A NEW PENSIONS DIRECTIVE: NEW DAWN OR DISASTER?

PENSIONS

The European Commission (the Commission) has embarked upon a review of the IORP Directive (Directive 2003/41/EC), the current directive on the activities and supervision of institutions for occupational retirement provision (IORPs), and issued a "Call for Advice" to EIOPA (CfA) asking how and to what extent provisions of Solvency II could be applied or might need amending in their application to IORPs. Solvency II is the directive on the taking-up and pursuit of the business of insurance and reinsurance (Directive 2009/138/EC).

This is causing controversy. There have been rumblings as to whether Solvency II should apply to IORPs almost since Solvency II was first enacted. The campaign in favour of similar treatment argue that there are no meaningful differences between the two and that different regulatory regimes give a competitive advantage to pension schemes over life insurance undertakings (the "level playing field" argument). The campaign against argue with equal vehemence that the differences are deep and meaningful and that it will be detrimental to pension provision if pension funds are forced to adhere to rules designed for insurance companies. The European insurance industry has long been organised in lobbying in favour. The opposition is more fragmented and has taken a long time to mobilise. It has now found its voice.

To give just a few quotes:

Steve Webb, Minister for Work and Pensions, has called it *"a nightmare scenario", "an answer without a question"* and declared war: *"There will be no compromise. […] It is unbelievable the commission is pressing ahead with these pointless proposals which would cost UK employers with final salary schemes hundreds of billions of pounds and lead to DB scheme closures. […] We will not let up until we make the Commission see sense."*

Lord Hutton, responsible for the review of public sector pensions, has called it *"a disaster"* that will have *"major negative impacts on growth, jobs and ultimately competitiveness, for no discernible benefits of any kind to anyone"*. He also stated that *"imposing a regulation designed for one sector on another is bad policy"*.

Mark Hyde-Harrison, Chairman of the National Association of Pension Funds (the NAPF) has predicted that *"the inevitable result would be corporate insolvencies, pension scheme closures and money that would have been invested in the European economic recovery being channelled into pension scheme purchases of government bonds instead"; "this would damage pension provision… and it would damage the economic recovery."*

The Association of British Insurers (ABI) are not in favour: *"We believe that requiring increased capital, reporting and disclosure requirements would add considerable burden to employer sponsored pension schemes. There are wider economic effects to consider in this debate including the impact on investment, growth and jobs in the market especially in the current climate. […] When considering Solvency II as a benchmark for amending the IORP directive, it must be emphasised that, in the UK pensions offered by insurance companies and employer sponsored occupational pension schemes are not the same and these differences merit different regulatory approaches."*

A joint statement has been issued by a number of organisations including the European Trade Union Conference (ETUC), the European Federation for Retirement Provision (EFRP), the European Venture Capital Association (EVCA), Business Europe and others representing business, including small and medium enterprises. These groups don't often sit on the same side of the table. Their statement says that *"it is dangerous to apply legislation made for insurance companies to IORPs. There are fundamental differences between them. Any effort to harmonise the regulatory regime is based on flawed logic and could have unintended consequences on pension plan members, IORPs and the economy as a whole by impeding growth and job creation."*

The following is an (incomplete) table of those in favour and those against the proposed changes.

For	Against
EC, EIOPA, The Pensions Regulator	DWP, Lord Hutton, NAPF, EFRP, TUC, ETUC, CBI, Business Europe, European centre for employers and enterprises (CEEP), ABI, EVCA, BVCA, ACA, APL

The Pensions Regulator is perhaps ambivalent but has been classified as supportive on the basis of the following, slightly cautious, quotation from Bill Galvin: *"the holistic balance sheet* [a key concept in EIOPA's advice for applying Solvency II to IORPs] *is not a new concept … but developing it into a regulatory tool would be a big step… to move from a world in which employer covenant is broadly taken into account in the risk assessment and funding requirements of a pension scheme to a world in which the employer covenant is valued and stacked on top of other things that are valued, hopefully consistently, is a hugely challenging technical endeavour but I think we should give it a go with an open mind about whether it will work or not".*

Also, the Pensions Regulator is a member of EIOPA which has proposed the holistic balance sheet and it may also be felt, perhaps consistently with Bill Galvin's quote above, that the holistic balance sheet is an idea that could have originated in Brighton.

