

IORP Directive - securing workplace pensions

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EFRP paper on Funding and Solvency Principles for IORPs



European Federation
for Retirement Provision

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KEY MESSAGES

- IORPs have their own EU-level regulatory regime, namely the Institutions for Occupational Retirement Provision Directive (Dir. 2003/41/EC) which provides adequate and effective protection to members and beneficiaries. The IORP Directive, adopted in June 2003, was not in full operation in all Member States until May 2007. Instability in legislation should be avoided especially where there is no evidence of a need to bring IORPs under an insurance-like regulatory regime.

- The application of the Solvency II Directive to IORPs would:
 - ignore the fundamental differences in many Member States between life insurers and IORPs;
 - seriously harm the provision of workplace pensions in those Member States using IORPs as the main financing vehicle for workplace pension provision;
 - have a very detrimental effect on the EU's financial markets and would increase financial systemic risk;

- EFRP accepts that the solvency regime of IORPs will be subject to further scrutiny as part of the EU Commission evaluation of the IORP Directive in the near future. Such a process should not be rushed but be properly prepared to avoid poor policy decisions which affect the future of workplace pensions.

EXECUTIVE SUMMARY

The provision of retirement income differs markedly between Member States. While all EU governments provide a state pension, the level varies greatly, and many have been reformed recently in response to the cost of Europe's ageing population. To help reduce the cost to today's workers, many EU countries have reformed their state pension provision so that state pension benefits are expected to decline by about 25% over the coming decades.

To help people save enough for retirement, EU Member State have sought to encourage funded pension provision, most recently through the adoption and implementation of the IORP Directive. It provides a prudential framework to ensure the security of IORPs and enables cross-border activities with a view to encouraging a Single Market for workplace pensions. It lays down rules for the calculation of pension liabilities ("technical provisions"), how they are to be funded, the investment of pension assets, information provision for workplace pension scheme members, governance and the role of the supervisor. It adopts a principles-based approach which sets a core set of rules but allows Member States to interpret them in the light of the different types of workplace pension that exist around the EU.

Workplace pensions are well suited to helping promote retirement saving. Due to their association with the workplace, they achieve high coverage and consistent saving, thereby overcoming the tendency identified by the study of behavioural finance for people to put off saving ("myopia") and to value spending today rather than spending in retirement ("hyperbolic discounting"). Due to their scale and governance arrangements, they also provide superior investment decision-making than would be made by individuals alone. They also operate at low cost. Some workplace pension schemes also provide risk-sharing between generations and often include insurance against disability and premature death.

In most Member States, IORPs, as financial vehicles, are fundamentally different to insurance companies and so require a different approach to their regulation:

- IORPs often have a plan sponsor (usually the employer such as corporations, local authorities, universities) providing backing for the pension promise.
- 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.

In such cases the employer is required to make those scheme rules absolutely clear in their communications to members.

- have more flexible rules regarding surplus distribution and thereby are potentially better equipped to provide inflation protected pensions than insurers.
- IORPs usually have a governance structure involving or representatives of plan members, ensuring that the pension scheme is managed in their best interest and that conflicts of interests are minimised.
- IORP tend to be not-for-profit institutions, which means there is no need to protect plan members from activities which are primarily undertaken in the financial interests of shareholders.

The application of the Solvency II Directive to IORPs would greatly alter the type of investment required by regulation with the result that many employers would be likely to terminate these high-value pension arrangements. Several Member States, including Belgian, Ireland, Netherlands, Spain, and the United Kingdom, would be severely affected. In these countries, pre-funding levels would have to be increased by 40-60% of current levels. This would be accompanied by a sell-off of equities which could threaten the stability of the EU's financial system.

The EFRP is supportive of the approach taken by Rapporteur Peter SKINNER in the European Parliament while proposing amendments 6 and 67 to the proposal for a Solvency II Directive.

1. INTRODUCTION

It has been suggested that the Solvency II Directive, which sets out the prudential funding rules for insurance companies, should be applied to IORPs (Institutions for Occupational Retirement Provision), often referred to as “pension funds”. The European pension fund sector, as represented by the European Federation for Retirement Provision (EFRP), has produced this report to explain why such an approach is neither necessary nor desirable.

