

**EIOPA's Advice to the European  
Commission  
on  
the review of the IORP Directive  
2003/41/EC**

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## **2. Introduction**

### **2.1. EIOPA's advice**

- 2.1.1 This document is EIOPA's advice to the European Commission on the review of Directive 2003/41/EC (the IORP directive).

#### Coverage of the advice

- 2.1.2 Advice is sought on the scope of the IORP directive, on certain cross-border aspects and on three other areas. Firstly, what quantitative requirements should apply to IORPs and how should these be measured. Secondly, what should be the qualitative requirements, particularly in respect of the governance of IORPs and their supervision. Thirdly, what information should be provided in respect of IORPs to members and beneficiaries.

#### Timetable

- 2.1.3 In April 2011 the European Commission asked EIOPA for advice by mid-December 2011 on the EU-wide legislative framework for IORPs. While the deadline was later extended to mid-February 2012, EIOPA's view is that this was an extremely demanding deadline for advice on the European legislative framework for the entire occupational pensions sector and that it also imposed demands on those who wished to respond to consultation.

#### Structure of the advice

- 2.1.4 The Commission's call for advice covered 23 parts. Each part is considered under the following headings:
- Extract from the call for advice
  - Background
  - Explanatory text
  - Impact assessment
  - EIOPA advice
- 2.1.5 The advice on each part is summarised in a blue box at the end of each chapter. Of necessity many important aspects of EIOPA's advice are in the body of the chapter and not in the blue box.

### **2.2. The scope of EIOPA's advice**

- 2.2.1 EIOPA seeks to be European and ambitious in its advice. It also seeks to provide where possible concrete advice rather than for example a list of options.

#### Limits to scope

- 2.2.2 It must be emphasised however that there are limits to the scope of EIOPA's advice.

## Technical

- 2.2.3 Firstly, EIOPA's advice is of a technical rather than political nature. EIOPA is a European Supervisory Authority. Its governing body comprises the national public authorities competent for the supervision of financial institutions. As is the case within many member states, the supervisory authority is not the body which takes decisions on political issues.

## EIOPA's remit

- 2.2.4 Secondly, the scope of EIOPA's advice is limited to its remit as set out in legislation: broadly speaking, regulation, supervision, consumer protection, financial stability and international relations. EIOPA's governing legislation requires it to act, in respect of IORPs, without prejudice to national social and labour law<sup>1</sup>.
- 2.2.5 EIOPA's technical role and its remit place limits on the subjects it should advise on. EIOPA acknowledges that the boundary of what is political or outside its scope is often unclear. Nevertheless, EIOPA has aimed not to provide advice on areas which are political in nature or outside of EIOPA's scope.

## Restriction of advice to questions asked

- 2.2.6 EIOPA's role in the context of this stage in the review of the IORP directive is to provide advice. It is not EIOPA's role to determine the subject of the advice nor to set the questions on which advice is sought. That is the role of the European Commission.
- 2.2.7 Advice is sought by the Commission on the extent to which the legislative framework for IORPs should be similar to that for other financial institutions and products, in particular the Solvency II framework for insurance and also the UCITS IV Key Investor Information Document.
- 2.2.8 To take a specific example, many of the questions asked whether specific articles of the Solvency II directive should be amended or removed in respect of their application to IORPs. The broader question of whether these articles were the right place to begin a review of the IORP directive was not asked of EIOPA.
- 2.2.9 Overall, EIOPA notes that the Commission may want to consider some of the wider issues raised by consultation respondents which are outside the scope of EIOPA's advice.

## **2.3. Consultation**

### Process

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<sup>1</sup> Paragraph 4 of Article 1 of Regulation 1094/2010.

- 2.3.1. EIOPA consulted between 8 July and 15 August 2011 on the scope, cross-border activity, prudential regulation and several governance aspects of the call for advice<sup>2</sup>. 49 responses were received.
- 2.3.2. EIOPA's second consultation was on the entire advice and was between 25 October 2011 and 2 January 2012<sup>3</sup>. 170 responses were received by the deadline.

### Appreciation of consultation responses

- 2.3.3. EIOPA would like to record its thanks to all those who took the trouble to respond to what was a large amount of material within a relatively short period of time.

