

Response to EC Consultative Document Ares(08)14767

28 November 2008

*IORPs covered by article 17 of the IORP Directive
IORPs operating on a cross-border basis*



28 NOVEMBER 2008



EFRP RESPONSE

**EUROPEAN COMMISSION CONSULTATION ON THE
HARMONISATION OF SOLVENCY RULES APPLICABLE TO
INSTITUTIONS FOR OCCUPATIONAL RETIREMENT PROVISION
(IORPs) COVERED BY ARTICLE 17 OF THE IORP DIRECTIVE
AND IORPs OPERATING ON A CROSS-BORDER BASIS**

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1. Identification of Response

The **European Federation for Retirement Provision (EFRP)** represents the various national associations of pension funds and similar institutions for supplementary/occupational pension provision. Its membership at large consists of institutions for workplace (2nd pillar) retirement. Some of them are also operating purely individual pension schemes (3rd pillar).

The EFRP has **29 members associations** in most EU-15 Member States and other European countries that have a significant – in size and relevance – workplace pension system¹

Within EFRP the **Central & Eastern European Countries Forum (CEEC Forum)** has been established (26 October 2006) to discuss issues common to pension systems in that region. The CEEC Forum has not expressed its view on this consultation as such since there are no IORPs operating in the CEEC region as focussed on by this consultation.

83 million EU citizens are covered for their workplace pension plan by EFRP Members. Through its Member Associations the EFRP represents approximately **3,5 trillion of assets (2007) managed** for future occupational pension payments.

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Non-EU Member States: Croatia, Guernsey, Iceland, Norway, Switzerland.

2. Executive Summary

Workplace pensions are well suited to helping promote private retirement provision and hence address the issues arising from Europe's ageing population. Due to their association with the workplace they achieve high coverage and consistent saving. Due to their scale and governance arrangements they provide superior investment decision-making at a lower cost than would be made by individuals acting alone. Some workplace pension schemes also provide risk sharing between generations.

The implementation of the IORP Directive will help promote the development of workplace pensions because its principle-based approach sets core standards which Member States can interpret in the light of the different types of workplace pension provision that exist around the EU. Within this framework IORPs, as long term investors, can provide stability to financial markets.

The consultation therefore touches on issues of keen importance to EU citizens. Its scope focuses on only IORPs covered by Article 17 or operating cross-border. EFRP notes that:

- Few, if any, IORPs classified by Member States or CEIOPS as Article 17 IORPs carry all their own risks in the way assumed by the consultation. Although they may hold regulatory own funds as referred to in Article 17(2) they have other security mechanisms, including support from the employer/ sponsor, and hence do not resemble insurance undertakings.*
- New cross-border activity has had insufficient time to develop significantly since the Directive was fully implemented across the EU in June 2007, with only 70 cross-border IORPs, at least 39 pre-dating the Directive.*

EFRP welcomes the statement to the effect that the European Commission has no pre-conceived ideas on the way forward. However, the 34 questions go well beyond the narrow scope promised. The document can be read as assuming that further harmonisation of the prudential regulation of IORPs would be desirable. At this stage, it is far from evident that further harmonisation would be desirable or feasible.

Being part of employment benefits, workplace pensions are fundamentally different from other financial services subject to EU harmonisation. A harmonisation agenda could prove inconsistent with their increasing importance for securing adequate retirement income. The diversity in arrangements in

different Member States, flowing from their discretion to organise their overall pension system to reflect national circumstances, constrains and makes undesirable harmonisation at this time. In particular, the Member States are entitled to opt for a great variety of different financial institutions to deliver workplace pensions.

In this context, EFRP considers that a revision of the IORP Directive would be a major and complex undertaking which currently is untimely and inappropriate. There is an absolute need for legislative stability at this point in time. The Directive already provides for common minimum standards. It is too early to draw firm conclusions about the effect of its implementation. It would be disproportionate to embark on a legislative process to amend the current Directive simply because of the linkage to the life-insurance Directive or misconceived level playing field arguments. No such proposal for an amendment should be made without first undertaking an extensive review of the relevant financial and technical data and each Member State being asked to map out the national social and labour law relevant to workplace pensions. EFRP is ready to assist the European Commission in this process.

Returning to the narrower issues that are the subject of this consultation, EFRP considers that, Article 17 IORPs as defined in Article 17(1) are the exception rather than the rule. The consultation appears also to relate to IORPs, with varying degrees of employer underwriting, that are required to maintain regulatory own funds as just one of several security mechanisms. EFRP emphasises that, despite superficial resemblances, these IORPs are different from insurance undertakings, and do not operate in the same market. As the security mechanisms available to them vary, it is not surprising that regulatory practices vary, as indeed is envisaged by the Directive. There is no evidence that those variations are unjustified or causing such problems that requires an amendment to the IORP Directive.

Applying the proposed Solvency II directive to IORPs with regulatory own funds would result in many sponsors withdrawing from defined benefit pensions, and in turn substantially reduced retirement incomes. It would also cause substantial shifts from equity to bond investment with negative impacts on financial markets. EFRP believes that, as there is no evidence that Article 17 is failing to provide sufficient protection, or indeed that there are material differences in the way it has been implemented, the most obvious and only cost-justifiable approach to Article 17 would be to retain it as is.

In relation to cross-border IORPs, EFRP has always been a strong supporter of pan-European pension institutions, so long as lower pension benefits do not result at national or EU level. European companies should be able to opt for an “in house” pension solution across the EU rather than having to contract a workplace pension scheme from a third party or outside provider.

EFRP re-states its position that the IORP Directive needs more time to deliver its full potential. There have been significant potential obstacles to such provision, such as the diversity and opacity of Member States’ social and labour law and differing interpretations of articles in the IORP Directive. Differences in tax treatment have or should have become historical in view of relevant ECJ decisions. But, there is no evidence that the prudential rules for cross-border providers are an obstacle requiring harmonisation.

Nor has EFRP seen any evidence that the diversity in funding regulations or supervisory practices across Europe has given rise to regulatory arbitrage or supervisory competition. While regulatory regimes vary, within bounds set by the IORP Directive, it is not clear that different Member States treat an identical promise sufficiently different to justify moving the domicile of the IORP. Furthermore, any arbitrage that is harmful for beneficiaries or sponsors would be unlikely to be successful, given the role of members, social partners and fiduciaries in the oversight of IORPs. The fear of a regulatory “race to the bottom” is therefore fundamentally flawed and unfounded.

In conclusion, EFRP continues to support the IORP Directive as a modern principle-based regulation that enables employers and social partners to enhance the efficiency, and hence affordability of workplace pensions, while maintaining existing pension benefit definitions established under social and labour law.

EFRP agrees entirely with the Commission that any move towards greater harmonisation of prudential rules, or modification of the IORP Directive, must be based on a solid business case and a rigorous analysis of the costs and benefits, in line with the Better Regulation agenda. Rushing the development of any new regulatory framework would jeopardise the development of workplace pensions.

EFRP calls instead for a more considered assessment of the impact of the IORP Directive on national and EU workplace pension provision, along with more detailed mapping of the diverse pension arrangements that are to be found across the EU before any new proposals are made. The federation looks forward to work with the European Commission and share its expertise on these issues.

IORPs ARE SPECIFIC FINANCIAL INSTITUTIONS

- IORPs often have a **plan sponsor** (usually the employer) that is required to guarantee pension benefits.
- IORPs have **flexible adjustment mechanisms**. For example, in some jurisdictions, IORPs:
 - operate workplace pension schemes in which contributions and liabilities may be adjusted, depending on agreements negotiated by the social partners or on discretionary decisions by the Board of Directors;
 - Target a specific benefit level instead of guaranteeing it.
- The **liabilities of IORPs** differ from most insurance (or indeed banking) liabilities
 - the earliest date that liabilities mature is fairly well known,
 - there cannot be a 'run' on a pension scheme, and hence the concept of short term solvency, as used for insurers, is not an issue.
- IORPs are **very long-term investors** that are able to sit out short-term volatility on financial markets. The financial crisis has illustrated that short-term solvency regimes increase systemic risk by encouraging pro-cyclical behaviour.
- Many IORPs are **governed by representatives of employers and employees** on a not-for-profit and non-competitive basis, which should ensure that decisions are made in the interest of the stakeholders. In such cases there is no incentive to take risks to improve market share.
- IORPs, unlike insurers, **do not operate in retail markets**, reducing the need for a harmonized solvency regime. Individual consumers cannot be expected to be aware of different regulatory regimes across Europe and to understand their implications.
- Decisions on the **location of IORPs** are however made by the sponsoring company(ies) or by the social partners that have to balance the interests of sponsors, plan members and beneficiaries alike.

WORKPLACE PENSIONS ARE WELL EQUIPPED TO PROMOTE ADEQUATE SAVING FOR RETIREMENT

- Workplace pensions provide an effective means of **achieving high participation** in retirement savings among groups of people, who would otherwise be unlikely to save or to save enough for a comfortable retirement.
- Workplace pensions can be provided at **very low costs**. They can exploit economies of scale in investment and pension administration. Marketing and sales expenses are negligible. Wholesale prices can be achieved through direct negotiations with asset managers and other financial providers.
- Workplace pensions –in general – **do not require scheme members to take investment decisions**. Scheme members benefit from professional decision makers who act in the interest of scheme members and sponsor.