In the teeth of so much criticism, why is the Commission persisting with this?

The Commission has a vision of a new dawn for pension saving. For the Commission, the revision of the IORP Directive is part of two wider projects:

- completion of the internal market in financial services by ensuring comparability between IORPs in different Member States and a level playing field with insurance undertakings; and
- creation of a new environment for pensions across Europe to solve the twin problems of an ageing demographic and fiscal instability arising from the growth in state pension payments.

The failure of the IORP Directive to generate significant cross-border pension activity is identified as a failure to overcome obstacles to the internal market in relation to IORPs. This gives rise to a need for a revision under the internal market agenda. The second issue however imbues this agenda with a far greater purpose: saving Europeans from poverty in old age and from the now familiar perils of fiscal deficits.

The revision of the IORP Directive is one of the measures proposed in the Commission's White Paper, *An Agenda for Adequate, Safe and Sustainable Pensions*. What is brought out with great clarity in the White Paper is the demographic challenge, namely that the future ability of the young to support a growing older population is unsustainable. The revision of the IORP Directive is intended to complement other steps to address this problem. Essentially, in the new Utopia, people will work longer, early access to pensions will be restricted and a new growth in occupational pension schemes will relieve the pressure on state benefits. With a new low risk, efficient, cross-border European market in IORPs, savings in these employer-related pension schemes will rise and enable state pensions to be cut-back, reducing the threat they pose to fiscal stability. 2012 is the *European Year for Active Ageing and Solidarity between Generations* and therefore a time for vision.

From a less visionary and more legalistic perspective, the European legislative authority is a conferred legislative authority i.e. the European institutions can only legislate on matters on which they have been given legislative authority under a treaty. Therefore, the revision of the IORP Directive can only take effect under the internal market agenda since there is no (current) mandate for reforming pension provision and regulation more generally. In fact, it is the only part of the White Paper that the Commission has authority to legislate on. But those wider issues of solving the demographic threat to fiscal stability give greater significance to the agenda of completing the internal market in financial services.

This clear purpose is probably better conveyed by its author, Michel Barnier, Commissioner for the Internal Market in Goods and Services. In a press statement he issued in February 2012, he gave the following reasons for reviewing the IORP Directive:

"Because we need to ensure that consumers who take out pension funds are properly protected and are guaranteed that the pension funds they put their money in are robust and will be able to pay out, when the right time comes;

Because strong occupational pensions are essential for long-term fiscal sustainability. This is particularly important in a context where the European population is ageing quickly;

Because we need to strengthen the Single Market for occupational retirement provision, and make it easier for providers to offer pension products across Europe. This will mean more choice for consumers."

He also explained the impact that he expects from the revisions:

"A new directive will lead to growth, promote long-term investment, relieve the pressure on public finances, take account of pension funds unique characteristics and maintain a level playing field."

"A real single market for occupational pensions means lower costs for employers, more choice and security for workers and a solid pension pillar to help the Member States to maintain sustainable public finances."

He also clarified that *"I have never said or implied that pension funds could be subject to exactly the same rules as those set out under Solvency II"* while also emphasising that he wants to *"maintain a level playing field within the Single Market"* so that *"the same products and activities are subject to the same requirements, regardless of the structure of the provider".*

So has everyone just misunderstood? Or is the Commission truly working on a flawed logic as some have said?

It's now time to explain in more detail what has happened, what is to be expected and what the proposals are.

What has happened and can be expected to happen can broadly be summarised by the following time-line:

- Green paper published by EC - July 2010
- Call for advice from EC to EIOPA - April 2011
- 1st EIOPA consultation - July-Aug 2011
- 2nd EIOPA consultation - Oct 2011 - Jan 2012
- EIOPA advice delivered to EC - 15 Feb 2012
- White paper published by EC -16 Feb 2012
- QIS consultation - June-July 2012
- QIS - Oct 2012 - Jan 2013
- 1st date for directive - December 2012
- New date for directive - summer 2013
- Original implementation date - December 2014
- Likely implementation - late 2015?