It should be emphasised at the outset that the EFRP is not alone in believing that the current Solvency II Directive should not be applied to IORPs. Indeed, both the European Commission¹, and before it the European Insurance and Occupational Pensions Committee (EIOPC), the forum for Member State insurance and occupational pension scheme regulators, also take the view that it would not be appropriate to extend the Solvency II Directive to IORPs at this point in time.² The CEIOPS recently stated in its survey on the funding regimes of IORPs that “material differences between pension funds and insurance companies in many countries suggest this (the application of Solvency II requirements to pension institutions) is not an appropriate course to pursue. Such action could lead to excessive costs and thus bears the risk of threatening the continued provision of defined benefit schemes”³

The EFRP believes there are **no convincing arguments** indeed as to **why the Solvency II Directive should be applied to IORPs**. The IORP Directive already imposes stringent requirements that secure the future retirement income of pension scheme members. Moreover, there is no sign that the current IORP regime is failing. Indeed, as it has been in place for only a little over two years, it is too early to undertake a review.

¹ Commissioner McCREEVY speech at:

- CEIOPS Conference – 2007-11-20;
- Insurance Institute London – 2008-02-07;
- FSA Conference – 2008-04-08;

² EIOPC decision of 5 April 2006.

³ CEIOPS – OPC Subcommittee on Solvency – 01/08, 31 March 2008, page 2.

This report begins by providing an outline of the nature of state pension provision across the EU, how state pensions have been reduced in the face of ageing populations and how Member States are encouraging workplace pensions to provide a means of additional saving (chapter 2).

It goes on to explain how workplace pensions (IORPS) are well suited to this task (chapter 3). This is followed by an explanation of why it would not be appropriate to apply the Solvency II Directive to IORPs and how doing so would have very negative consequences for both the extent of workplace pension (IORP) provision and for the wider economy (chapter 4).

This report then outlines how the IORP Directive already provides a regime similar in many respects to that under the Solvency II regime (chapter 5) before dealing with some specific issues raised by the interlinkage between the Solvency I Directive (the precursor to the Solvency II Directive) and the IORP Directive (chapter 6).

Finally, the report concludes by urging EU decision-makers to acknowledge that it would not be appropriate to apply the Solvency II Directive to workplace pension schemes (IORPS) and that if it is decided to adopt any amendments to the regulatory regime of such schemes, this should be undertaken as part of the IORP evaluation already planned for the near future.

2. OVERVIEW OF EUROPEAN PENSION SYSTEMS⁴

*The provision of retirement income differs markedly between Member States. Many Governments have reformed state pension provision in reaction to the challenge of ageing populations. As a result, state pension benefits are projected to decline by 25 % over the coming decades, raising doubts over the adequacy of future retirement income. Member States are increasingly turning to supplementary pension provision. Commissioner McCREEVEY recently underlined “the need to manage the transition from a State-financed pension system to a partnership model, including workplace and private pensions”.*⁵

2.1 Pay-as-you-go arrangements under pressure

In all Member States the state provides a core level of pension financed, in the main, from current taxation or contributions on a pay-as-you-go basis. In some countries, such as Germany, Sweden and Spain, the statutory pension provides a pension over half the level of previous earnings, in others, such as the UK, Ireland and the Netherlands, it provides a much lower amount (20 to 30%) of earnings. Statutory pensions may be earnings-related or provided at a flat-rate.

Reforms of state pension arrangements...

Many countries have started to reform statutory pension provision in recent years, as pay-as-you-go arrangements are becoming increasingly more difficult to sustain due to the ageing of European populations. In doing so, governments have strengthened the link between contributions and the level of pension, increased the period over which contributions must be made and decreased the value of the resulting state pension. Moreover, the early retirement option has generally been curtailed or removed entirely, and statutory retirement ages have been raised. Reducing the indexation of pensions both during their accrual and payment stages is another policy measure which has been used to curb state pension expenditure. In addition, in several countries, such as Italy, Latvia, Poland and Sweden, defined benefit earnings-related arrangements have been changed into (notional) defined contribution schemes. This has had the effect of

⁴ See European Commission, Adequate and Sustainable Pensions – Synthesis Report 2006, Brussels, August 2006 and European Commission, Privately Managed Pension Provision, Report by the Social Protection Committee, Brussels, February 2006 for a comprehensive overview of recent developments in European pension provision.