3. Introductory remarks

Before addressing the specific questions posed in the consultation, EFRP wishes to make some general comments on the consultation and the possible way forward in the context of a revision of Directive 2003/41, the IORP Directive.

3.1 GENERAL COMMENTS

1. EFRP welcomes the opportunity to respond to the European Commission consultation on “the harmonisation of solvency rules for IORPs under Art. 17 IORP Directive and for IORPs operating on a cross border basis”². In doing so, it reminds the Commission of EFRP’s **recent paper on funding principles for IORPs**³. Its content remains relevant to this consultation.
2. In particular, our earlier paper notes that in response to **Europe’s ageing population** and to help people save for retirement, EU Member States have sought to encourage funded pension provision. **Workplace pensions are well suited to helping promote private retirement provision**. Due to their association with the workplace they achieve **high coverage and consistent saving**, thereby overcoming the tendency identified by behavioural finance studies for people to put off saving and to value spending today rather than spending in retirement. Due to their scale and governance arrangements, they also provide **superior investment decision-making** at a **lower cost** than would be made by individuals acting alone. Some workplace pension schemes also provide **risk sharing between generations**.
3. The **implementation of the IORP Directive** should help promote the development of workplace pensions. It adopts a **principle-based approach** which sets a core set of rules but allows Member States to interpret them in

² European Commission, Consultative document - Ref. Ares (08)14767, 3 September 2008.

³ EFRP, IORP Directive – securing workplace pensions, 23 May 2008.

the light of the different types of workplace pension provision that exist around the EU. It is hard to see all the implications of the current **financial turmoil**, but thus far IORPs have not come under the same degree of stress as other financial institutions. It may be that the flexibility allowed by the EU framework will enable IORPs, as long term investors, **to provide stability to financial markets.**

BOX 1 - THE FINANCIAL TURMOIL AND SHORT-TERM SOLVENCY REGIMES

The past years there has been a trend towards risk-based supervision of banks (Basel II) and insurance companies (Solvency II).

Solvency regimes for banks and insurers have in common that they impose one-year risk-based capital requirements based on market consistent valuation of assets and liabilities.

Short-term solvency capital encourages pro-cyclical investment behaviour.

- In bull markets, there is abundant risk-based capital, which can be used to increase risk taking. This allowed the financial sector to make high risk investments with excessive leverage in the years preceding the current turmoil.
- In bear markets, financial institutions have to attract additional capital or sell risk-bearing securities to reduce risk. The latter feedback mechanism has destabilized financial markets during the crisis by triggering a downward spiral of financial institutions selling off equities with consequential stock market declines.

A rigid application of market valuation has increased balance sheet problems even further. Financial institutions had to value assets using low prices resulting from very, if any, few transactions in illiquid markets. Market valuations under such circumstances do not provide a fair value, which recently incited the European Commission to promptly endorse the IASB amendments to the accounting rules for financial institutions.

IORPs often have an investment horizon of an average of twenty years, which makes these one-year solvency regimes unfit to monitor the financial security one seeks in pension provision. There is wide agreement that stock returns exhibit mean reversion, which implies that the volatility of equities declines with the investment horizon. Financial markets are very volatile in the short run, but these swings have a tendency to revert to their mean in the long run. This implies that very long-term investors like IORPs are able to allocate a larger proportion of assets to equities without the need hold higher solvency capital. Moreover, a separate regulatory regime with a long-term orientation allows IORPs to fulfil their role as long-term investors and to contribute to the stability of financial markets.

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4. This consultation therefore addresses **issues of keen importance to EU citizens**. We understand that the consultation seeks to canvass views from a wide range of the stakeholders on the further harmonisation of the IORP Directive's provisions relating to funding, only for IORPs:
- subject to Article 17(1) IORP Directive., and,
 - engaging in cross-border activities.
5. We also understand that the consultation is intended to **cover only a small proportion of IORPs and Member States**, as:
- The consultation does not apply to **IORPs providing defined contribution (DC) schemes**;
 - EFRP disputes that most, if any, of the IORPs that have been classified by the Member States as Art. 17(1) IORPs carry their own risks in the way that Art 17(1) defines them. There is some **confusion between national implementing legislation** and requiring the provision for regulatory own funds which seem to have been implemented based on Article 17(3). Just because a Member State requires regulatory own funds does not mean that the IORPs concerned are those envisaged by the Directive under Article 17(1) which would, as the Directive and consultation document state, carry resemblance with insurance companies.
 - There are at most 70 **cross-border IORPs** to which this consultation would apply at least 39 of which pre-date the Directive⁴. This is not surprising given the limited amount of time since the Directive was fully implemented across the EU.
6. In this context the **issues at stake appear to be limited to**:
- whether the **existing link between Article 17 (2)** and the Life Insurance Directive (2002/83/EC), regarding the calculation of regulatory own funds should be preserved when that directive is replaced by the proposed Solvency II directive; and

⁴ CEIOPS, 2008 Report on Market Developments – CEIOPS-OP-19/08, 11 November 2008.

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- whether the Directive's provisions relating to IORPs funding rules **are impacting** negatively on, or as a result of, **cross-border activity**.
7. The **34 consultation questions** go wider than might be expected of such a narrow set of issues and appear to encompass nearly all the matters considered in the CEIOPS OPSSC-11/08 document⁵. For instance, they cover the objectives of “solvency rules”, the principles under-pinning the supervisory framework, the application of Solvency II and the treatment of inflation indexation. These are interesting questions but do not fit easily within the scope of the consultation. It would probably have sufficed to ask whether there was any evidence that the current regulatory regime for these two types of IORP needs to be changed.
8. We are pleased to see the statement in the consultation document that the Commission has “**no pre-conceived ideas** on the way forward at this stage and there will be **no automatic extension of the Solvency II Directive proposal to IORPs subject to Article 17**”. We also welcome the statement that “possible changes (...) need to be based on a **solid business case** and a **rigorous analysis of the costs and benefits** of such changes in line with the **Commission’s Better Regulation agenda**”. This position makes much sense in this early stage of implementation and limited market experience with cross border provision of services by IORPs.
9. We note, however, that the consultation **questions go well beyond the narrow scope promised** and that the consultation document **can be read as assuming that further harmonisation** of the prudential regulation of IORPs **would be desirable**. In particular:
- the consultation title refers to “harmonisation” and the purpose of the consultation is to consider the need for such harmonisation;

⁵ CEIOPS, Key issues on Solvency for the European occupational pension sector – CEIOPS-OPSSC-11/08, 30 May 2008.

- The consultation title and some of the questions refer to “**solvency rules**”. This term is not used in the carefully drafted CEIOPS-OPSSC survey⁶, nor is it found in the IORP Directive itself. The survey report used language referring to “**technical provisions and additional security mechanisms**” that, in EFRP’s view, seems more appropriate in order to avoid any misconception.
- The consultation document states that Article 17 IORPs are “in some sense comparable to insurance undertakings⁷” It then unhelpfully states that Article 17 would aim at establishing “**a level playing field** with insurance undertakings and support fair competition in terms of capital requirements⁸” which hence should be “maintained”. **EFRP does not agree that those IORPs that have been categorised under Article 17 are on the same playing field as insurers** and notes that this assertion is made without any data or analysis as to what the ‘playing field’ means in this context. IORPs are not providers in the same sense as insurers, **but a means by which employers can deliver in-house an important component of their remuneration packages**. Furthermore, Member State governments can have good reasons for applying different conditions to these different types of service as part of their freedom, recognised by the Directive, to determine how pensions, including workplace pensions should be provided⁹. This may result in different regulatory requirements, not least through social and labour law.
- Some consultation questions imply that an approach using short-term solvency margins is the only way to apply risk-based supervision or to secure effective risk management by IORPs. EFRP notes that there are **many ways in which supervision can be risk-based and in which**

⁶ CEIOPS, Survey on fully funded on technical provisions and security mechanisms in the European occupational pension sector – CEIOPS-OPSC-01/08, 31 March 2008.

⁷ European Commission, Consultative document - Ref. Ares (08)14767, 3 September 2008, page 3.

⁸ European Commission, Consultative document - Ref. Ares (08)14767, 3 September 2008 page 3-4.

⁹ IORP Directive, 2003/41/EC, Recital 9.

supervisors can promote risk management, for instance by focusing on the fitness and propriety of IORP fiduciaries/managers or requiring risk management reviews. Allowing such diversity is consistent with the diversity of pension systems found across the EU.

