the people paying their contributions and tax, usually based on their earnings. The level of benefit is determined by the level of contributions and the

number of pensioners. As these are the only elements in the system that can be adjusted, financial gaps can only be plugged by either raising contributions or lowering benefits.

Feasible changes on the income side include channelling more tax into the pension system, setting higher contribution rates and extending the assessment basis. However, there are limits to these measures, particularly in systems financed purely by contributions, since they would create an additional burden on the people paying the contributions and therefore on labour costs. This, in turn, would have a negative impact on economic growth. The only alternative means available is to lower pension benefits. There would only need to be a small cut if, for example, the basis for measuring a person’s pension payments were changed from the average income of the last or best ten years to the average income of their entire working life. But the change would be more

The three pillars of pension.



extensive if, for example, pension indexation were linked to price growth instead of wage growth. An increase in the number of people making contributions would also reduce the financial burden, at least in the short term; in the long term, however, there would be more pensioners receiving benefits. Increasing the effective age of retirement would counteract this by lowering benefit payments. This could include tightening the criteria for early retirement or raising the legal retirement age. Raising the retirement age has a double benefit: it increases the number of people contributing, while at the same time lowering the number of people receiving benefits.

Another possibility is introducing a funded element into the State pension system. Increasing the level of pension savings should, as part of this, absorb the cut in the State pension and the associated loss of income that pensioners would feel in their pockets.

1.3. Europe's reform trends.

1.3.1. Reform basics.

In the European Union, the most common way in which the demographic problem is being redressed is by countries reducing first pillar benefits. Austria, Belgium, France, Germany, Ireland and the UK have already agreed proposals to lower – in some cases, by a significant amount – future pension levels. In Germany, as a consequence of the 'Riester reform', the replacement ratio will fall from its current 70% of average net earnings to 64% by 2030. Italy intends to lower its replacement ratio by just under 30% from its current 80%.

Second on the list of reform measures is extending the employment period by raising the effective age of retirement. Most countries are achieving this by making it more difficult to take early retirement,

by raising the effective age of retirement for women and/or adjusting the minimum number of contribution years required before a full pension can be drawn. Denmark is an exception to the rule, with its legal age of retirement having been lowered from 67 to 65 years. The legal age of retirement for men is 65 in most countries, apart from a few exceptions: in France, men can draw a full pension as young as 60, but Norwegian men have to wait until they are 67.

A further measure taken by some countries is to change the basis of pension indexation. France, Greece, Italy and the UK, pensions are increased in line with inflation, instead of wages. And there's a host of countries, such as Denmark, Germany and Sweden, that have added a funded element to their State pension systems. Germany, for example, has introduced special, State-sponsored pension products, whilst in Sweden a portion of the pension contribution is invested in funds chosen by the pension saver.

1.3.2. The pension landscape.

With the pace of demographic change, there will be a need for further European pension reforms in the future. Benefit reductions will be a major factor here. They will mean a drop in future living standards of the elderly compared with the level enjoyed by today's pensioners. The amount by which first pillar pension benefits – future or existing – reduce, will be reflected in a corresponding requirement for additional pension provision. This will create market potential for providers of private pension products. The extent to which occupational and individual pension provision will benefit from reductions in first pillar benefits will depend, to a large degree, on each country's tax regulations and history. It is ultimately a political question, with each country having its own, individual answer. The Netherlands, Switzerland and the UK have placed more importance on the role of occupational pension provision, and at an earlier stage, than other European countries.

We expect that most countries will concentrate on expanding the role of occupational pension provision, particularly because it is cheaper to implement and administer than private provision. In many cases this will take place with the involvement of social partners, with employers' associations and trade unions negotiating the methods within the framework of collective pay bargaining. The basis on which companies in the relevant sector sign up can be partly mandatory (as it is, for example, in the Netherlands) or partly optional (as is the case with MetallRente, the new pension

fund for the German metal and electrical industries). Likewise, there will probably be different combinations of employer and employee contributions. And even with models funded purely by employees, the employers are likely to function as disseminators. Nevertheless, individual provision will also be in greater demand, since increasing numbers of people are themselves taking charge of ensuring they have an income in old age. This trend should continue to benefit the life insurance sector in particular.