What most of the comment is about is the proposals as they can be identified from EIOPA's advice (the Advice). The Advice summarises both the Commission's requests and the advice given in response. Some further detail about the proposals emerges from the QIS consultation.

Although the Advice is divided in to 29 sections covering specific questions from the Commission on different topics (divided into 23 sections in the CfA), one could say that there are three parts to the Advice with an introductory section on scope. This is because it follows the structure of Solvency II that uses three pillars. In European law, there are a lot of pillars and it is easy to get confused between pillars. While pension provision is divided into three pillars being state provision, occupational provision and personal saving, for Solvency II and financial regulation the Commission uses another three pillars: quantitative rules, governance and risk management and disclosure requirements. Pillars II and III (governance and risk management and disclosure) are also referred to jointly as the qualitative measures.

To say just a few words on scope. The Commission does ask about whether the scope of the IORP directive should be changed. I happen to think this is a meaningful and important question. Unfortunately, EIOPA felt constrained not to give a meaningful answer.

IORPs are schemes where the employer has a role in the establishment or funding of the scheme, i.e. Pillar II. There is however a mismatch between actual and potential participants in an internal market in pension provision and this division between Pillars I, II and III. There are many schemes in many jurisdictions that don't fit neatly in one of these three pillars but rather straddle several pillars. Also, if the legislation is proposed on the internal market legislative basis, then whether or not an entity is actually or potentially a market participant, and potentially in competition with life insurance providers, should be critical to whether or not it is subject to the proposed regulatory obligations based on a level playing field with insurers.

EIOPA's answer is that:

- it can't look at anything that isn't already within its own scope, i.e. that isn't already an IORP (you've asked the wrong person);
- the matter is too political (you've asked the wrong person); and
- since the concept of the holistic balance sheet is central to EIOPA's advice on the main issues and the existence of a sponsoring employer is key to the holistic balance sheet, we need the employer to remain central to the concept of an IORP (using the answer to frame the question).

It is disappointing that the question on scope isn't answered properly because the campaign for a level playing field between insurance undertakings and pension funds that compete in the same space selling similar products does, in my view, have a *prima facie* case. The critics' main argument is that most IORPs, including UK IORPs, are very different and are not in business at all and not competing for any market. Most UK defined benefit pension schemes state in their constitutional rules that they can only provide benefits for the employees of a particular employer and associated employers. They are not permitted to seek new markets. There may well be jurisdictions where pension funds are run as enterprises marketed directly to the public, albeit via employers or unions, and which compete for business with insurance companies. With the advent of auto-enrolment and multi-employer occupational pension schemes competing with insurance companies, the UK may well become one such jurisdiction. But most of those occupational pension schemes will not qualify as IORPs and are exempt from the legislation. Any that are not exempt are likely to be operating on a DC basis. So, it would be coherent to argue that the pension funds operating commercially or competing for market share with insurance companies should be subject to Solvency II and that those that are just ring-fenced security for a particular employers' pension promises should not.

Moving on to the substance of the Advice, the Commission's objectives (with the ultimate aim of saving Europe from the fiscal burden of its demographic crisis) are:

- to facilitate establishment of cross-border schemes by setting prudential regulation at a European level such that it becomes unnecessary for such rules to be supplemented at national level; and
- to ensure consistency across financial sectors and compatibility with Solvency II as far as necessary and possible.

Consequently, it asks specifically in the CfA whether various measures of Solvency II could be applied to IORPs and what if any amendments would be needed or recommended. It specifies that it wants:

- a common level of security irrespective of the mechanisms for providing that security;
- the valuation of assets and technical provisions or liabilities to be market consistent; and
- detailed rules to ensure consistency.