10. The assumptions and questions in the consultation document therefore appear much more relevant to a wider consultation, exploring the scope for further harmonisation of the prudential regulation of IORPs than to the purported narrow scope. **At this stage, it is far from evident that further harmonisation would be either feasible or desirable**, in particular:

- As mentioned above, workplace pensions are increasingly becoming an **essential element to secure adequate retirement income**, as demographic trends make generous 1st pillar provision unsustainable. Many Member State governments have responded through initiatives to widen participation through the workplace. The priority should be to avoid jeopardising existing provision and facilitating expansion. It is not evident that a harmonisation agenda would be consistent with this priority.
- Member State governments are currently free to favour certain vehicles for managing occupational pension schemes, as part of **Member States' discretion to organise their overall pension system** to reflect national circumstances¹⁰. Through their social and labour law competence they are entitled to define benefit levels, and more generally, product requirements (including the scope for provisions by non-IORP institutions). Member States also are entitled to opt for certain types of financial institutions in respect of occupational pensions. The resultant diversity constrains the scope for meaningful harmonisation.
- **Member State freedom to determine social and labour law for 2nd pillar pensions** can be viewed as being equivalent to single market principles such as the “general good” approach and the “consumer protection” logic that constrains Member State discretion in relation to

¹⁰ IORP Directive, 2003/41/EC, Recital 27;

individual (3rd pillar) pension provision – mainly provided by life-insurers. But social and labour law is by definition not harmonised.

- **workplace pensions are therefore fundamentally different from other financial services** where a harmonised free market across the EU has clearly evident benefits.

11. While EFRP would be happy to engage on a policy debate regarding the future of workplace pensions and their regulation, any review of the IORP Directive would be a major and complex undertaking, and would be **neither timely nor appropriate** because:

- The IORP Directive already provides for **common minimum standards** and it **took until at least June 2007 for it to be implemented across the EU**¹¹. It is **too early to draw any concrete conclusions about issues** that might arise from its implementation. The CEIOPS-OPSSC survey reports differences in the prudential regulation applied in different member states. Such variation is to be expected with the minimum harmonisation approach adopted in the Directive, reflected for example in the statement that member states “should have the possibility of making the calculation of technical provisions subject to additional and more detailed rules than those laid down in this Directive”¹². Crucially, the survey offers **no evidence that this variation is currently causing problems**, referring only to an **unsubstantiated risk of harmful regulatory arbitrage**.
- Much more **time, evidence and analysis are needed** before any conclusion could be drawn, in line with Better Regulation principles, showing that the benefits of further harmonising prudential regulation would outweigh the costs.
- EFRP understands that **the consultation is viewed as timely in the context of the upcoming solvency rules for life-insurers** under the

¹¹ There are indications that supervisors, for instance in Belgium, may still be sending out guidance notes or other communications to enable an interpretation of how the Directive is being implemented at operational level.

¹² IORP Directive, 2003/41/EC, Recital 27.

- proposed Solvency II Directive.¹³ EFRP would not wish the “pensions issue” to confuse or complicate the Solvency II debate, nor would it like that issue to become a stumbling block for a smooth legislative process of an important piece of EU legislation.
- Competition in cross-border pension provision by life-insurers still has yet to take off. It seems at least **premature to advocate** measures to establish **a level playing field narrowed down to capital requirements**.
 - An imminent change to a Directive that has only recently come fully into force could well stifle the developments in building a single market that the Directive was intended to encourage. There is an absolute need for **legislative stability** to ensure that the market can be responsive to the enhanced possibilities for occupational pension provision.¹⁴
 - The **need to avoid increased uncertainty** is increased by the current serious stresses in financial markets and troubled economic outlook. This is a particularly unfortunate time to be considering changes which could have the potential, perceived or real, consequence of increasing the costs of provision through IORPs or shifting their optimal asset allocation.

12. It is EFRP's view that it would be **disproportionate to embark on a legislative process to amend the current IORP Directive** because of the existing link between Article 17 (2) IORP Directive and the life-insurance Directive or by misconceived level playing field arguments. Such a process would need to be underpinned by extensive market data at Member State level including not only **financial and technical data** but also mapping the **social & labour law** that has a major bearing on occupational pension provision. Furthermore, were there to be a consultation on broader issues,

¹³ European Commission, Amended proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance, COM (2008)119, 26 February 2008.

¹⁴ EFRP has heard from companies that ordered a feasibility survey on a pan-European pension scheme but cancelled this assignment upon seeing media reports about the « review » of the IORP Dir. in 2008. The companies had become uncertain about the legal framework and wanted to wait until the relevant legislation would become more stable. This demonstrates the harm that uncertainty of this nature can occasion.

including the impact on non-Article 17(1) IORPs, level playing field arguments would require it to encompass all types of workplace pension providers. EFRP notes the intention of CEIOPS to document social and labour law across the EU and to survey the full range of workplace provision¹⁵.

13. EFRP has some more general observations in relation to the two issues being considered by this consultation, below.

3.2 ARTICLE 17 IORPs

14. EFRP considers that **distinction between Article 17 and non-Article 17 IORPs** adopted in this consultation to be **arbitrary**. During the negotiations that led to the IORP Directive the distinction was never a point of debate.

15. Article 17 is worded so as to apply only to institutions that bear the full risk of, and hence underwrite pensions liabilities, without recourse to a plan sponsor. This distinguishes them from IORPs where a plan sponsor is expected to underwrite the risks where the IORP becomes unable to do so. As defined, Article 17 IORPs are an extreme case of the actual risk distribution across EU occupational pension plans which provide for **varying degrees or kinds of employer underwriting**.

¹⁵ CEIOPS, draft Work Programme 2009, 22 September 2008 – Consultative Panel Meeting, 25 September 2008.

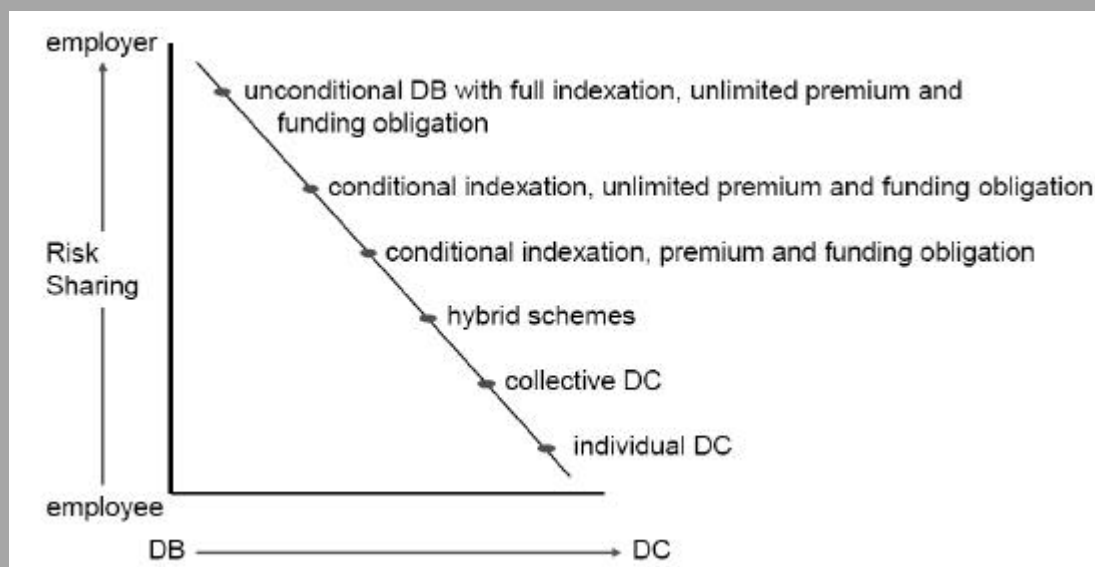
Box 2: MANY DIFFERENT TYPES OF WORKPLACE PENSIONS EXIST ACROSS THE EU

Workplace pension schemes are often classified as being either of the defined benefit type (DB) or the defined contribution type (DC).

It should be recognised that many hybrid schemes exist in which the risk is shared between employers and employees.

Examples of hybrid plans are

- DC schemes guaranteeing a minimum rate of return
- cash balance plans
- DB schemes with conditional indexation.



EFRP believes that policy makers need to understand all the implications of the scheme design as it significantly affects the financial risk-profile of European citizens.

The recent financial crisis has illustrated that upon retirement age and throughout retirement period, individuals' retirement income should not excessively depend on economic cycle and financial markets.

16. Member State governments have considered it necessary or expedient to require some IORPs to maintain solvency margins or financial buffers which the IORP Directive, using insurance terminology, calls regulatory own funds and refers to only in Article 17. Some Member State governments and the CEIOPS OPSSC survey have categorised all IORPs required to maintain such regulatory own funds as falling within Article 17. But, many of these IORPs that the CEIOPS survey places under Article 17 employ a **model in which the risks are shared between employers and employees, or indeed at an industry level between social partners**.¹⁶ In such cases IORPs do not fully underwrite pension commitments.

17. Those **consultation questions** that ask about variations in employer sponsorship or support add to the confusion – they are meaningless in the context of IORPs as defined in Article 17(1), but relevant to those so categorised in the CEIOPS-OPSSC survey. It is therefore not clear whether the consultation relates to existing IORPs required to maintain **regulatory own funds as one (of a number) of security mechanisms** or those **that genuinely resemble insurance undertakings, but may not exist in practice**. Indeed, such **regulatory own funds should be seen as examples of the additional requirements that Member States can place on top of technical provisions**, further to Article 17(3), not as regulatory own funds required by Article 17(1).