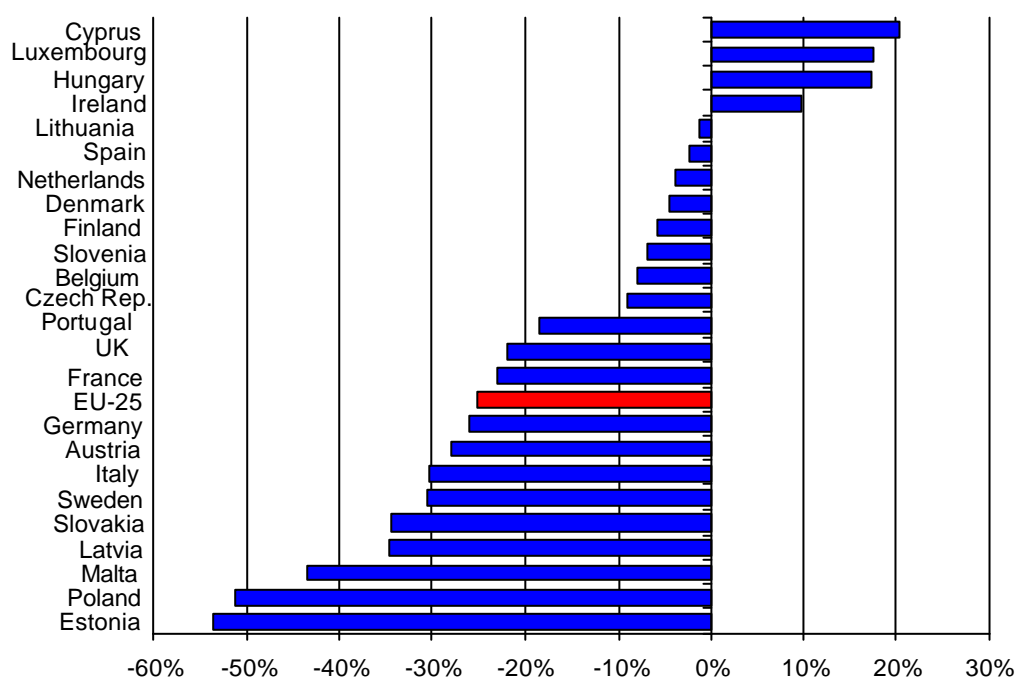
⁵ Speech Commissioner McCREEVEY, 26 June 2007, Brussels – EFR Report on Pan European Pension Plans.

transferring the cost burden of increases in life expectancy from the state to the individual with the result that over the longer term the annual level of state pensions is likely to fall.

...raises the question of adequacy

The European Commission estimates that the state pension benefit ratio, that is to say the average value of the state pension compared to average earnings, will decline by on average 25 percent in Member States in the coming decades (see Figure 1).⁶ Reductions of this magnitude raise the question of whether future retirees will consider their overall pension provision to be adequate to their needs. There is a risk that some may suffer from poverty in old age. It is certainly the case that many will be unable to maintain the standard of living to which they have become accustomed during their working lives.

Figure 1: Public benefit ratio (% change) 2005-2050



Source: EC (2006)

⁶ See European Commission, The long-term sustainability of public finances in the European Union, European Economy No. 4, Brussels, 2006.

There is also a danger that inadequate pension provision may also pose a threat to the sustainability of public finances. Future generations may “demand” through the ballot box higher value pensions thereby exerting an upward pressure on public expenditure.

These two threats, that of lower pensioner incomes due to lower state pension provision and that of constrained public finances if people call for higher tax-funded pension payments, mean that **an increase in private retirement savings is essential for the future well-being and stability of Europe.**

2.2 Promotion of workplace pensions

The role of workplace pensions⁷ has grown substantially in recent years. Traditionally, occupational pensions have played an important role in Denmark, Ireland, the Netherlands and the United Kingdom. The existence of widespread workplace pension provision has probably made it easier for the statutory pension arrangements to provide for a lower and more affordable level of pension than in some other EU countries such as Germany or Italy.

In a significant number of countries - Belgium, Germany, Spain, France, Italy, Portugal – national policy encourages the provision of workplace pensions (IORPs) to supplement the decline of state pension benefits. Governments in these countries have extended the provision of tax incentives for such pensions and/or have set up or strengthened their institutional and regulatory basis. Also, work-related privately managed mandatory savings have been increasingly used in recent years to compensate for reductions in the value of the state pension. For example, in Sweden, and especially in the CEE region, governments have introduced a mandatory requirement for employees to make retirement arrangements through private pension providers.