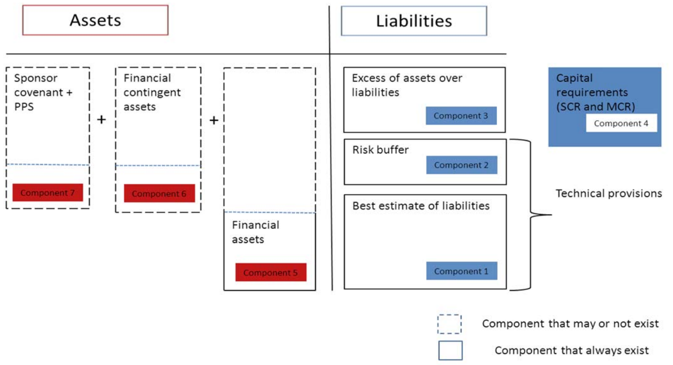
EIOPA in its Advice answers these questions as technical questions – i.e. whether it is technically possible – while occasionally highlighting that there may be a related political decision (the difference between 'can' and 'should').

What this means more specifically on the quantitative elements is that EIOPA recommends that:

- valuations should be market consistent, which means "insurance market consistent";
- valuations should include the actuarial value (on an insurance market basis) of all enforceable pension promises (more detail is given about contingent and discretionary benefits); and
- the holistic balance sheet is the means of recognising all security mechanisms consistently.

EIOPA's key creative proposal is the 'holistic balance sheet' as the means of recognising the security provided to an IORP by a sponsoring employer while applying the same rules as under Solvency II on valuing assets and liabilities and capital requirements.

This is what the holistic balance sheet looks like:



It is intended to be a balance sheet and so the elements that lie in parallel on either side are in fact intended to stack on top of each other.

The intention as EIOPA sees it is that the IORP's own financial assets (component 5) should cover the best estimate of the liabilities (component 1) and that the sponsor covenant and pension protection schemes (if any) and financial contingent assets (if any) (components 6 and 7) should, together with the IORP's own financial assets (component 5) cover the best estimate of the liabilities, the risk buffer and the capital requirements (components 1, 2 and 4).

There are any number of issues with this balance sheet.

On the asset side, the valuation of the scheme assets is simple enough. Applying Solvency II, these are to be valued on a mark to market basis. The valuation of the other elements on the 'asset side' and their mere appearance on the balance sheet is controversial. How do you measure sponsor covenant on a consistent basis? If it is to be market consistent, it the market value of the sponsor's business that should be used but what matters to the IORP may be its economic value. More fundamentally, the sponsor covenant and pension protection scheme (PPS) are not assets of the IORP at all. As EIOPA itself notes, sponsoring employers have other commitments (i.e. other parties to whom they owe duties and other creditors and stakeholders) and that valuation of sponsor support needs further elaboration. At its simplest, the employer is someone else's asset. The Pension Protection Fund (as a PPS) is a safety net for the members but not a reinsurance policy that will pay out to the scheme. The method for valuing PPS proposed in the Quantitative Impact Study gives a higher value the weaker the solvency basis of the IORP. This has its logic but also has the perverse effect of masking the true weakness of the IORP's solvency position.

In Bill Galvin's words *"to move from a world in which employer covenant is broadly taken into account… to a world in which the employer covenant is valued and stacked on top of other things… is a hugely challenging technical endeavour".* And if, after counting the employer covenant and PPF on the balance sheet as if they were current assets of the scheme, the balance sheet still doesn't balance, where next? Solvency II assumes a forced termination of business and transfer of the business to another insurer. That hardly works for an insolvent pension scheme, unless the PPF is the recipient. Is that intended? That would seem to incentivise underfunding.

On the liability side, there are unanswered questions even on the identification of the liabilities: should contingent and discretionary benefits be included? Applying Solvency II the proposal is that the liabilities be measured on what EIOPA term the "best estimate" basis. This is not a 'best estimate' as UK actuaries have used the term because it involves the use of a risk free interest rate to discount the liabilities, likely to result in a very high value for the liabilities. Other assumptions are to be "market consistent"; this appears to mean consistent with the insurance market (i.e. the annuity market).

On top of that conservative valuation of the liabilities, a risk buffer is required although it is not quite clear why and what risks it is intended to cover.