### Handling of responses

- 2.3.4. All the consultation responses have been carefully read and considered. Where appropriate the advice has been amended in light of the response.
- 2.3.5. The Occupational Pensions Stakeholder Group of EIOPA has responded, its opinion is on the EIOPA website at <https://eiopa.europa.eu/about-eiopa/organisation/stakeholder-groups/sg-opinion-feedback/index.html>
- 2.3.6. A number of respondents raised issues which either go beyond EIOPA's remit or EIOPA was not asked for advice on the issues raised. Many of these are identified later on in this chapter but are not subject to further analysis in this advice.
- 2.3.7. Reasoned feedback by EIOPA on the responses to the second consultation is being published simultaneously with this advice and is available via the EIOPA website. The responses themselves are also being published. The 14 respondents who asked for their response to be confidential are excluded.
- 2.3.8. In many cases EIOPA's reasoned feedback is brief. Our judgement was that what really matters is that all the responses to the second consultation were read and considered before finalising the advice, even if that meant feedback on responses, in the time available, could only be brief.

## **Some key issues raised**

### **2.4. Proportionality**

- 2.4.1. EIOPA wishes to highlight the importance of the principle of proportionality, in particular its application to small IORPs but also in respect of the nature and complexity of IORPs, in the whole of its advice. EIOPA also wishes to refer to

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<sup>2</sup> Draft response to Call for Advice on the review of Directive 2003/41/EC Scope, cross-border activity, prudential regulation and governance EIOPA-CP-11/001

<sup>3</sup> Response to Call for Advice on the review of Directive 2003/41/EC: second consultation EIOPA-CP-11/006  
7/515

its advice that the choice by member states of a one hundred member exemption from the IORP directive be retained.

## **2.5. The basis for review of the directive**

### The position of the European Commission

2.5.1. The Commission gave three main reasons for reviewing the IORP directive.

2.5.2. Firstly, in order to propose measures which simplify the setting-up of cross-border pension schemes. According to the CfA there are currently fewer than 80 out of around 140,000 IORPs in the EU operating cross-border; EIOPA's more recent Market Development Report gave a figure of 84 cross-border IORPs<sup>4</sup>. Secondly, in order to introduce a risk-based regulatory and supervisory framework at EU level, with measures that would allow IORPs to benefit from risk-mitigation mechanisms. Thirdly, to secure modernisation of prudential regulation for IORPs which operate DC schemes.

### The position of some stakeholders

2.5.3. A number of stakeholders supported the basis for review adopted by the European Commission. However, a significant number did not. The arguments made are summarised below:

- The evidence of the case for change is insufficient. It is for the advocates of change to demonstrate the need for it, not for change to be the presumption unless evidence is provided of its harm.
- On cross-border activity, the small number of cross-border IORPs is less likely to be due to lack of harmonisation of the regulatory framework and more likely to be due to:
  - A lack of demand to sponsor IORPs on a cross-border basis
  - Differences between member states in social and labour law
  - Differences between member states in the interaction between occupational and first pillar (social security) pensions
  - Differences between member states in the tax treatment of pensions
  - According to one IORP which currently operates cross-border, the length and number of the notifications which need to be sent between competent authorities is a cause of delay and possibly a deterrent to cross-border provision.

## **2.6. Technical advice on harmonisation**

### Position of the European Commission

2.6.1. The current directive provides for prudential regulation of IORPs based on minimum harmonisation and mutual recognition. The Commission's aim is "to attain a level of harmonisation where EU legislation does not need additional

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<sup>4</sup> EIOPA-BoS-11/023 (14 July 2011)

requirements at the national level”<sup>5</sup>. Elsewhere the Commission states it is seeking increased harmonisation in the calculation of technical provisions, and greater consistency in recovery periods across member states.

### EIOPA’s position

- 2.6.2. EIOPA acknowledges the Commission’s view that the internal market in pensions is small in terms of the number of institutions where the employer and the IORP are in different member states. EIOPA’s governing legislation specifies that EIOPA shall contribute to improving the functioning of the internal market<sup>6</sup>.
- 2.6.3. EIOPA’s advice implies greater harmonisation of IORP’s regulation in some areas. EIOPA’s advice in this respect is that greater harmonisation in the IORP directive would be technically possible. EIOPA emphasises that the proposals for greater harmonisation follow from the CfA’s objective of increasing the level of harmonisation, and EIOPA acknowledges that alternative approaches to that proposed by the Commission could be adopted. The advice considers the Commission’s requests on technical grounds without challenging political decisions in this respect. Increasing harmonisation of occupational pension provision is principally an area which requires a political steer.