⁷ In this paper workplace pensions are defined as labour agreements, negotiated between employer and social partners or individual employees, to supplement state social security pensions in which the risk is often shared between the sponsors and/or the employees through pre-specified risk sharing mechanisms, ranging from DB, hybrid and DC pension schemes. The benefits provided in a pension scheme depend largely on the negotiations between employers and/or social partners and can be materially influenced by decisions taken by member (for example to retire early, investment choice, etc) but also by governmental decisions. It is important to note that national diversity of workplace pensions systems complicates the picture.

Pension plan design

Many different types of workplace pensions exist across the EU. Usually pension schemes are classified as being either of the defined benefit type (DB) or the defined contribution type (DC), but it should be recognised that many hybrid schemes exist. Historically, workplace pension plans in Belgium, Ireland, the Netherlands, Sweden and the UK were to a large extent pure DB schemes. However, in recent years a clear trend has appeared towards DC schemes and hybrid plans. Examples of hybrid plans are DC schemes guaranteeing a minimum rate of return or cash balance plans (Austria, Belgium and UK) and DB schemes with conditional indexation (Netherlands).

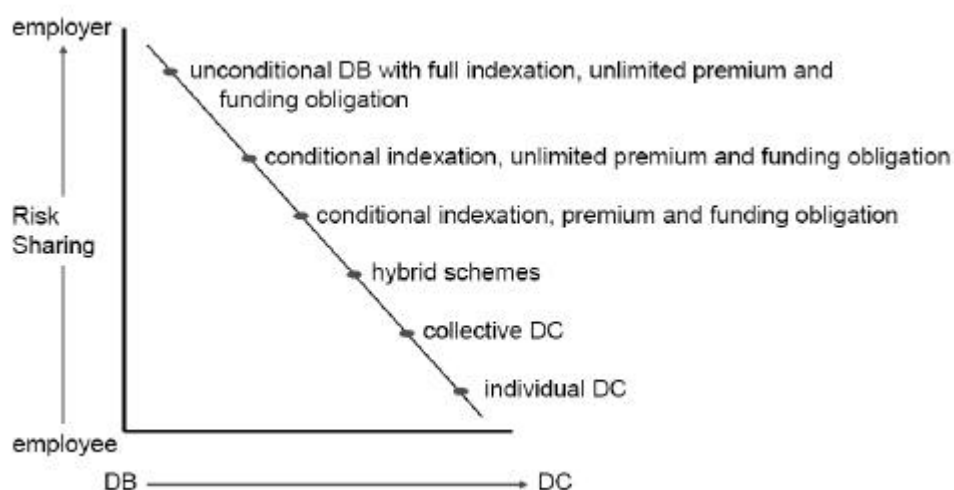


Figure 2: Range of different pension types

The wide diversity of workplace pension schemes was also highlighted in the FSC⁸ Report on the implications of ageing populations for financial markets and in the recent CEIOPS Survey on the European Occupational Pension sector.⁹

⁸ Agreed at the FSC Meeting of 21 March 2007.

⁹ CEIOPS survey of fully funded, technical provisions and security mechanisms in the European occupational pension sector, 31 March 2008, CEIOPS.

Brussels facilitates workplace pensions

The importance of workplace pensions in supplementing state pension schemes was recognised in the adoption of **the Institutions of Occupational Retirement Provision Directive** in 2003.¹⁰ The IORP Directive:

- provides Member States with a **prudential framework for IORPs** and enables **cross-border activities of IORPs**;
- acknowledges **IORPs as specialised financial service providers with their own regulatory framework**.

The IORP Directive lays down rules for the calculation of technical provisions, the funding of liabilities, the investment of assets, information provision to plan members, governance and the role of the supervisor.

The IORP Directive takes a **principles-based approach**. It requires workplace pensions (IORPs) to hold sufficient assets to liabilities (“technical provisions”). It is left to Member States to define the specific funding rules that are appropriate to those local arrangements and to decide on additional quantitative measures to secure pension benefits of plan members. This approach has safeguarded the wide diversity in valuation methods, discount rates and additional protection measures which necessarily exist in various Member States - see Table 1 summarising the results of an EFRP survey on this issue.

All respondents to this EFRP survey answered that, **in addition to these quantitative requirements, regulations are in place requiring sound governance structures, adequate internal control mechanisms and information provision to plan members**. Additional rules regarding the involvement of plan members in the governance of a workplace pension (IORP) are more diverse. Involvement of plan members ranges from optional advisory bodies to mandatory participation on the governing board.

¹⁰ Directive 2003/41/EC of the European Parliament and the Council, 3 June 2003.