18. “Article 17” IORPs, that is those maintaining regulatory own funds, in practice share risks with sponsoring employers and employees in a variety of ways unknown in the insurance market, where the insurer always underwrites the full liabilities. As the **security mechanisms available to these IORPs vary**, it is not surprising that there are variations in regulatory practice to reflect national circumstances, akin to the variations envisaged in relation to the technical provisions of **all** IORPs as reported by the CEIOPS-OPSSC survey.

¹⁶ EFRP Paper, IORP Directive – securing workplace pensions, 23 May 2008.

19. EFRP recognises that Article 17 is distinctive in so far as it makes explicit reference to the insurance directive¹⁷, which is scheduled to be replaced by the proposed Solvency II directive and that this provides some explanation for the restricted scope of the consultation. EFRP wants to highlight, however, that **despite superficial resemblances** which doubtless resulted in the link to insurance regulation, the **IORPs categorised under Article 17(1) are different from insurance undertakings**.

20. It is therefore far from evident that insurance regulation should continue to read straight across to Article 17 IORPs except perhaps for those IORPs where there is genuinely no risk sharing and the provider is profit driven. Authoritative research shows that **applying the proposed Solvency II directive to existing IORPs will result in many sponsors withdrawing from defined benefit pension provision** and cause substantial shifts from equity to bond investment¹⁸ with possible **negative impacts on financial markets**. Wide-scale closures of DB schemes would in turn result in **substantial reductions in retirement incomes**, without compensating increases in taxpayer funded provision. Europe cannot afford the risk of wholesale closures of workplace pension schemes at a time when ageing of the population is rendering public pay-as-you-go pensions under strong pressure.

21. In the absence of any evidence that Article 17 is failing to provide sufficient protection, or indeed of material differences in the way it has been implemented, the **most obvious and only cost-justifiable approach to this**

¹⁷ Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance.

¹⁸ EFRP, IORP Directive – securing workplace pensions, 23 May 2008, drawing on

- J. PEEK, A. REUSS and G. SCHEUENSTUHL, Evaluating the Impact of Risk Based Funding Requirements on Pension Funds, in OECD, Financial Market Trends, 2008;
- Punter Southall, Solvency funding in pension schemes - the application of solvency regimes to European pensions, December 2007.

Article would be to retain it as it is¹⁹. EFRP does not believe that this would lead to regulatory arbitrage between pensions and insurance, because of the market differences cited above.

3.3 CROSS BORDER IORPs

22. EFRP has always been a strong **supporter of pan-European pension institutions**, so long as lower pension benefits do not result. This is not primarily because of a desire for cross-border competition. These institutions can benefit companies and schemes operating in several EU countries by enabling them to enhance the **efficiency**, hence **affordability** of occupational schemes and improve **cross-border labour mobility**. European companies should be able to opt for an **“in house” solution** across the EU rather than having to contract the workplace pension scheme to a third party or outside provider. Employees can potentially benefit from lower contribution rates or higher retirement benefits and move between countries without administratively complex pension transfers.

23. Currently, however, there are only 70 IORPs engaging in cross-border operations, of which at least 39 were already in existence before the IORP Directive was implemented. The available data on these IORPs is insufficient to base robust conclusions but it is clear that the internal market for

¹⁹ The reference technique is accepted and widely used in EU legislation to keep in force some specific articles of otherwise repealed legal acts. Examples of this reference technique can be found in:

- Art. 23(1) of the Regulation EC 1831/2003 on additive for animal nutrition;
- Art. 31(1) (2) of the Directive 2008/50; Article 31 (1) and (2) of the Directive 2008/50/EC of the European Parliament and the Council on 21 May 2008 on the ambient air quality and cleaner air for Europe;
- Article 90 of the Regulation (see the Corrigendum) (EC) n° 883/2004 of the European Parliament and the Council of 29 April 2004 on the coordination of social security systems;
- Recital 10 of the Directive 2006/87 of the European Parliament and the Council of 12 December 2006 laying down technical requirements for inland waterway vessels and repealing Council Directive 82/714/EEC.

occupational pension provision is only just starting to develop. There are good reasons for this. In particular, **it has taken until at least June 2007²⁰ for the IORP Directive to be fully implemented** leaving many interested parties uncertain of the details of IORP regulation in each of the Member States. This situation has not been conducive to the vigorous development of cross-border activity by IORPs. EFRP re-states its position that the **IORP Directive needs more time to deliver its full potential²¹**.

24. It is **hard to find any evidence that would underpin a need for harmonising the prudential rules for cross-border providers**. Much interest in cross-border IORPs has related to defined contribution schemes (without guaranteed returns) to which funding regulation does not apply²², reflecting trends in private pension provision generally. There have been some significant potential obstacles such as the **diversity and opacity of social and labour law**, historical differences in **tax treatment²³** and **differing interpretations** of other articles in the IORP Directive (documented by CEIOPS²⁴). Only once these issues have been addressed would it be possible to tell whether prudential rules have had any bearing.

²⁰ EFRP, survey: IORP Directive – a catalyst for change, November 2007.

²¹ see footnote 20.

²² CEIOPS, Initial Review of Key Aspects of the Implementation of the IORP Directive, CEIOPS-OP-03-08, 31 March 2008.

²³ Recent case law of the ECJ about taxation of occupational pensions (deductibility of contributions and transfers) as well as dividend and interest payments to corporations include:

- **Case C-118/96**, 28 April 1998, *Safir / Skattemyndigheten i Dalarnas län*, Rec.1998, I-1919;
- **Case C-513/04**, 14 November 2006, *Kerckhaert and Morres*, Rec.2006, p.I-10967;
- **Case C-170/05**, 14 December 2006, *Denkavit Internationaal and Denkavit France*, Rec.2006, p.I-11949;
- **Case C-150/04**, 30 January 2007, *Commission of the European Communities v. Kingdom of Denmark*, Rec.2007, p.I-1163;
- **Case C-522/04**, 5 July 2007, *Commission of the European Communities v. Kingdom of Belgium*, Rec.2007, p.I-5701;
- **Case C-379/05**, 8 November 2007, *Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam*, Rec.2007, p.I-9569.

²⁴ See footnote 22.

25. EFRP members have confirmed that they have seen **no evidence** that the **diversity in funding regulations or supervisory practices** across Europe has by itself **given rise to regulatory arbitrage or supervisory competition**, not surprisingly given the limited amount of cross-border activity. Nor does the CEIOPS OPSSC survey provide any evidence of such arbitrage. Were arbitrage happening or in prospect we would expect to see employers relocating their IORPs to a home state where they have few or no members. This is not happening.

26. Nor is any **arbitrage that would be harmful for beneficiaries or sponsors likely to be a successful strategy, given the involvement of members, social parties and fiduciaries in the oversight of IORPs**. Such groups are unlikely to countenance actions designed to weaken the security afforded to members. Where sponsors wish to change their exposure to pensions they are in any case free to change benefit structures, for instance to a defined contribution arrangement, without the disruption involved in changing location.

27. EFRP emphasises that the IORP **Directive lays down minimum harmonised standards for prudential supervision, information to members and fund governance**. While regulatory regimes vary, it is not clear that the treatment in different Member States of an identical promise would be treated sufficiently differently on balance to justify moving the domicile of the IORP to another country. The **fear of a regulatory “race to the bottom”** is therefore **fundamentally flawed and unfounded**.

3.4 CONCLUDING REMARKS

28. While EFRP is not complacent about the possible negative effects on IORPs of the current financial turmoil, we continue to support the **IORP Directive** as a **modern, principle-based regulatory framework**. The Directive enables

employers and social partners to enhance the **efficiency**, and hence **affordability** of workplace pension provision, while **keeping in place social protection rules** (expressed in the social and labour law of Member States) to secure pension benefits to plan members. This approach has safeguarded the **institutional differences** between pension provision in the various Member States

29. There would need to be a strong, broad-based and well evidenced case for change or greater harmonisation at this time. EFRP agrees entirely with the Commission that **any modification of the IORP Directive must be based on a solid business case and rigorous analysis of the costs and benefits of such changes, in line with the Better Regulation agenda.**

30. EFRP therefore believes that the development of a new regulatory framework should not be rushed – otherwise the development of workplace pensions could be put in jeopardy. In that context, the **current consultation is not a suitable starting point for any revision of the IORP Directive.** No case has been made for a different treatment of limited subsets of IORPs.

31. Instead, EFRP would expect to see any process of revision starting with a **Green Paper** on whether or not there is a need for EU-level action in the market for workplace pensions²⁵ provision. Such a wide ranging consultation could then be followed by a **White Paper** sketching the Commission conclusions on the Green Paper and proposing a **policy action plan** to improve regulation for IORPs as workplace pension providers. Were change needed, this process would lead to an exposure draft amending the IORP Directive and then a legislative proposal.