Then above that, there is the solvency capital requirement (SCR) and the minimum capital requirement (MCR) which is a proportion of the SCR. The SCR is calculated according to the risk profile of the entity; it is partly on account of this element that the nature of the investments held impacts on the capital requirements and hence creates an incentive, in the view of some critics, to divest equities. The SCR is an amount of capital to be held to ensure the solvency of the undertaking over a certain time period with a certain confidence level. Under Solvency II this is set as a one year period and 99.5 per cent confidence level, checked annually. EIOPA suggests using a one year period, a 97.5 per cent confidence level and triennial checks for IORPs. Even a 97.5 per cent level of certainty requires either a very high level of funding (or over-funding) or very predictable assets or close matching of assets and liabilities. This is of course possible in principle but would be expected to:

- result in more resources being locked up or withdrawn from the real economy for every £1 (or 1 euro) of pension promise;
- discourage investment in equities; and
- limit the economic shock absorbing capacity of IORPs (their counter-cyclical, stabilising influence on markets).

Where the SCR is not met, Solvency II allows a one year recovery period. EIOPA suggests a 15 year recovery period for IORPs. This longer period, while essential if the system is not to result in a tidal wave of unnecessary insolvencies, seems quite unprincipled: why look for 97.5 per cent confidence over one year if you can allow a higher likelihood of failure to go unremedied for 15 years? A key issue that has not been clarified is what the sanctions will be for failing to balance the holistic balance sheet. If no regulatory action follows, then perhaps it is all an expensive waste of breath.

As noted, there are many issues with the very structure of the holistic balance sheet and with the manner in which the different elements are to be valued, not least the use of a risk free interest rate to discount the very long-term liabilities of IORPs.

The proposal seems likely to please no one. While the application of the Solvency II methodologies seems bound to produce much higher, and potentially inflated, deficit figures leading to the many complaints that this will stifle growth and cause pension scheme closures and job losses, the longer proposed recovery period and lower confidence level will not in fact achieve the desired level playing field with insurance undertakings anyway. EIOPA itself notes the pro-cyclical risks of using a risk free interest rate to discount liabilities and having a short recovery period. The longer recovery period proposed as a solution may not be a sufficient cure.

EIOPA itself identifies many of these problems and states that its proposal is subject to an impact assessment. The difficulty is that an impact assessment doesn't answer the problems. Perhaps, there is an assumption that the problems will disappear if you ignore them for long enough.

A quantitative impact study (QIS) is currently being undertaken. The basis was consulted on and drew much criticism, principally for being too narrow and too technical and failing to address the big issues.

Turning to the qualitative proposals, these have received less attention principally because they are not very controversial and are unlikely to have the devastating effects expected from the quantitative proposals. They may for this reason be more likely to be implemented.

The qualitative proposals cover:

- **information to members and beneficiaries**;
- **governance**, including: general governance requirements, fit and proper persons, risk management, internal control system and internal audit function, outsourcing, custody, actuarial advice; and
- **supervision** including information to supervisors, scope, transparency and accountability, general principles, general supervisory powers, supervisory review process and capital add-ons and supervision of outsourced functions and activities.

The proposal on **information to be provided to members and beneficiaries** is for the requirements to be set at EU level and modeled on Solvency II. Requirements apply before joining, during the accumulation phase and during the decumulation phase. The approach is principles based and differentiated for defined contribution (DC), defined benefit (DB) and hybrid schemes. The proposals are not materially different to current UK requirements.

The general proposals on **governance** will require that:

- IORPs are legally separate from the sponsor undertaking (as currently);
- member participation in the governance structure should be permitted (as currently required in the UK);
- written policies on some aspects of governance should be approved by the supervisory body of the IORP;
- a sound remuneration policy where relevant;
- the persons who effectively run the IORP or have other key functions must meet the "fit and proper" criteria; supervisory authorities will have the power to assess this and take measures where necessary (this might entail a modification of the basis on which the Pensions Regulator can currently remove trustees in the UK);
- the IORP (or trustees) must retain responsibility for outsourced functions, have a legally enforceable agreement in place and ensure the outsourcing does not prejudice governance or increase risk;
- provision for the independence of the actuary, avoidance of conflicts of duty and whistle-blowing functions (the Actuarial Standards Board has already issued new guidance);
- proper management systems to identify, measure, monitor and report on risks incurred and risks that might occur and regular assessments of compliance, including administrative and actuarial;
- own risk and solvency assessments (ORSA) on compliance with funding and solvency capital requirements (SCR), taking account of different risk sharing mechanisms; and
- an internal audit system to evaluate the adequacy and effectiveness of the internal control systems and other elements of the system of governance, including outsourcing and key functions.