Reforms of state pension systems – overview and consequences.

Basic measures within the 1 st pillar	Consequence for future retiree	Countries which implemented these measures	Effect on future additional saving for old age provision (for protection of financial assets)
<ul style="list-style-type: none"> - Raising the entitlement age to early retirement - Raising the retirement age of women - Change of entitlement to a (full) pension, i.e. (minimum) contribution years 	Longer work life	A, B, D, F, IT, SP DK, IR, SF, CH, UK	
<ul style="list-style-type: none"> - Change of calculation method of retirement income ("best" income years of a certain period) - Change of adjustment method (price vs wage indexation). Reduction of pension in case of early retirement 	Benefit cuts	A (2000) B (1997) SF (nineties) F (1993) GR (1992, very first steps) IT (2002) PR (1993/99/2002) D (2002) SP (1997) UK (2001/2002)	A yes B yes SF yes F no, because of already high flows into Insurance products IT yes, incentives for 2nd pillar PR yes, changes for people with high income, pension level, participation rules for 1st pillar SP no, no awareness of the need UK yes, big benefit cut
<ul style="list-style-type: none"> - Change of system - Broadening the contributor base - "Reserve Fund" 		S (1999) DK (93/97), B, F (1999), NL (1998) PR (1989), SP(1997), S	S yes

Source: Allianz Group Economic Research

2. Consequences for market operators.

As the demand for privately organised funded pensions increases, so does the significance of institutional investors in continental European markets.

However, the big share price rises that were the order of the day in the second half of the 1990s are not expected in the foreseeable future. Like everyone else, asset managers and life insurers have to adapt to the new trend.

The financial services industry has to offer products with a balanced risk/return profile that can successfully optimise the long-term savings process. This requires good cost management, so highly efficient administration and services systems are becoming increasingly important.

However, financial services providers can only optimise the product range if the legal and tax conditions enable them to do so. In particular, it is up to governments to ensure a clearly structured legal framework and a sufficiently favourable tax environment for occupational and private pensions. The universal application of taxation according to the EET principle (contributions exempt, interest income exempt, pensions taxed) would be needed here.

Companies also need a clearly structured legal framework. If they want and need to offer stronger occupational pension systems, they have to be able to plan ahead with sufficient certainty. The issue of a single market for occupational pension products has long been on the European agenda (see appendix: Europe's path to a single market for pension products).

To date, employer-financed models have been at the heart of occupational pensions. As the population ages, and with it the workforce, occupational pension plans will become more important as an instrument of Human Resources' policy. This certainly applies to the EU market. Increasingly, employers are looking abroad as well as in the home market when recruiting skilled employees. Pension provision systems need to be geared towards this mobility among the workforce. The trend is clearly towards employee-financed occupational pensions. Deferred compensation models are becoming an increasingly important form of supplementary second pillar pension provision.

Europe's path to a single market for pension products.

The issue of a single market for occupational pension products has long been on the European agenda. However, companies offering pension products are currently the only significant group of financial services providers for whom there is still no “European passport”.

“Intense competition and the use of economies of scale enhance the product for customers”. So far, this statement only applies to the individual national markets for pension provision products in Europe.

Attempts by the European Commission to adopt a directive, at least covering the providers of occupational pensions, go back a long way. The Commission put forward its first proposal for a liberalisation of investment regulations in 1991. This was followed in 1997 by a green paper and in October 2000 the Commission presented its long-awaited proposal for a directive on occupational pensions (the “EU pension fund directive”). The draft highlights the importance of occupational pension institutions for all pension provision and for social security in the member states, outlining the need for occupational pension plans to achieve a high degree of security and efficiency. Its core elements are the free use of the European capital markets by means of a general transition to the Prudent Person Principle (with member states still able to apply quantitative investment criteria, subject to restrictions) and a level playing field for all competing provider groups. The directive is to apply to all occupational pension institutions that

- are legally separate from the sponsoring company;
- operate on a funded basis; and
- give the employee a legal right to occupational pension benefits.