²⁵ Having regard to market developments, it seems more appropriate to use the term “workplace” pensions instead of “occupational pensions”. Workplace covers a broader range of pensions instruments/plans that employers and social partners can use to deliver pension benefits to employees.

32. In the meantime additional work is needed. A **full scale implementation check of the IORP Directive should be performed** as soon as possible. More detailed comparative analysis should be undertaken (for instance regarding Article 17 IORPs) and evidence should be collected on the actual impact of the Directive on the level of provision, costs and the security of member benefits. A more detailed **mapping of the diversity across the EU of overall retirement provision** would greatly assist the discussion of priorities for the future, including the prospect of enhancing the regulatory regime by extending it to more institutions and Member States.

4. Responses to questions

4.1 IORPs subject to Article 17 of the IORP Directive

4.1.1 Objectives and Principles

Question 1(1) - *Do you agree, or do you consider that the overall objective of solvency rules for these IORPs should be different?*

All pension institutions – not only IORPs subject to Article 17 – should provide for a high level of income security at reasonable cost, bearing mind that if costs are too high voluntary workplace pension provision would not be sustainable in the long term. Furthermore, it must be recognised that this goal can be interpreted and applied differently by – and within – the various Member States.

Question 2(2a) - *Do you believe that prevailing solvency rules for IORPs subject to Article 17 provide adequate protection relative to the objective of safeguarding pension beneficiaries' claims at reasonable cost for the sponsoring undertakings?*

EFRP notes that the regulatory own funds requirement of Article 17(2) can enable Member States to put in place appropriate safeguards for the protection of the claims of the beneficiaries of IORPs under Art. 17(1). EFRP believes, however, that most IORPs holding regulatory own funds do not fall within this narrow definition. Instead they employ a model in which the risks are shared between employer and employees. For these IORPs the regulatory own funds should be seen as additional requirements that Member States can place on top of technical provisions – further to Article 17(3) - not as regulatory own funds required by Article 17(2).

Question 3(2b) - *Have there been shortcomings or flaws identified in the prevailing solvency rules for IORPs subject to Article 17? If yes, please specify. What could constitute the main challenges lying ahead?*

EFRP is not aware of any shortcomings or flaws in the prudential regulation of IORPs falling within or categorised within Article 17(1).

As explained in response to question 2, most IORPs categorised within Article 17, by Member States or the CEIOPS-OPSSC survey report because they hold regulatory own funds do not meet the definition of IORPs in Article 17(1). This is because risks in the IORP are shared collectively between employers and employees. These IORPs appear to have been categorised in this way because the only reference in the Directive to regulatory own funds is in Article 17. This is especially as Article 17(3) can be read as saying that Member States can require other IORPs to hold regulatory own funds without applying the provisions of Article 27 and 28 of the Life Assurance Directive as required by Article 17(2). The challenge, in considering the future of Article 17, is to reflect the diversity of IORPs that are treated as falling within its scope by recognising that they can differ fundamentally from insurance companies.

Question 4(2c) - *Which solvency rules could be viewed as proactively dealing with different risks and improving risk management techniques?*

EFRP **supports risk-based regulation** that encourages the use of appropriate risk management techniques. We are convinced that the principle-based IORP Directive has facilitated supervisors to implement a risk-based approach for workplace pension providers governed by the IORP Directive.

EFRP notes that the prudential regimes of banks (Basel II) and of insurance undertakings (proposal for Solvency II) are seen as proactive since those regimes have in common that they impose **one-year** risk-based capital requirements based on market consistent valuation of assets and liabilities. This approach would appear to be reflected in the term ‘solvency rules’ which is used neither in the IORP Directive nor the CEIOPS OPSSC survey.

EFRP considers that the short-term (one year) solvency regimes for the banking and insurance sector, and hence ‘solvency rules’ are not appropriate for IORPs. The long time horizon of IORP liabilities, and the reasonable certainty with which their date of maturity is known, mean that the regulations covering IORPs need to focus on the long term. Short-term (one year) solvency regimes work against a long term investment and could encourage pro-cyclical investment behaviour. A separate regulatory framework for IORPs with a longer-term orientation would in our view in addition to its more appropriateness for pension funding also be beneficial to the stability on financial markets.

Question 5(2d) - *To what extent do compulsory versus voluntary membership in pension schemes have a different impact on the overall outcome of solvency rules and in which case(s) are problems likely to arise in the future?*

Whether membership is voluntary or compulsory should have no impact on solvency rules. Anyone who chooses to join a pension scheme operated by an IORP subject to Article 17 should have the **same assurance** that their promised benefits – which depend on the **characteristics of the pension scheme** - are safe whether or not membership is compulsory.

Question 6(2e) - *To what extent do the solvency rules prevailing today in the different Member States need to differ for single-employer or multi-employer IORPs subject to Article 17?*

As most IORPs falling within the definition in Article 17(1) are not supported by a scheme sponsor that underwrites the pension promise, there is no reason for solvency rules to differ between single or multi-employer IORPs subject to this article.

Question 7(3a) - *Do you agree with these principles and which principles do you consider particularly relevant or not relevant to underpin the supervisory framework for IORPs subject to Article 17?*

Our reply to this question is more generally applicable to all IORPs not just Article 17 IORPs.

1. Forward looking risk based approach

EFRP feels a risk-oriented approach to the prudential regulation and supervision of IORPs is advantageous in enhancing risk awareness among stakeholders and encouraging proper risk management. Such a risk-oriented approach should enable each Member State to vary the requirements placed on IORPs according to the risks that different types of IORPs are considered to pose to members and beneficiaries, bearing in mind the different circumstances prevailing in each Member State.

2. Market consistency (valuation of assets & liabilities)

EFRP finds that different valuation methods have their pros and cons. Market valuation provides objective data for prudential supervision and financial policy. However, pension liabilities cannot usually be replicated by securities available in deep or liquid financial markets. In such cases it would be more beneficial to rely

on estimated valuations using rather marked-to-model approaches since it provides for greater stability in supervision and financial policy.

EFRP would, in particular, oppose a definition of market consistency that is based on International Accounting Standards. There is a big difference between prudential and accounting requirements.

3. Transparency

EFRP believes it to be self-evident that IORPs are transparent towards their supervisors on how they assess their financial position.

4. Proportionality

The IORP Directive already reflects this concept through article 5. (see our response on question 9).

Question 8(3b) - *Are there any other overarching principles that you consider relevant for IORPs subject to Article 17?*

Another overarching principle EFRP feels relevant for Art. 17 IORPs is respecting **diversity**.

Any regulatory framework for IORPs subject to Art.17 should factor in the institutional differences between Member States. The strength of the current IORP Directive is that it takes a principles based approach and has due regard for this pension plan variety.

Question 9(3c) - *Do you see a case for a different supervisory approach for IORPs subject to Article 17 depending on their size or complexity?*

There is a case for differences in supervisory approach dependent on size and complexity. Large, complex IORPs subject to Art.17 may be comfortable with using complex models to assess risk and take decisions on funding levels. Furthermore, they may be able to use such models to demonstrate that they need less funding than would be required by simple rules. Small IORPs subject to Article. 17 on the other hand are unlikely to have the capacity to undertake sophisticated modelling; requiring them to do so could add disproportionately to their costs. The rules applying to them must therefore be kept simple.

Question 10(3d) - *To what extent do you consider that the supervisory frameworks existing today for IORPs subject to Article 17 already meet the principles emerging out of international best practice, as described in the CEIOPS survey?*

We consider that the supervisory frameworks existing today for Article 17 IORPs already meet the principles emerging out of international best practice while emphasising that we do not support a definition of market consistency based on International Accounting Standards.

1. Forward looking risk based approach

Risk-based regulatory frameworks that enable each Member State to vary the requirements placed on Art. 17 IORPs according to the risks they pose to the plan members - bearing in mind the different circumstances prevailing in each Member State - are in our view widespread throughout Europe, and are facilitated by the IORP Directive.

2. Market consistency (valuation of assets & liabilities)

Market consistent valuation for assets is widely used in all the Member States. However, Member States employ a wide variety of methods for valuing liabilities ranging from fixed discount rates to market valuation. Valuation methods and discount rates depend on judgements about the level of risk that can be carried in an IORP subject to Art. 17 taking account of other security mechanisms as well as differing views about the acceptability of volatility or pro-cyclicality. These judgements and the circumstances that inform them are very Member State specific because the systems of pension provision and reliance on and organisation of workplace pensions differ significantly across the Member States.

3. Transparency

EFRP would like to refer to the requirements set out in Article 13 of the IORP Directive.

4. Proportionality

EFRP would like to refer to Article 5 of the IORP Directive.

4.1.2 Regulatory own funds and funding rules

Question 11(4a) - *Do you anticipate competitive distortions emanating from the application of different solvency regimes between insurance companies and IORPs subject to Article 17? Please specify.*

EFRP would first like to emphasize that a ‘level playing field’ – as this issue is frequently referred to in the consultation document – **should not be the policy goal in itself**. The ultimate policy objective for all IORPs whether or not subject to Article 17, is **to secure as far as practicable the cost-effective delivery of the pension promise** in whatever form it takes.