Table 1: Prudential regulations for defined benefit/hybrid plans a)

Country	Valuation b)	Discount rate	Protection	Plan member involvement
Austria	ABO1	3.5% - 5% c)	Reserve fund/ bankruptcy fund d)	Supervisory board/ investment committee
Belgium	ABO1	Asset return/ market yield	Sponsor e)	Governing board/ advisory body
Finland	ABO1	3.5%-3.8%	Sponsor	Governing board
Germany	ABO1	0%-4%	Risk-based buffers Sponsor Insolvency insur. f) Protection fund g)	Supervisory board
Ireland	ABO2	Market yields	Wind-up funding standard	Board of trustees
Netherlands	ABO1	Market yields	Risk-based buffers	Governing board/ plan member council
Spain	PBO	5%	-	Governing board/ control commission
UK	ABO2/PBO	Market yields	Sponsor plus protection fund	Board of trustees

a) Based on a survey conducted among EFRP members in October 2007.

b) ABO1: Accrued benefit obligation, ABO2: accrued benefit obligation including future indexation, PBO: projected benefit obligation including expected salary increases.

c) 3.5% for DC plans with minimum returns, 5% for DB plans.

d) DC plans with minimum guarantee require reserves, occupational plans are covered by a bankruptcy fund.

e) Back-up protection by the sponsor follows from social and labour law.

(f) for Pensionsfonds.

(g) possible for Pensionskassen.

3. WORKPLACE PENSIONS – WELL EQUIPPED TO BE PART OF THE SOLUTION

Many Member States face the important challenge of ensuring adequate retirement income for current and future generations. Workplace pensions are well equipped to meet this challenge. They provide high coverage, sound investment decisions, low costs and allow for risk-sharing between generations.

3.1 High coverage

Workplace pensions - mainly provided by IORPs - provide an effective means of achieving high participation in retirement saving among groups of people, who would otherwise be unlikely to save enough for a comfortable retirement. Behavioural finance demonstrates that most individuals tend to be short-sighted regarding saving (“myopia”) and repeatedly postpone saving for retirement. They also tend to value consumption today far more than consumption in the future such as that for retirement (“hyperbolic discounting”).

Workplace pensions overcome the problems of “myopia” as employees generally join their workplace pension scheme more or less automatically when they begin a new job and they combat the problem of “hyperbolic discounting” as the money is “locked-away” until retirement.

3.2 Better investment decisions

Most people are unable to make rational or sensible investment decisions. People who are not able to make effective investment decisions themselves are very much dependent on independent advice from financial specialists. However, the experience with financial advisors and intermediaries in various countries has demonstrated that substantial conflicts of interests can arise and it is far from easy to mitigate or manage them.

In workplace pension schemes, either the Social Partners or scheme members acting in the interest of all members (“trustees”), take investment decisions on behalf of individual scheme members. The economies of scale involved in making decisions on behalf of all members enables them to draw on professional

advice and the fact that the decision-makers do not benefit commercially from the decisions they make means the risk of conflicts of interest are greatly reduced.

3.3 Low costs

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 and wholesale prices can be achieved through direct negotiations with asset managers. There is also considerable evidence that the fees charged on individual saving products are much higher than on collective pension products.^{11 12} It is important to stress that small differences in annual return can make significant differences in private retirement income.

3.4 Intra and Intergenerational risk-sharing

Some workplace pensions also provide for risk-sharing between generations (sometimes referred to as “solidarity”). The ability of defined benefit and hybrid schemes to spread surpluses or shortages across future generations reduces costs. In the event of disappointing investment returns, not only current generations, but also future generations bear some of the burden. Of course, in the event of returns exceeding expectations the reverse holds true – both current and future generations share the benefits. Risk-sharing implies that at given contribution rates the volatility of pension outcomes is reduced. Or equivalently, at a given level of risk, the contribution rate will be lower.

Many workplace pensions also include disability and incapacity insurance and therefore offer elements of additional risk-sharing (or “social solidarity”). Similarly, most workplace pensions also provide for payments to the surviving family members in the event of premature death (“life assurance”).

¹¹ See J.A. Bikker and J. de Dreu, Operating costs of pension schemes, in O.W. Steenbeek and S.G. van der Lecq (eds.), *Costs and Benefits of Collective Pension Systems*, Springer, 2007.

¹² See K. Ambachtsheer and R. Bauer, *Losing Ground*, Canadian Investment Review, Spring 2007.