In addition to pension funds, which are being introduced in more and more European countries, and similar vehicles like the German and Austrian “Pensionskasse”, life insurance companies with their occupational pension business may also fall within the scope of the directive.

In July 2001 the European parliament responded with the publication of the “Karas report”. Named after its author, the Austrian Euro MP Otmar Karas, the report called for numerous changes to the proposal. The main issue was stronger protection for the employee the report said that cover against longevity risk should be obligatory. According to the report, therefore, only fixed-annuity pension plans should be promoted, and lump-sum payouts at the beginning of the pension should only be allowed in certain exceptional cases. Protection against other biometric risks should also be offered to members of pension institutions. Employees could then decide whether or not to take out insurance against reduced earning capacity and survivor's insurance. The financial services provider would be obliged in any event to disclose the costs of the cover. The report also called for a minimum capital guarantee, requiring the capital available at the start of the pension to be at least equivalent to the sum of the contributions paid in.

The European Council has again rejected the changes requested by the parliament, but at the same time – probably influenced by the worldwide stock market downturn – placed significant

restrictions on the wide-ranging freedom of investment that had previously been proposed by all parties. The door is being opened to allow member states to maintain existing quantitative investment limits. The proposal for the EU pension fund directive is currently undergoing its second reading in the European Parliament. The parliament is insisting on more emphasis being placed on the aspect of protection for employees.

EU pension fund directive – sending out a signal, but of limited relevance to the market.

The adoption and implementation of the EU pension fund directive would be an important step towards a single market for pension products. It would finally send out a signal that the political will is there.

The arguments in favour of a single market for pension products are unquestionable:

- The lack of an institutional framework for EU-wide occupational pension systems is generating huge costs for multinationals and hindering the mobility of employees.
- Restricting pension funds to one, in some cases very small, national market is detrimental to efficiency. Economies of scale cannot be exploited. Given the importance that will have to be attached to occupational pensions in future, this lack of efficiency is no longer financially sustainable.

But even if the pension fund directive were to be swiftly implemented by the national governments – the earliest is usually three years after adoption by the European Commission – in practice, there would probably be little change for the time being because there are still major obstacles to a European pension fund. The current draft directive gives absolute priority to national regulations, both on

tax issues and on the question of protection against biometric risks, because both tax and social policy come under the authority of the national governments.

As far as the providers are concerned, if the guidelines were implemented it would be possible from a purely legal point of view to offer a European pension fund. An umbrella fund structure would be feasible, with at least one cover fund per country to take account of national practices and regulations. However, the product would be very complex. The remaining advantage over the current national vehicles would be that the investment process could be centralised – at least to some extent – and therefore more efficient. Luxembourg is already getting ready to act as a tax-efficient location for future pan-European pension funds.

The decision to sacrifice investment efficiency by maintaining detailed quantitative investment limits is hard to justify from the asset manager's point of view. Quantitative investment limits no longer mean security but compromise the efficiency of the investment process and therefore have an adverse effect on performance. Long-term investment regulations also need to be reshaped for institutions that take the form of life insurance companies. The Prudent Person Principle should be applied long-term. Pension assets are sufficiently secure if the asset liability management systems used are technically sound, of market-standard and regularly monitored. Asset liability management can ensure that the occupational pension system is always sufficiently funded to meet liabilities out of current pension payments. Minimum capital guarantees represent a fair distribution of risk between employee, employer and, if applicable, the financial services provider. They do not normally compromise investment efficiency.