EFRP also considers that in general IORPs, even those subject to Article 17 or holding regulatory own funds, and insurance companies **do not compete in the same market**. Pension schemes provided by IORPs and pension products provided by insurers are different arrangements with different “product” features.

If the European Commission seeks like to pursue a “real” level playing field for all workplace pension providers we believe the first step should be to structure the private pension market and to identify the relevant market for workplace pension provision. Article 17 scales down the level playing field issue to “same capital requirement” which seems **unjustifiable**.

Question 12(4b) - *Do you have any evidence of such competitive distortions (as mentioned in the previous sub-question) existing already?*

EFRP has no evidence of any competitive distortions.

As mentioned above, IORPs subject to Art. 17 do not operate in the same market as insurance undertakings. IORPs, even those subject to Article 17, or holding regulatory own funds, have a different function from insurers, as a key element in each Member State’s social protection system. Member States have the competence to decide how pensions, in all the three pillars, are provided so as best to meet national circumstances. They are complementary to insurers, not competitive with insurers.

Question 13(4c) - What would be the likely impact of applying Solvency II (or similar solvency rules) to IORPs subject to Article 17?

According to the quantitative impact study performed by the EFRP, IORPs subject to Article 17 would be severely hit by such an extension.²⁶ IORPs in Member States that have implemented Article 17 into their national legislation would have in a worst-case scenario to raise assets by 10-45% of existing technical provisions (see Table - below). Alternatively, these pension funds would have to sell-off equities and buy bonds in order to reduce the impact of risk buffers that penalise equity holding, which could de-stabilise financial markets. Studies by Allianz Global Investors & OECD²⁷ and the actuaries Punter Southall²⁸ reach similar conclusions.

The impact of Solvency II on IORPs subject to Article 17		
	Increase in funding ratio	Effect on asset mix
Austria	12%	Equity share -23%points or duration +14 years
Belgium	41%	Equity share -68%points and duration +6 years
Germany	7%	Equity share -14%points or duration +8 years
Netherlands	39%	Equity share -58%points and duration +9 years
Spain	46%	Equity share -29%points and duration +23 years

Source: EFRP (2008)

Policy measures should be judged by their effect on efficiency. The extension of Solvency II to IORPs subject to Article 17 would not be beneficial to safeguard European citizens pensions. The Solvency II framework was designed for insurance undertakings and does not take into account the special features of IORPs subject to Art. 17.

Question 14(4d) - What would be the impact on the future provision of defined benefit schemes and the risk of closing down existing schemes?

The accumulation of the additional financial buffers required by Solvency II would demand a reduction in retirement benefits and/or a massive rise in contribution rates. This would hurt the purchasing power of consumers and raise labour costs,

²⁶ EFRP, IORP Directive – securing workplace pensions, 23 May 2008,

²⁷ J. PEEK, A. REUSS and G. SCHEUENSTUHL, Evaluating the Impact of Risk Based Funding Requirements on Pension Funds, in OECD, Financial Market Trends, 2008.

²⁸ Punter Southall, Solvency funding in pension schemes – The application of solvency regimes to European pensions, December 2007

eroding the competitive position of companies in those Member States. A lower allocation to equities by these IORPs would reduce the expected return on investments, which would necessitate a massive rise in contributions to maintain the same level of pension benefits. In general, a lower expected return of 1% point requires an increase in contributions by 30%. The higher allocation to bonds might reduce bond yields in the market and hence further increase costs for IORPs.

An equally likely scenario is that DB and hybrid workplace schemes would be closed. DB pension promises operated by IORPs categorised under Art. 17 would become increasingly hard to afford. It would result in many millions of employees being poorer in retirement.

Question 15(4e) - *What would be costs and benefits of this? Please provide quantitative information, where available.*

Costs are certain to be large in Member States with a high proportion of IORPs categorised under Article 17 and could undermine the viability of existing pension provision.

EFRP believes that it will be the employees who will have to bear the ultimate effect of the closure of DB workplace pension schemes as it will result in lower pension outcomes and less savings for retirement.

Question 16(4f) - *In case a Solvency II-type regime were to be applied to IORPs subject to Article 17, which elements would need to be adjusted to take account of the specificities of the institutional set-up in which that IORP operates (e.g. recovery plans, additional contributions, flexibility of benefits, etc.)?*

EFRP feels that – as indicated in Questions 4 and 7 – a Solvency II-type regime could have extremely serious consequences for IORPs subject to Article 17.

Furthermore, EFRP would not like to see that the Solvency II regime is used as a starting point to review the solvency regime for IORPs subject to Article 17.

A solvency regime for IORPs subject to Article 17 would need to take into account the special features of the institutional arrangements in which these IORPs operate, including the extent of any risk sharing with employers and employees.

Question 17(5) - *In case of overfunding can the excess assets be returned to the sponsoring employer or are there restrictions to this (thereby reducing the upside potential for employers)? Does this partly depend on whether occupational pension schemes are closed or open to new members?*

This question does not seem particularly relevant for IORPs that underwrite all liabilities themselves. In that case, the sponsor does not have a stake in the IORP and should not have a claim on excess assets. As already mentioned, most IORPs that are required to maintain risk buffers, and which may be subject to legislation based on Article 17(3) do not underwrite all liabilities themselves, but instead the risks are shared by employers and employees. In such cases there is a risk that over-funding upfront may become a trapped surplus in the IORP, especially where the IORP is closed to new member or accrual. This would be economically inefficient.

4.2. IORPs operating on a cross-border basis

4.2.1 Technical provisions

Question 18(6a) - *To what extent do you consider greater harmonisation within the EU in this field or in individual elements of the valuation of technical provisions possible or necessary for IORPs operating on a cross-border basis?*

EFRP has always supported the development of a Single Market for workplace pensions provided that it does not result in lower pension benefits. We are convinced that pan-European IORPs operating in a single market offer substantial potential advantages to employers and employees.

EFRP sees no reason at this stage to consider a further harmonisation of EU regulations with regard to the valuation of technical provisions for IORPs engaging in cross-border activities, as:

- It is too early to judge whether additional measures are called for, since the IORP Directive has been fully implemented for little over a year. It is generally the case that four or five years must pass before it is possible to assess how EU legislation has helped single market integration.
- Seeking further harmonisation of technical provisions would be an irrelevance so long as fundamental issues of interpretation remain in relation to the IORP Directive, such as the definition of cross-border activity, the scope of social and labour law or, in practice, tax systems.
- By contrast, there is already a single prudential framework (through the IORP Directive) applying to cross-border IORPs.

- It would be more realistic, in the short term, to expect beneficial cross-border provision of wholesale investment and administrative services.

It would therefore be **disproportionate** to introduce changes applying **to a single aspect** of the regulation (technical provisions) of a small number (70) cross-border IORPs which, unlike some other aspects, **is not known to cause problems**.

Question 19(6b) - *Should prudential requirements be considered separately from Social and Labour Law (SLL)? If yes, how could prudential requirements and SLL be distinguished?*

Social and labour law can affect the extent of the sponsoring employer's liability and the security mechanisms applying to the IORP. This may in turn affect the level of prudential technical provisions that each member state expects IORPs to maintain. The delivery of a benefit complying with characteristics determined by the domestic SLL conditions a number of prudential requirements because those should ensure the benefit is delivered according to the SLL standard.

It is therefore not possible to consider prudential requirements in isolation from social and labour law. From this it follows that further harmonisation of prudential requirements would be problematic without considering the scope of social and labour law.

EFRP considers that the best solution is for regulatory frameworks as well as supervisory practice in the Member States to be sufficiently flexible to accommodate the additional demands from host State's social and labour legislation. Hence EU-wide regulations should be framed in a qualitative rather than quantitative manner so as to enable prudential regulation to reflect local circumstances and social and labour law. This is the approach adopted by the IORP Directive, which is therefore fit for purpose in this regard.

Question 20(7a) - *How should differences in indexation promises (i.e. in nominal, conditionally indexed and real terms) be taken into account or included in a solvency framework for IORPs operating on a cross-border basis?*

There is a wide range in the inflation protection provided in EU pension contracts. Indexation may be unconditional or conditional or indeed no indexation may be provided at all. Indexation may cover pensions in payment, benefits pre-retirement, or both. In any event these benefit aspects are generally detailed

provided either through social and labour law or social partners' arrangements/agreements, and hence are host-state specific. However, the **home-state supervisor** should decide which prudential requirements are needed to match and deliver the different forms of indexation.