4. APPLYING SOLVENCY II TO IORPS IS UNNECESSARY

EFRP believes that the extension of the Solvency II Directive to workplace pensions (IORPs) is unnecessary. Firstly, IORPs have distinct features which render an extension of the Solvency II Directive inappropriate. Secondly, an extension of the Solvency II Directive to IORPS would certainly lead to reduced workplace pension provision and, due to the consequent changes in investment strategy, harm the EU economy in general.

In the summer of 2007 the European Commission published its proposal for a Solvency II Directive¹³. The Solvency II Directive is intended to replace the Solvency I framework for insurers, which was drafted some thirty years ago. An important element of the new solvency framework is that liabilities are to be valued at market rates. Insurers will also be required to hold risk-based capital such that the probability of remaining solvent within one year exceeds 99.5%. The Solvency II Directive also introduces new regulations on the quality of risk management and governance and the role of the supervisor.

4.1 IORPs are different to insurance companies

In most Member States, IORPs, as financial vehicles, are fundamentally different to insurance companies and so require a different approach to their regulation:

- IORPs often have a **plan sponsor** (usually the employer such as corporations, local authorities, universities) providing backing for the pension promise.
- 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.

In such cases the employer is required to make those scheme rules absolutely clear in their communications to members.

¹³ European Commission, 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 – Solvency II, Brussels, 10 July 2007. An amended proposal COM(2008)119 was issued on 26/02/2008.

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- have more flexible rules regarding surplus distribution and thereby are potentially better equipped to provide inflation protected pensions than insurers.
 - IORPs usually have a **governance structure** involving or representatives of plan members, ensuring that the pension scheme is managed in their best interest and that conflicts of interests are minimised.
 - IORP tend to be **not-for-profit institutions**, which means there is no need to protect plan members from activities which are primarily undertaken in the financial interests of shareholders.¹⁴

4.2 Impact of extending Solvency II to IORPs

The application of the Solvency II Directive to IORPs may seriously harm the economy and scale and quality of pensions offered to employees. To assess the impact of applying the Solvency II Directive to IORPs the EFRP has conducted a quantitative impact study (see Table 2).

The study analyses the impact of market valuation of liabilities and the solvency capital requirement that the probability of underfunding within one year does not exceed 0.5 percent. The table below shows by how much an IORP would have to increase its funding ratio – given its financial position on December 31, 2006 - to comply with the solvency capital requirement under the condition of liabilities being marked to market. Instead of raising risk-based solvency capital the IORP may alternatively choose to lower the risk of its investment portfolio. This can be achieved by reducing the share of equities in the asset mix or by increasing the duration of fixed income assets. Most IORPs face a positive duration gap between liabilities and assets, which implies that a decline in interest rates has a detrimental effect on the funding position.

¹⁴ The shareholders of insurance companies have a clear incentive for risk taking at the expense of policy holders, since their downside risk is limited – share prices cannot turn negative – while their upside potential is unlimited.

Table 2: The impact of Solvency II on seven European pension funds

Impact of Solvency II on required funding ratio or asset mix for seven IORPs		
	Increase in funding ratio	Effect on asset mix
Austria	12%	Equity share -23%points or duration +14 years
Belgium a)	41%	Equity share -68%points and duration +6 years
Germany	7%	Equity share -14%points or duration +8 years
Ireland	62%	Equity share -75%points and duration +15 years c)
Netherlands b)	39%	Equity share -58%points and duration +9 years c)
Spain	46%	Equity share -29%points and duration +23 years c)
United Kingdom	57%	Equity share -90%points and duration +10 years c)

a) Concerns a pension fund that is representative for Belgium.
b) The IORP provides for discretionary, conditional indexation and the assumption is made that it is required to hold solvency capital over real liabilities, but Article 106 of Solvency II is not entirely clear on this issue. On the one hand it only allows for simultaneous adjustments of liabilities to reduce the capital requirement, but on the other hand it recognises the risk mitigating effect of future discretionary benefits.
c) The adjustment to the asset mix would still leave these IORPs with a funding shortage.

NB. With regard to the solvency requirement we assumed that IORPs should be able to withstand an interest rate shock of -30%, an equity shock of -35% and a foreign currency shock of -25%. We would like to emphasise that the results are based on a limited cross section of scheme types and some simplifying assumptions were made. Nevertheless, the analysis illustrates that the potential impact of Solvency II would be considerable.