3. European pension markets still an attractive growth market.

3.1. Outlook.

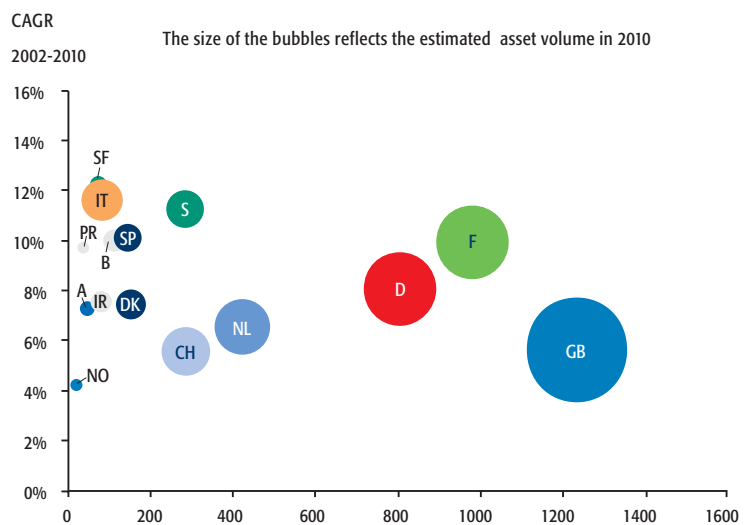
Even without any decisive stimuli from the EU, we expect the European pension markets to continue growing strongly. Overall, we anticipate average annual growth of 7.5% until 2010. The continuing decline in State pension benefits is making private provision increasingly essential. However, with the modest macroeconomic outlook extending into the mid term, employees' readiness and ability to make sufficient provision for themselves is being adversely affected. With real incomes stagnating, they can only increase pension provision at the expense of other forms of saving.

In addition, companies are currently rather reluctant to make their own contributions towards their employees' pension provisions, as the cost of occupational pension plans is turning into a growing burden. The performance of the stock markets in the last three years has significantly intensified this reluctance. Instead of making additional gains from the performance of their occupational plans, many companies are now having to pump in additional cash. And nobody currently thinks the trend will change in the near future. We expect the equity markets to rise by an average of 6% until 2010, with the bond markets advancing 4.5%.

Against this backdrop, we believe that the most stable growth will be in private insurance schemes. This is especially the case for France and Germany, the largest European life insurance markets after the UK, where endowment policies are the most important private pension product. Stability is provided through long-term contracts with regular contributions and 'smoothing' of investment performance by the insurer. However, life companies are finding there are limits to their ability to offset market fluctuations through appropriate management of their reserves. This is clear-

Trends in European pension markets.

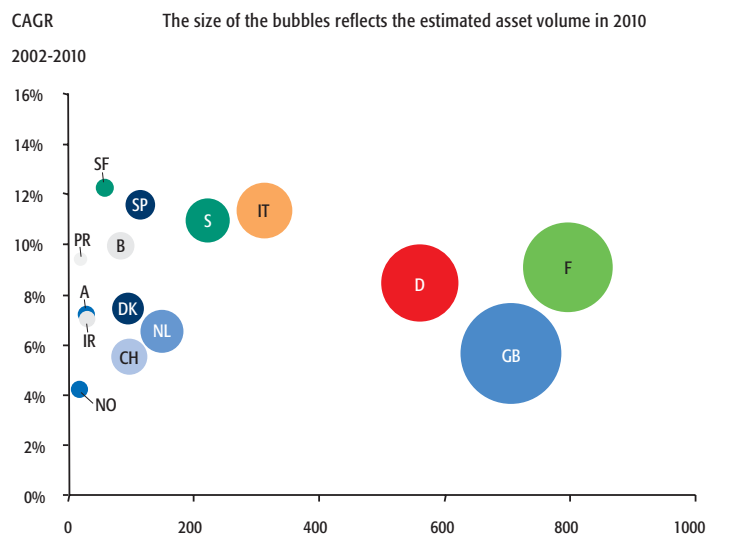
Increase in assets in absolute terms in bn EUR 2002-2010



Source: EFRP, CEA, Allianz Group Economic Research

Trends in life insurance.

Increase in assets* in absolute terms in bn EUR 2002-2010



Source: CEA, Allianz Group Economic Research

*AuM of life insurance companies

ly the case in the present harsh market environment, with many life companies having to revise their anticipated returns downwards.