### Position of certain stakeholders

- 2.6.4. A number of stakeholders supported the position on harmonisation adopted by the European Commission. In general, they recommended that the regulation of IORPs should be on the basis of the risks they pose to members and beneficiaries rather than on the basis of their legal form. This approach is necessary to secure a level playing field between the occupational pensions business of insurance undertakings and of IORPs.
- 2.6.5. However, a significant number of respondents did not support the position on harmonisation and the arguments made are summarised below:
- The high degree of diversity of pension systems throughout the EU cannot be adequately catered for to the extent that additional requirements at the national level are not needed.
  - The key role of social and labour law in respect of IORPs likewise prevents a high level of harmonisation.
  - Harmonisation risks producing harmful, pro-cyclical behaviour, particularly during periods of financial stress.
  - Harmonisation on a Solvency II basis would discourage investment in equities.
  - The cost in some member states of moving to a harmonised framework would be economically unaffordable.
  - One consequence could be a shift from defined benefit to defined contribution pensions, which some respondents considered an adverse development.

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<sup>5</sup> Paragraph 7.1 of the Call for Advice.

<sup>6</sup> Article 1 paragraph 6(a) of Regulation 1094/2010.

- Another consequence could be a reduction in the amount of the “pension promise” due to the higher expected costs under a harmonised approach.

## **2.7. Defined contribution schemes**

- 2.7.1. The Commission stated that “It is important to consider whether the IORP Directive needs to be adjusted to better address the specific needs for the regulation and supervision of DC schemes”.
- 2.7.2. EIOPA’s aim is that members should have confidence in their DC IORP regardless of where in the EU it is located.
- 2.7.3. Some stakeholders were of the view that a requirement for capital provision in respect of operational risks for defined contribution schemes would reduce benefits payable to members.
- 2.7.4. The term “pure” DC scheme is used on occasions to identify pension arrangements where the member bears at least all the investment risk. The broader term “defined contribution scheme”, is not further defined by for example the degree of investment risk faced by members. EIOPA notes that the boundary between defined contribution and defined benefit schemes is not always a clear one and that care would be needed in practice to implement those areas of the advice which EIOPA specifies as applying only to defined benefit arrangements or only to defined contribution arrangements.

## **2.8. Consistency across financial sectors**

### European Commission’s position

- 2.8.1. The Commission’s view is that EIOPA’s advice “should endeavour to maintain consistency across financial sectors....the general layout of the supervisory system should, to the extent necessary and possible, be compatible with the approach and rule used for the supervision of life assurance undertakings subject to Directive 2009/138/EC (Solvency II<sup>7</sup>)”.

### EIOPA’s position

- 2.8.2. As the EU authority for both occupational pensions and insurance, EIOPA will adopt a consistent approach to both sectors. It is important to emphasise that consistent is not the same as identical, and that sometimes the differences will merit different approaches.
- 2.8.3. In some areas, in response to the Commission’s questions, EIOPA’s advice recommends for IORPs an approach similar to that for insurance undertakings. For example, the approach at the level of principle to the governance of IORPs and insurance undertakings is recommended to be the same. Where the advice recommends the application at principle level of the Solvency II framework to IORPs, the differences between insurance undertakings and IORPs should still be respected.

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<sup>7</sup> Paragraph 4.4 of the Call for Advice.