Question 21(7b) - *Do you foresee any difficulties arising from differences in the specific nature of pension promises in case of cross-border activity?*

The differences in indexation requirements - just one aspect of pension promise - (question 20) provide a serious obstacle. There are other significant differences relating to the payment of cash sums at retirement, treatment of spouses, and early retirement rules, which can also affect the level of technical provisions. Taken together, such differences make it harder to design an IORP that is compliant across several member states, as in practice the plan rules will need to differ from country to country. **Further harmonisation of prudential rules would not change this position.** Indeed, if IORPs are to operate cross-border, national regulatory frameworks need to be sufficiently flexible to accommodate the different pension contracts of the host states in which their IORPs may operate. EFRP refers back to its concept of an EIORP with different national sections which can be inspirational for addressing host State requirements.²⁹

Furthermore, EFRP would like to point out that **growth is situated in the area of pan-European DC schemes.** All the difficulties arising due to differences in national SLL and indexation practices are less relevant in these kind of schemes. Nevertheless, we believe that a pan-European DB IORP is also possible (see our model on national sections, EIORPs) but the potential of these kind of pan-European schemes is limited due to the great **variety of pension promises** requirements by **social and labour law.**

4.2.2 Solvency rules

Question 22(8a) - *To what extent are the differences in solvency rules for IORPs operating on a cross-border basis acting as an obstacle towards cross border activity of occupational pensions?*

EFRP is convinced that cross-border operations are not likely to be hindered by different funding requirements across Europe. On the contrary, the IORP Directive provides IORPs engaged in cross-border operations with a single

²⁹ EFRP - European Institutions for Occupational Retirement Provision, October 2003

prudential framework - that of the home country. Problems may arise where prudential provisions exist in social and labour law, as happens in some Member States, and hence IORPs must comply with prudential regulation from both the home and host state. This may prove to inhibit the establishment of cross-border IORPs, but social and labour law is the responsibility of individual Member States and not governed by EU prudential regulation.

Question 23(8b) - *Do you think that there may be other, and potentially more important, reasons beyond the scope of prudential regulation that complicate the conduct of cross-border activity? Please specify.*

EFRP considers that it is too early to tell whether the development of the internal market for occupational pensions is materially obstructed. It has after all taken time for other financial services to open up after enabling EU legislation, for instance in relation to pan-European investment funds covered by the UCITS Directive, adopted almost 23 years ago. The IORP Directive has been fully implemented for only one year now, which could well help explain the relatively small number of cross-border IORPs. **We agree with the Commission's view above Question 22(8a): "More time is therefore needed for the full effects of the Directive to unfold."**

National social and labour law may well prove to be a serious impediment to cross-border activity, as:

- There continues to be uncertainty about the boundaries of the social and labour rules put in place by different Member States. Such uncertainty must act as a serious obstacle to anyone wishing to pan-European operations. There needs to be clear and exact disclosure of the relevant social and labour law requirements, preferably in one place, such as the CEIOPS website.
- Cross-border IORPs must comply with as many sets of different host State social and labour law as the number of States in which they operate. As the scope of social and labour law varies considerably, the resultant complexity is burdensome for the IORPs concerned and could well require defined benefit IORPs to design a separate scheme for each country, negating much of the benefit from operating cross-border.
- It is worse still, where Member States include some (prudential) requirements within social and labour law, which others include within prudential law. In such circumstances, the regulation applying to the IORP is potentially contradictory or incompatible. For instance, German members of an IORP with UK as the home State and Germany as the host would be covered by two levy-funded insolvency protection funds. (UK members of an IORP with Germany as home and the UK as host would

not be covered by any protection fund). Such outcomes are liable to bring pensions regulation into disrepute and overwhelm the benefits of pan-European operation. EFRP considers that **cross-border activity will be severely constrained so long as there is the potential for duplicate coverage between social and labour law and prudential regulation.**

- There is a perception that some Member States may be maximising the requirements of social and labour law as a means of discouraging innovation from cross-border IORPs, or indeed any cross-border activity whatsoever.

Another long standing, although decreasing, impediment is the different treatment of **taxation** of occupational pension saving across Europe. EFRP recognises that the EU is working to tackle this and the relevant decisions of the European Court of Justice are inducing Member States to give up some of their entrenched positions on taxation of transfers of pension capital and dividends³⁰.

Finally, **differences in Member State interpretation of the provisions of the IORP Directive**, not covered by this consultation, could well constrain cross-border activity; most notably the absence of an agreed definition of what constitutes cross-border activity.

Question 24(9a) - *Is there any evidence of i) regulatory arbitrage by IORPs operating on a cross-border basis, and/or ii) supervisory competition between Member States? If so, please give examples.*

EFRP does not see any current evidence of regulatory arbitrage. So far only 70 IORPs are reported as having cross-border activity. 39 of these were already operating cross-border prior to the introduction of the IORP Directive - many UK pension funds servicing Irish employees and vice versa. **Little information is available** on the remaining IORPs established after the introduction of the IORP Directive.

EFRP would like CEIOPS to disclose the underlying information to draw firm conclusions. By any means, their limited number indicates that regulatory arbitrage is not currently a problem.

Question 25(9b) - *Do you expect regulatory arbitrage by IORPs operating on a cross-border basis, and/or supervisory competition between Member States to occur in the future, and what evidence do you have to support your belief?*

³⁰ See footnote 23;

EFRP feels that regulatory arbitrage will not prove to be a significant problem in the future, as:

- IORPs **do not suffer from principal-agent problems** to the same extent as other financial institutions. Banks and insurers have an incentive to base themselves where regulatory requirements are lowest, hence maximising shareholder benefits while subjecting consumers to higher risk. There is a much greater **alignment of interests** for IORPs as employers and employees share the risks and benefits and managers have a **duty to act in the interests of beneficiaries**.
- Occupational pension provision is delivered on a **wholesale market**. This widely differs with the retail logic of banking and insurance pension products in third pillar pension provision. Under such circumstances, there is a risk that individual consumers will not understand the implications of different regulatory standards in different countries. Decision takers in IORPs are mostly representatives of employers and employees or employers themselves. They understand that less strict security standards would come at the cost of higher uncertainty regarding contribution rates and/or retirement benefits.

EFRP is aware that the establishment of cross-border vehicles in some Member States has been interpreted by some as encouraging regulatory arbitrage and supervisory competition. We do not think these Member States are pursuing such a strategy. **If they were, it would not prove to be very successful, because, as mentioned above, the governance of IORPs would work against any move designed to loosen protection for members.** In any event, member States must comply with the IORP Directive, which lays down adequate minimum standards which prevent the “race to the bottom” as feared by some.

Question 26(9c) - *Do you think that regulatory arbitrage and/or supervisory competition due to differences in the treatment of IORPs operating on a cross-border basis could ultimately be in the interest of pension beneficiaries or sponsoring undertakings or do you think that this may ultimately be harmful? If so, in what way?*

Regulatory arbitrage and supervisory competition that erode the minimum standards in the IORP Directive might prove harmful to pension beneficiaries. Therefore the Commission needs to ensure there is **full and compliant implementation** of the Directive.

Arbitrage could, however, be beneficial where it is directed at regulatory requirements additional to the minimum standards in the Directive that do not add materially to beneficiary protection. The “gold plating” of EU Directives once

those have reached implementation at Member State level is an issue not exclusive to the IORP area.

The consequential elimination of unnecessary costs on sponsors could be beneficial for sponsors, and ultimately for pension beneficiaries. It might enable sponsors to improve the pension promise or provide other forms of benefit. It might improve their international competitiveness and hence enable them to preserve or create jobs. It might, in particular, encourage employers to make or retain pension provision that they would otherwise consider too expensive.

Question 27(9d) - *Do you think that the EU solvency rules for IORPs operating on a cross-border basis should be risk-oriented, and based on a market-consistent valuation of assets and liabilities?*

The concept of **short term** 'solvency rules' as understood in the insurance market, is not relevant to occupational pensions. It makes more sense to use the terminology of the Directive and the CEIOPS OPSSC survey. Furthermore, EFRP reiterates that further harmonisation of EU solvency rules for cross-border IORPs would be premature at this stage as outlined above.

As mentioned in our answer to Questions 4 and 7, we believe that a risk-based orientation to supervision may be advantageous, but note that there are different interpretations of the term 'risk-oriented'. We are convinced that the IORP Directive has facilitated supervisors to implement a risk-oriented approach.

Question 28(9e) - *Do you think that the definition of the right level and method of risk orientation should be determined at EU level or left to individual Member States?*

Again, EFRP believes it **premature** to consider further harmonization of solvency rules for cross-border IORPs at this stage, as outlined in Question 18 and 30.

As in its response to Question 8, EFRP believes that a regulatory framework for IORPs should respect the large institutional differences between Member States. It would be difficult to unite this overarching principle with the imposition of a level and method of risk orientation determined at EU level onto the individual Member States. Instead, the EFRP feels more comfortable with a **long term risk-oriented approach** that enables each Member State to vary requirements placed on IORPs depending on the risks they pose to plan beneficiaries in the specific circumstances in each State. A harmonized regime that does not reflect the diverse regulatory and supervisory practices in Member States, including

social and labour law would suffer from high transition costs and hence discourage workplace pensions.

Question 29(9f) - *Do you think that the solvency requirements should include rules relating to governance and disclosure?*

Solvency requirements should **not include** rules relating to governance and disclosure. The IORP Directive provides indeed a comprehensive framework of minimum standards covering not just quantitative funding requirements which could be viewed as solvency requirements. The IORP Directive also includes requirements for professionally qualified governing bodies, sound administrative procedures, adequate internal control mechanisms and transparency towards plan members. Those qualitative governance and disclosure rules should not be viewed or classified as belonging to **solvency requirements which are quantitative by nature**.