The provisions are to be implemented in a reasonable and proportionate manner, although it is not clear what that would mean, and to include a whistle-blowing function.

These proposals seem likely to involve some codification of what is currently either required or good practice in the UK. A further shift away from trust law as a significant element in the governance of UK pension schemes seems inevitable, particularly given the call for the same rules to apply across the EU and for all EU supervisors to regulate in a consistent manner.

Some elements such as the use of the ORSA and actuarial compliance are linked to the quantitative parts of the proposals and would suggest a shift towards solvency based funding (or liquidation logic as some critics put it). It may result in more prescription and a reduction in trustees' discretion and responsibility.

With regard to **supervision**, the proposal is for the adoption of Solvency II provisions. This provides for supervision to be prospective and risk based and proportionate to the nature, scale and complexity of the inherent risks of the IORP. Supervision is required to be conducted in a transparent and accountable manner, with transparent procedures for appointments to key roles, clear disclosure of requirements, statistical data and information relevant to the comparison of supervisory approaches.

There is to be some harmonisation of information requirements to reduce costs for cross-border operation. Supervisory authorities are to have sufficient powers to take preventive and corrective measures to ensure compliance by IORPs, including information gathering, on-site investigations, quantitative tools and stress testing (and the ability to require IORPs to carry out stress testing) and enforcement powers. It also requires powers for effective, proportionate and dissuasive penalties and for these powers to be exercised consistently and transparently.

On one level, this is what one would expect of supervisory powers and the UK Pensions Regulator already has most of these powers. However, the impact will depend on whether and what provisions are made on the quantitative proposals. EIOPA has recommended that given the special status of IORPs and the fact that they are not generally commercial financial institutions, penalties should not be required to be made public. It is certainly curious to have the non-commercial status of IORPs being noted here when it is so firmly ignored in relation to the quantitative elements which rely so much on the level playing field argument for their justification.

The use of "capital add-ons", namely additional capital requirements where the risk profile (investments) of the IORP significantly differs from its assumptions (as set out in the statement of investment principles) is recommended as an ultimate sanction only. EIOPA also notes that it may be inappropriate for IORPs where the members bear the risk as it would directly affect members. It might also be noted that, for employer sponsored IORPs, the capital add-on is a sanction on the sponsor who does not control the investment strategy.

'Host supervisors' are to have powers to intervene directly to request that an IORP resident in another member state stop breaching applicable legislation, provided it notifies the 'home' supervisor.

Regarding the **supervision of outsourced functions**, the proposals are that:

- service providers must cooperate with supervisory authorities;
- the IORPs, auditors and supervisory authorities must have effective access to data related to the outsourced functions;
- the supervisory authorities must have effective access to the business premises of the service provider;
- supervisory authorities must have necessary powers to intervene in outsourced functions;
- the IORP must ensure access if the service provider is non EEA; and
- similar provisions to be applied on sub-contracting.

These are very wide provisions. It is not clear what 'data' is referred to. It may cover the data used for sponsor covenant assessment which may raise confidentiality issues if this information is to be shared as suggested with the IORPs (i.e. the trustees).

Throughout its Advice, EIOPA has been at pains to point out that the advice is technical and limited to providing answers to the specific questions asked. The questions ask whether particular provisions of Solvency II should be amended or removed in their application to IORPs. On a number of points EIOPA's response identifies that there are wider political issues which need consideration.

Because EIOPA's response is limited to answering whether or not, each provision of Solvency II can, technically, be applied to IORPs and if not what amendments would be required, the questions whether Solvency II should be applied to IORPs, and what the impacts might be, are never asked. This applies to both the quantitative and qualitative aspects. Even the QIS only measures the shift in valuations not the likely changes in the behaviour of sponsors and trustees.

This is perhaps what has caused the real controversy. The political questions are treated as closed without ever having been opened.

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