- 2.8.4. There are however important differences between IORPs (taken as a class) and insurance undertakings (taken as a class) which EIOPA advises should be reflected in the legislative framework.
- 2.8.5. Three key differences between insurance undertakings and IORPs which have had an impact on EIOPA's advice are, firstly, the extent to which IORPs have a social and employment context. Among the consequences are that social and labour law has a significant impact on IORPs. In some member states the social partners are responsible for the terms of the occupational pension. In addition, employers are involved in the funding and governance of IORPs. IORP members are frequently on the IORP's governing body. Another consequence is that in a number of member states, in the IORP context, pension benefits could be reduced as part of a "social contract" agreed at national level in order to seek a good balance between security and affordability of the pension promise. These consequences carry implications in areas such as how requirements for technical knowledge of the governing body of an IORP are implemented. EIOPA acknowledges that some of the social and employment context also applies to the occupational pensions business carried on by insurance undertakings.
- 2.8.6. Secondly, that the suppliers of capital to IORPs can have more extensive commitments than providers of equity to insurance undertakings. In some member states, member contributions and the employer are sources of capital for IORPs. In both cases these parties can be required to provide additional capital in the event of shortfall, though this is also the position in respect of some mutual insurance undertakings. Some IORPs can also address shortfalls via reducing benefits or via sharing the cost intergenerationally for schemes of a collective nature. EIOPA's advice is that these more extensive commitments should be recognised. These factors, as well as the greater length on average of pension fund liabilities, also have the potential to impact on the length of time required to recover a funding deficit. In addition, in some member states there are pension protection schemes to protect IORP members and beneficiaries in the event of employer insolvency.
- 2.8.7. Thirdly, there are a greater number of IORPs. According to the CfA there are 140,000 IORPs<sup>8</sup> of which many have a handful of members. In contrast there are 4,753 insurance undertakings<sup>9</sup>. EIOPA's advice is that a difference of this order of magnitude means that the supervision of IORPs cannot be the same as insurance undertakings; the supervisory capacity does not exist in every member state to regulate IORPs with the same intensity as insurance undertakings. The application of proportionality is therefore particularly important in the IORP context.
- 2.8.8. Finally, different treatment of IORPs compared with insurance undertakings, where justified, would not represent a departure from what is already the case *within* insurance. The Solvency II directive for insurance permits significant differences of treatment between insurance undertakings in certain circumstances, for example insurance undertakings which hold equities for a significant period or those whose assets and liabilities are closely matched.

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<sup>8</sup> Paragraph 1.2 of the Call for Advice.

<sup>9</sup> Figure is for end-2009. See page 21 of EIOPA's Report on the fifth Quantitative Impact Study (QIS5) for Solvency II. [https://eiopa.europa.eu/fileadmin/tx\\_dam/files/publications/reports/QIS5\\_Report\\_Final.pdf](https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/QIS5_Report_Final.pdf)

### Position of certain stakeholders

- 2.8.9. EIOPA's position above has been adapted since the second consultation in light of a number of responses. A number of stakeholders also asserted that IORPs do not generally have commercial shareholders and are not governed by the profit motive. Nor are IORPs and insurance undertakings in commercial competition.
- 2.8.10. For many respondents their view was that all these differences between IORPs and insurance undertakings were such that the case for consistency of approach based on the need for a level playing field in a competitive sense was not made.
- 2.8.11. Other respondents however took very much the opposing view on the need for a level playing field particularly between IORPs and the occupational pensions business of insurance undertakings.

### Information to members/beneficiaries

- 2.8.12. The CfA asks about consistency of information to IORP members with requirements in other financial sectors, particularly the UCITS IV Key Investor Information Document<sup>10</sup>. This issue is considered in chapter 29 of the advice.

## **2.9. Impact assessment**

### Recognition of importance

- 2.9.1. EIOPA recognises the importance of impact assessment in its advice. The Commission does likewise, it states in the Call for Advice<sup>11</sup> that its proposal to review the IORP Directive will be accompanied by an impact assessment study and that "the new supervisory system for IORPs should not undermine the supply or the cost-efficiency of occupational retirement provision in the EU."

### Approach to impact assessment

- 2.9.2. Each chapter of the CfA has an assessment of the impact of the advice. This comprises a qualitative assessment of the costs and benefits to:
- IORP members;
  - IORPs (including sponsoring employers);
  - Supervisory authorities.

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<sup>10</sup> Paragraph 4.7(b) of the Call for Advice.

<sup>11</sup> Paragraph 1.3 of the Call for Advice.

- 2.9.3. The “do nothing” option is to retain the current IORP directive; this is compared with an option or options for change.
- 2.9.4. This is not a quantitative cost-benefit analysis. Such analysis will be carried out by the European Commission in the context of any legislative proposals.

#### Need for deeper assessment: quantitative impact study

- 2.9.5. EIOPA recognises that a deeper assessment of impact is also needed. It has therefore started work, in cooperation with those member states which expressed an interest in this aspect, many of which will also be the member states most affected by changes in this area, on a quantitative impact study (QIS). This QIS is in respect of the valuation methods and capital requirements proposed in this advice.
- 2.9.6. The intention is to complete a QIS by the end of the third quarter of 2012.