Question 30(10a) - *Do you think that a harmonised solvency regime for IORPs operating on a cross-border basis is desirable? Please outline in broad terms how such a regime would look like.*

EFRP sees no evidence at this stage to warrant a harmonised solvency regime of IORPs on a cross-border basis (see our response to question 18).

Question 31(10b) - *Do you think that in some parts or elements of the solvency regime there is scope for harmonisation? If so, for which parts or elements?*

In view of the answer to question 30, EFRP sees no value in speculating as to which, if any, elements of the IORP Directive could be open to further harmonization.

Question 32(10c) - *Is there scope to consider separately different types of IORPs operating on a cross-border basis in this harmonisation? Please explain that view.*

It is premature at this stage to consider further harmonization of the IORP Directive for cross-border IORPs, as outlined in Question 18 and 30. In any case, EFRP does not support the creation of multiple EU regulatory regimes. Instead, we would look for a single regime that makes sufficient allowance for the different types of liabilities incurred by IORPs and the different arrangements in place to mitigate risks.

Question 33(10d) - *Do you see any problems relating to a harmonised approach?*

There is already a minimum harmonized approach, which applies to all IORPs. EFRP doubts whether a fully harmonised approach would be feasible so long as Member States are competent to specify the organisation of the pension system and the nature of the pension promise, and are largely unconstrained in what they include within social and labour law.

Furthermore, the costs of introducing a fully harmonised approach just for cross-border IORPs would considerably outweigh the benefits. As indicated above, the benefits of such harmonisation would be highly uncertain. But the costs of such a harmonised approach could well be significant, given the wide variety of approaches to the calculation of technical provisions and supplementary security mechanisms across Europe. Establishing a separate regime for cross-border IORPs would therefore be disproportionate and could well discourage IORPs from going cross-border because of the additional costs involved in complying with two different prudential frameworks.

Question 34(10e) - *Do you think that the current solvency regimes for IORPs operating on a cross-border basis, which are based on minimum harmonisation, provide a more desirable outcome? Please explain that view.*

Yes, EFRP sees no reason at this stage to move from the **existing regime: minimum harmonization of prudential standards with mutual recognition and supervisory cooperation**. There is no evidence that this approach is a significant obstacle to cross-border activity, especially given the impact of other potential obstacles. By retaining the same framework for IORPs regardless of

whether they operate cross-border the additional costs of operating of cross-border are minimised.

Further harmonisation of the systems applying to domestic as well as cross-border IORPS would be highly disruptive given the wide variation in domestic regulation and the way it interacts with social and labour law.

EFRP wants to highlight that **mutual recognition seems to be unexplored** as an option for further development of occupational pensions provided in cross-border provision of services. We would recommend leaving the drive for further harmonisation apart and instead focus on how **further cooperation can be fostered at Level 3** to create a more favourable operational environment for IORPs. Mutual recognition can be based on largely equivalent systems. The CEIOPS OPSSC survey already provides elements that illustrate diversity can mount to equivalence. Regulatory harmonisation should be kept to a minimum level while **supervisory cooperation should be maximised**, EFRP feels there is still scope for intensifying the Level 3 cooperation.

5. Annexes

ANNEX 1 – EFRP COMMENTS: CEIOPS REPORT “INITIAL REVIEW OF KEY ASPECTS OF THE IMPLEMENTATION OF THE IORP DIRECTIVE – CEIOPS-OP-03-08, 31 MARCH 2008

- EFRP endorses the CEIOPS-OPC main findings that
 - “it is **too early** to tell whether the implementation has generated issues that in turn give rise to the need for legislative change” (page 4, 2nd paragraph)
 - “implementation has **not led to major difficulties**” (page 4, 3^d paragraph)
 - “a considerable part of the **diversity** arises from the very different historical, social and cultural situations across the Member States” (page 5, 2nd paragraph)
 - “the Directive, by virtue of the option it explicitly grants, allows for states to **implement** its provisions in **accordance** with their existing **national priorities and preferences**” (page 5, 3^d paragraph)
- EFRP supports CEIOPS-OPC request to the Commission to provide **clarification** on several issues before new legislative action is considered. Whereas the report calls for clarification in four areas³¹, EFRP believes the focus of the clarification process need to be the **cross-border activity of IORPs**.
 - The objective of this work needs to be to **facilitate cross-border pension provision**. Market participants would like CEIOPS reach an agreed interpretation on cross-border activity and **issue a Level 3 guidance note** on this that is consistent with the **objectives** of the IORP Directive
 - Clarification of the concept of “**additional requirements on information to Members and beneficiaries**” would in our opinion also be conducive for cross-border pension provision.
- EFRP would favour the inclusion of **sub-ordinated loans** as part of the prudent person principle and hence being allowed under the IORP Directive article 18.
- EFRP agrees that the term “**ring-fencing**” is undefined in the IORP Directive but in our opinion a sensible meaning can be construed in each

³¹ cross-border activity, sub-ordinated loans, ring-fencing and investment regulations

of the articles where the term occurs and that is consistent with the objectives of the IORP Directive. EFRP is happy to table a proposal for this.

- EFRP fails to see the need for further clarification in the area of **investment regulation**.
- EFRP is convinced that market participants would hugely benefit from obtaining access to the underlying documents of this report.

ANNEX 2 – EFRP COMMENTS: CEIOPS SURVEY ON “FULLY FUNDED, TECHNICAL PROVISIONS AND SECURITY MECHANISMS IN THE EUROPEAN OCCUPATIONAL PENSION SECTOR – CEIOPS-OPSSC-01/08, 7 APRIL 2008

EFRP endorse the following CEIOPS-OPSSC key messages:

- “Demographic pressures are increasing **the need for fully funded pension systems**, while pay-as-you-go systems become difficult to sustain” (page 1, 1st paragraph);
- “the **material differences between pension funds and insurance companies** in many countries suggest that this [application of Solvency II requirements to pension institutions] is not an appropriate course to pursue (page 2, 1st paragraph)
- “The existing prudential frameworks in the EEA are very diverse. Differences relate to complex technical aspects and in part reflect **provisions in national social and labour law**... These requirements influence the level of technical provisions to be held by the IORP and the functioning of security mechanisms” (page 2, 2nd paragraph)
- “ ... heavy funding requirements may impose **inappropriate large up-front payments** that are not needed because of other security mechanisms in place, thereby discouraging defined benefit provision. Funding standards need to **balance beneficiaries’ security and associated costs**” (page 2, 3rd paragraph)
- “Variance in valuation measures and security instruments does not necessarily imply substantially different security levels between Member States, in practice the **variances are linked and often cancel each other out.**” (page 3, 1st paragraph)
- “**partial analyses** of security levels based on individual valuation elements or adjustments instruments **are misleading** (page 3, 1st paragraph)
- “different methods can be used to secure pension benefits, **national pension supervision frameworks do not have to be identical**” (page 3, 1st paragraph)
- Overall security or solvency can not be understood without **a full appreciation of all the elements involved** (page 7, 2nd paragraph)

EFRP notes that while the survey provides extensive data on the differences between different member states, it contains much less on why the differences occur. We would welcome **in depth research** into the origin of the difference in valuation methods. In our opinion these differences are linked to the different level of reliance on the second pillar in Member States’ social protection systems, as well as the differing balance between funding and other security mechanisms. Second pillar pension provision cannot be analysed in isolation from first pillar pension provision. Therefore we believe the illustration of the components of

technical provisions for a theoretical model in the different Member States - page 26 of the report - is misleading if considered in isolation.

EFRP is concerned that the CEIOPS OPSSC survey occasionally leaps beyond the evidence to draw **conclusions that are not substantiated**; for instance that “substantive variations in regulatory requirements may spur regulatory arbitrage by IORPs and supervisory competition between member states”. Our members are not aware of any supervisor who is prepared to weaken standards so as to encourage IORPs to move to their jurisdiction.

EFRP questions whether the wide **reach of social & labour law into prudential supervision** (for instance, maximum discount rates and mortality assumptions) found by CEIOPS OPSSC is legitimate. We would not expect the scope of social and labour law to duplicate that of the IORP Directive, as taken to an extreme it could be used to negate the intent and impact of the Directive. Further work is needed to define where the boundaries of social and labour should lie and how to identify them. .

EFRP is convinced that market participants would hugely benefit from obtaining access to the underlying documents of this report.

EFRP notes the different scope of the CEIOPS OPSSC survey and the European Commission Consultative document. In particular, the absence of any in-depth analysis of Article 17 IORPs or existing cross-border IORPs considerably reduces its value to this consultation. Such a sub-analysis would be needed were the Commission to continue to focus on these types of IORPs.

EFRP notes that, while the CEIOPS OPSSC survey has identified two archetypes of IORPs relating to the use of separate risk buffers, it does not explicitly link these archetypes to Article 17.

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