The Belgian, Irish, Dutch, Spanish and British IORPs would be severely affected by the extension of Solvency II. These IORPs would have to increase assets by around of 40-60% of liabilities. Alternatively, they would have to both sell off all equity investments and raise the duration of the fixed income portfolio in order to minimize mismatch risk. Pension fund assets in these countries account for 75 percent of total European pension fund assets (approximately 2063 billion euros). The Austrian and German IORPs would have to hold additional assets amounting to 5-15% of technical provisions. Alternatively they could reduce the risk of their

investment portfolio by reducing the share of equities by 15-25% and/or by increasing the duration of the fixed income portfolio by 7.5-15 years. The impact of the risk-based solvency requirement exceeds the impact of market valuation by a wide margin. Longer duration would raise the volatility in the market value of IORPs' assets and, in some cases, require new types of asset-backed securities.

While each outcome would clearly be of direct disadvantage to employees across the EU, the first two of the possible reactions identified above would seriously harm economic growth. The accumulation of financial buffers would demand a massive rise in contribution rates. This would **hurt the purchasing power of consumers** and **raise labour costs, eroding the competitive position of European industry**. A sell-off of stocks held by IORPs would threaten the stability of the EU's financial systems and seriously damage the economy. Total assets of European pension funds amount to 2.880,00 billion euros of which around 40 percent is invested in shares. A reduction of equities in investment portfolios would also have more long-term implications. Economies thrive on the willingness of investors to hold risk-bearing capital. A lower inclination to do so reduces capital expenditure and in the long run productivity growth. Clearly, this is not in line with the objectives set out in the Lisbon agenda.

Another likely scenario is that **DB and hybrid workplace schemes will be closed** to new members as pension promises become increasingly hard to afford. Those individuals would then have to rely exclusively on individual retirement arrangements, affecting the risk profile of European households. Moreover, experiences in Ireland and the UK show that contributions (made by the employer) are generally much lower in DC schemes (see Table 1). In Ireland there are concerns that the decline of DB schemes in the private sector would have a negative impact for public sector pensions as private and public sector pensions become the subject of substantial adequacy disequilibrium.

4.3 Diversification of Systemic Risk

Indeed while it appears illogical to subject IORPs to the same solvency requirements as insurers for the reasons already laid out, it may even be beneficial to retain separate regimes.

If IORPs have to act in the same manner as insurers in order to maintain solvency margins, this will exacerbate the difficulties in the financial markets. Firstly, if IORPs are subjected to the Solvency II Directive they will have to engage in a sell-off of equities in favour of a large increase in bonds, resulting in an increase in the price of bonds. Secondly, market fluctuations are likely to be more extreme if a larger group of investors have to act in the same manner.

5. IORP DIRECTIVE - A SECURE BASIS FOR A SINGLE MARKET

The IORP Directive imposes stringent requirements to secure future retirement income. Moreover, a completely new regulatory framework will not move the internal market for workplace pensions forward. Instead, the IORP Directive, the regulatory framework for funded pension providers with a workplace connection, should be given the time to deliver its full potential.

5.1 Providing benefit security

The ultimate goal of a regulatory framework is to ensure that financial institutions deliver on expectations. EFRP believes that the **IORP Directive** already **imposes sufficiently stringent regulations to secure future retirement income and to deliver on expectations.**

According to the Directive an IORP must at all times have sufficient and appropriate assets to cover technical provisions, which means in principle that it always has sufficient capital to continue paying existing retirement benefits and to honour pension commitments. Besides the quantitative requirements (referred to as pillar I requirements in Basel II for banks and Solvency II for insurers) the IORP Directive also contains regulations that provide for professionally qualified governing bodies, sound administrative procedures, adequate internal control mechanisms (referred to as pillar II requirements) and transparency towards plan members (referred to as pillar III requirements).

Table 3: IORP Directive brought into Basel II/Solvency II pillar framework

Pillar I: Quantitative requirements	Pillar II: Qualitative requirements and supervision	Pillar III: Disclosure
Article 15: Technical Provisions	Article 9: Conditions of operation	Article 10: Annual accounts and annual reports
Article 16: Funding of technical provisions	Article 14: Powers of intervention and duties of the competent authorities	Article 11: Information to be given to the members and beneficiaries
Article 17: Regulatory Own Funds	Article 20: Cross-border activities	Article 12: Statement of investment policy principles
Article 18: Investment rules		Article 13: Information to be provided to the competent authorities
Article 19: Management and Custody		

5.2 A Single Market for workplace pensions

EFRP has always been a clear proponent of achieving a Single Market for workplace pensions provided that it does not result in lower pension benefits. The possibility of pan-European IORPs operating in a Single Market offers substantial advantages to employers as well as employees. Employers can benefit by centralising their workplace pension in a single Member State. Employees can benefit from lower contribution rates or higher retirements benefits as well as enjoying cross-border mobility without the need for administratively complex pension transfers.