#### Role of the QIS in the advice

- 2.9.7. There are no implications of this QIS for the advice on scope, governance, information, and DC schemes in general. The QIS also cannot address some of the wider issues raised in this chapter such as the best starting point for the IORP review.
- 2.9.8. There are however potentially significant implications for EIOPA’s advice on valuation and capital requirements. For those aspects of the advice which are affected by this QIS, the advice is *conditional* on its outcomes. Once the QIS is completed, EIOPA will consider whether to offer further views on those aspects of valuation and capital requirements which are affected by the QIS. These areas are identified in the relevant chapters.

### **2.10. Delivery of the advice**

- 2.10.1. The CfA was received by EIOPA on 7 April 2011 with a then deadline for response of 16 December the same year (later extended to mid-February). Advice is sought on 23 different aspects. The advice has therefore been constructed to a very short timetable.
- 2.10.2. EIOPA’s Occupational Pensions Committee comprising representatives of member states’ competent authorities, as well as EIOPA staff, divided the CfA into four workstreams. The workstreams were: scope and other; capital requirements and investment; governance; and information and investment. Many member states provided membership of the workstreams and contributed significantly to the response to the call for advice.

### 3. Scope and definitions

The next four chapters cover those parts of the call for advice which asked about the scope of the IORP directive and the definition of certain cross-border and other aspects.

These are:

- CfA 1: The scope of the IORP directive
- CfA 2: The definition of cross-border activity
- CfA 3: Ring fencing
- CfA 4: Prudential regulation and social and labour law

## 4. CfA 1: Scope of the IORP Directive

### 4.1. Extract from the call for advice

The Commission Services would like EIOPA to advise on the scope of the IORP Directive, covering at least the following issues:

- The possibility to extend the scope of the IORP Directive to other occupational pension funds that operate on a funded basis.
- The provisions that would need to be amended or added (if any) in order to suit the needs for the supervision of those occupational pension funds.
- Other advice, if any.

### 4.2. Background

#### Current legal requirements (IORP Directive)

4.2.1. The current scope of the IORP directive (Art. 2.1) is institutions for occupational retirement provision (IORP) and, where the IORP does not have legal personality, those authorised entities responsible for managing them and acting on their behalf.

4.2.2. The current Directive explicitly excludes (Art. 2.2)

- a) institutions managing social-security schemes which are covered by Regulation (EEC) No 1408/71 and Regulation (EEC) No 574/72<sup>12</sup>;

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<sup>12</sup> Replaced by respectively Regulation 883/2004 and Regulation 987/2009.  
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- b) institutions which are covered by Directive 73/239/EEC, Directive 85/611/EEC, Directive 93/22/EEC, Directive 2000/12/EC and Directive 2002/83/EC;
- c) institutions which operate on a pay-as-you-go basis;
- d) institutions where employees of the sponsoring undertakings have no legal rights to benefits and where the sponsoring undertaking can redeem the assets at any time and not necessarily meet its obligations for payment of retirement benefits;
- e) companies using book-reserve schemes with a view to paying out retirement benefits to their employees.

4.2.3. Art. 3 foresees the application of the Directive to the non-compulsory occupational retirement provision business of IORPs managing social-security schemes covered by Regulations (EEC) No 1408/71 and (EEC) No 574/72.

4.2.4. Art. 4 provides the option for Member States to apply Articles 9 to 16 and Articles 18 to 20 to the occupational-retirement-provision business of insurance undertakings which are covered by Directive 2002/83/EC.

4.2.5. The second paragraph of Art. 5 provides the option for Member States not to apply Articles 9 to 17 to institutions where occupational retirement provision is made under statute, pursuant to legislation, and is guaranteed by a public authority.