The environment for pension funds and comparable institutions providing occupational pensions has always been more volatile than for insurance schemes. Performance fluctuations in this area have a direct impact on assets under management. In the UK, by far the largest market in the EU, these pension assets lost around 15% of their value in 2002. We expect a below-average annual growth rate of 5% for the UK which, because of the sheer size of its market, will significantly depress the European market as a whole. We also foresee only moderate growth in the highly developed pension fund markets in the Netherlands and Switzerland.

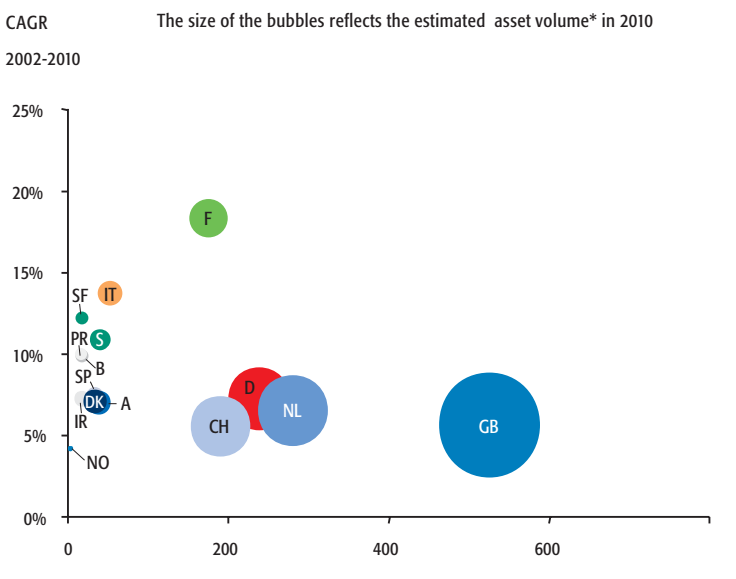
The best growth rates will be in the markets where there is significant ground to be made up in pension reform and which can provide the public with highly attractive pension products. We see the most exciting markets in the next few years as being France, Italy and Germany:

- In France, market penetration of company savings schemes will continue apace.
- Italy will shortly kick-start its pension fund market.
- In Germany, the impact of the “Riester reform” is increasing.

Together with France, the German market for occupational pensions will generate, in absolute terms, around half the inflow of new pension money that we are expecting across Europe.

Trends in investment-based pension products.

Increase in assets in absolute terms in bn EUR 2002-2010



Source: EFRP, Allianz Group Economic Research

* in Austria and Germany also book reserves incl.

3.2. In Europe the trend is towards hybrid pension plans.

Until now the predominant type of pension has been the defined benefit plan. Under this, the employer agrees to pay a defined occupational pension based on the employee's final earned income or average salary. The employee is therefore assured of receiving a fixed level of benefits. But defined contribution plans are gaining ground everywhere. With this type of pension, the employer undertakes only to pay a defined regular contribution. The reasons for this are obvious: employers are increasingly unwilling to bear the risks inherent in defined benefit plans.

- However, the trend towards defined contribution plans will probably receive a further boost from the rise in employee-financed occupational pensions.
- With a defined benefit plan the employer bears the entire investment risk and reward. If the calculated performance cannot be achieved, the employer must nevertheless meet the full amount of the agreed benefit. The heavy falls in investment returns in the last three years have dramatically increased the costs for employers of occupational pension plans on the defined benefit basis. During the capital markets' boom, employers were often able to suspend regular contributions under their pension commitments ('contribution holidays'), but the slump is now forcing them to make top-up contributions.

Currently, virtually all new occupational pensions are defined contribution plans, which in many countries is also a legal requirement. Furthermore, existing pension commitments are also being converted from defined benefit into defined contribution plans, usually to the considerable dissatisfaction of employees. The UK has seen its first strike over the issue of occupational pensions. Employees are critical, not only of the transfer of the investment risk to them but, above all, of the reduction in employers' contributions that usually accompanies the changeover. In current condi-

tions many companies can simply no longer afford the occupational pension plans to which they committed themselves when equity markets were booming.

However, we think Europe, especially continental Europe, is unlikely to see a total transfer of pension risk as part of a move from a defined benefit to a pure defined contribution commitment. This would fly in the face of traditional social consensus, as is clear from the debate on the EU pension fund directive.