EFRP is convinced that **cross-border operations are not hindered by different funding and solvency requirements across Europe**. On the contrary, the IORP Directive provides that an IORP engaged in cross-border operations is subject to a single prudential framework - that of the home country. The IORP must also comply with the relevant national social and labour law of the host country but this legislation is unrelated to funding regulations. If across the EU there exist differences in the approach to workplace pension regulation – hence also to IORPs – this is largely due to or to be explained by the different level of statutory pension provision on which the workplace has to be built in order to suit the citizens needs for adequate retirement income.

The “**regulatory and supervisory race to the bottom**” for IORP funding standards will not happen. There is no evidence coming neither from regulators nor from supervisors. Moreover, and equally valid is the fact that European pension funds want to act as responsible partners in an overall social protection system. Their decisions are made balancing the interests of sponsors, members and beneficiaries alike.

It has been suggested that new EU rules are required in order to achieve the Single Market for workplace pensions. In the view of the EFRP, given that **the IORP Directive has only been in place for a little over two years, it is too early to judge whether additional measures are necessary**. It is generally the case that four or five years must pass before it is possible to assess how EU legislation has had an impact on Single Market integration.

6. IMPACT OF THE CURRENT SOLVENCY II PROPOSAL ON IORP REGULATION

EFRP accepts that the solvency regime of IORPs will be subjected to further scrutiny as part of the European Commission evaluation of the IORP Directive in the near future. However, although the European Commission has clearly stated¹⁵ that it does not intend the Solvency II Directive to apply to IORPs due to a legal link, there is a risk that it may do so.

This issue arises as the IORP Directive includes a provision (article 17) that refers to the current solvency directive for insurers, Solvency I,¹⁶ (the precursor to Solvency II).

In this respect EFRP is **supportive** of the approach taken by Rapporteur Peter SKINNER in the European Parliament while proposing **amendments 6 and 67**.

Amendment 6, creating a **new recital 93(a)** which states:

*Recasting the applicable instruments and, consequently, repealing Directive 2002/83/EC **should not lead to pension funds becoming subject to new solvency rules**. The review of Directive 2003/41/EC, which was due in 2007, should be carried out by the Commission as quickly as possible. The Commission should also consider the consequences of applying a similar solvency system as Solvency II to institutions for occupational retirement provision (IORPs), **taking full account of the differences in products and institutions between IORPS and insurance companies**.*

Amendment 67 creating a new paragraph(a) to **article 311** which states:

Notwithstanding paragraph 1, references to Articles 27 and 28 of Directive 2002/83/EC in Article 17 of Directive 2003/41/EC shall continue to be read as references to those Articles.

¹⁵ European Commission, Proposal for a Directive of the European Parliament and of the Council on the taking up of the business of insurance and reinsurance – Solvency II, Explanatory Note, Brussels, 10 July 2007

¹⁶ European Commission, Directive 2002/83/EC, article 27 and 28.

7. CONCLUSION

The IORP Directive provides a sound regulatory framework for IORPs including a “three pillar” framework in the case as under the Basel II and the Solvency II proposal. This framework ensures the security of members’ future retirement income and the long-term sustainability of workplace pensions as provided through IORPs.

Calls to include IORPs within the ambit of the legal framework for insurance companies, (the Solvency II Directive) are misguided. In most Member States IORPs are different from insurance companies, hence require specific regulation relevant to the risks involved.

Questions related to the appropriate funding rules for IORPs should be left to the European Commission’s evaluation of the IORP Directive which is due to take place in the near future.

Given that the IORP Directive has only been in force for a little over two years, we believe it is too early to judge whether it has been effective at contributing to a Single Market for workplace pensions.

EFRP believes that workplace pensions have a key role to play in supplementing statutory pensions, a role that will be increasingly important as the value of statutory pensions decline. EU legislators, through the IORP Directive, have created the framework necessary to enable Member States to make use of this option. In the wake of this adoption many EU Member States have taken measures to encourage workplace pension provision.

For the well-being of future generations of pensioners, it is essential that the current EU legal framework for IORPs is not undermined by an inappropriate extension of the Solvency II Directive to those funding institutions.

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