In fact, it is already noticeable that minimum guaranteed rates of return are gaining ground in Europe. Guaranteed minimum interest rates of return from employers or financial services providers have already been introduced in Germany (guarantee of the nominal value of contributions paid in, which can be expressed as a 0% interest rate guarantee), Austria (currently 1.75%), Belgium (3.25% and 3.75% for employer and employee contributions respectively), Denmark (4%) and Switzerland (just lowered from 4% to 3.25%), and are under discussion in other countries, such as the Netherlands. Caution is required here. Some minimum safeguarding of employees is certainly desirable on social policy grounds, but these considerations must not be allowed to prejudice efficient investment. For an asset manager, a guaranteed zero rate of return is no obstacle to an optimised and efficient investment. However, a minimum rate of return of 3% is quite a different matter.

3.3. International accounting guidelines support trend towards funded pension commitments.

A variety of accounting systems are currently used in Europe, and each handles company pension commitments differently. With effect from 2005, all listed companies in the EU, and other companies falling within the scope of the directive, will be required to prepare their balance sheets in accordance with the International Accounting Standards ('IAS'). A longer transitional period (up until 2007) will apply to companies which already use the GAAP accounting standards of the US. This will make it far easier to compare the balance sheets of companies throughout the EU.

The key aspects of the relevant IAS regulation (IAS 19) are as follows:

- The cost of funding occupational pension plans counts as an operating expense.
- Pension assets are measured at fair value.
- Liabilities are discounted by the yield on high-quality (AA) corporate bonds with a maturity of 10-15 years.
- Profits and losses which account for 10% or less of pension liabilities are not stated on the balance sheet. Profits and losses which exceed 10% of pension liabilities can be smoothed out over 15 years in accordance with the 'corridor principle'.

Current IAS regulations are being scrutinised and will probably be revised. However, there will undoubtedly be increased transparency as to the true extent of a company's pension commitments and the resulting positive or negative financial impact. The valuation of pension commitments will be conducted in a more timely way and with closer reference to the markets. As a result, strong

market fluctuations will feed through to company balance sheets more rapidly. This means that the high equity weightings in defined benefit pension plans of the kind traditionally found in the UK are likely to become a thing of the past. Two scenarios are possible: pension plans will be converted into defined contribution plans or equity weightings will be reduced. Consequently, the changes in the balance sheet regulations will indirectly be to the detriment of defined benefit plans.

The switch to IAS will undoubtedly be to the disadvantage of companies that still have non-funded pension commitments on their balance sheets, something which is particularly prevalent in Germany. In future, these pension reserves will be shown as 'unfunded liabilities'. Some of these companies' balance sheet ratios will deteriorate, particularly their equity ratios. This is in contrast to companies which do not show their funded pension commitments on the balance sheet, and only report the net balance of pensions assets and liabilities. Many companies in Germany still need to take action on this front. One solution would be to remove pension reserves from the balance sheet by means of a 'Contractual Trust Agreement' (CTA), also called a 'in-house pension fund'.

3.4. Risk management: a challenge in the efficient asset management of pension funds.

In the current market environment, the basic structure of pension plans and by association, the strategic allocation of assets, often come under scrutiny. During the stock market boom, the distribution of income between employers and employees was a potentially controversial matter. These days the focus is on the management and distribution of risk. Continental Europe appears to think the solution lies in hybrid pension plans: the employer enjoys the security of a fixed contribution level but doesn't benefit from performance opportunities, while the employee benefits from performance opportunities and a guaranteed minimum level of protection, but also bears the investment risk. In general, the trend should not be so much towards a formal minimum level of protection as towards intelligent investment strategies which safeguard the long-term savings process without missing out on the performance opportunities offered by the stock market. Professional risk management represents a crucial challenge in the operation of private pension plans. The absolute level of risk assumed when making investments and the distribution of risk among participants both require careful management. Asset liability models should certainly be made compulsory for occupational pension plans. Risk management instruments such as Constant Portfolio Protection Insurance strategies are the management orientated solutions.

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