### **International standards, guidelines and good practice**

4.2.6. The following OECD definitions are useful for common understanding of the proposals which are set out in this advice:<sup>13</sup>

Public pension plans: Social security and similar statutory programmes administered by the general government (that is central, state, and local governments, as well as other public sector bodies such as social security institutions). Public pension plans have been traditionally PAYG financed, but some OECD countries have partial funding of public pension liabilities or have replaced these plans by private pension plans.	Private pension plans: A pension plan administered by an institution other than general government. Private pension plans may be administered directly by a private sector employer acting as the plan sponsor, a private pension fund or a private sector provider. Private pension plans may complement or substitute for public pension plans. In some countries, these may include plans for public sector workers.
Mandatory occupational plans: Participation in these plans is mandatory for employers. Employers are obliged by law to participate in a pension plan. Employers must set up (and make	Voluntary occupational pension plans: The establishment of these plans is voluntary for employers (including those in which there is automatic enrolment as part of an employment contract or

<sup>13</sup> Pensions Glossary, PRIVATE PENSIONS: OECD CLASSIFICATION AND GLOSSARY – ISBN 92-64-01699-6 – © OECD 2005

<p>contributions to) occupational pension plans which employees will normally be required to join. Where employers are obliged to offer an occupational pension plan, but the employees' membership is on a voluntary basis, these plans are also considered mandatory.</p>	<p>where the law requires employees to join plans set up on a voluntary basis by their employers). In some countries, employers can on a voluntary basis establish occupational plans that provide benefits that replace at least partly those of the social security system. These plans are classified as voluntary, even though employers must continue sponsoring these plans in order to be exempted (at least partly) from social security contributions.</p>
<p><b>Mandatory personal pension plans:</b> These are personal plans that individuals must join or which are eligible to receive mandatory pension contributions. Individuals may be required to make pension contributions to a pension plan of their choice normally within a certain range of choices or to a specific pension plan.</p>	<p><b>Voluntary personal pension plans:</b> Participation in these plans is voluntary for individuals. By law individuals are not obliged to participate in a pension plan. They are not required to make pension contributions to a pension plan. Voluntary personal plans include those plans that individuals must join if they choose to replace part of their social security benefits with those from personal pension plans.</p>
<p><b>Occupational pension plans:</b> Access to such plans is linked to an employment or professional relationship between the plan member and the entity that establishes the plan (the plan sponsor). Occupational plans may be established by employers or groups thereof (e.g. industry associations) and labour or professional associations, jointly or separately. The plan may be administered directly by the plan sponsor or by an independent entity (a pension fund or a financial institution acting as pension provider). In the latter case, the plan sponsor may still have oversight responsibilities over the operation of the plan.</p>	<p><b>Personal pension plans:</b> Access to these plans does not have to be linked to an employment relationship. The plans are established and administered directly by a pension fund or a financial institution acting as pension provider without any intervention of employers. Individuals independently purchase and select material aspects of the arrangements. The employer may nonetheless make contributions to personal pension plans. Some personal plans may have restricted membership.</p>

<p>Pension plan: A legally binding contract having an explicit retirement objective (or – in order to satisfy tax-related conditions or contract provisions – the benefits cannot be paid at all or without a significant penalty unless the beneficiary is older than a legally defined retirement age). This contract may be part of a broader employment contract, it may be set forth in the plan rules or documents, or it may be required by law. In addition to having an explicit retirement objective, pension plans may offer additional benefits, such as disability, sickness, and survivors' benefits.</p>	
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## OPC reports

4.2.7. According to the OPC Report on pension institutions outside the statutorily managed first pillar<sup>14</sup>, pension schemes/institutions in the following member states are explicitly excluded from the scope of the IORP Directive on the basis of Art. 2.2:

1. social-security schemes falling under Regulation 1408/71 & Regulation 574/72: BG, HU, IT, LI, LT, LV, NO, PL, RO, SK<sup>15</sup>
2. covered by other EU Directives: AT, BE, CY, DE, DK, EE, ES, FR, HU, IE, IT, LT, LU, NL, NO, PT, PL, SE, UK
3. PAYG schemes: CY, FR, NO
4. institutions where employees of the sponsoring undertakings have no legal rights to benefits: DE, NO
5. book reserve schemes: AT, BE, CY, DE, IT, LU, NO, PT, SE.

4.2.8. OPC analysis<sup>16</sup> has shown that in EEA countries there are some other pension schemes or institutions which do not fall under the exclusions mentioned in Art. 2.2 of the IORP directive but which fall outside the scope of any EU prudential legislation (including the IORP Directive) These schemes/institutions can be categorised as follows:

- a) voluntary personal pension plans in which the employer can make contributions: BG, CZ, HU<sup>17</sup>;
- b) voluntary personal pension plans in which the employer cannot make contributions: MT, PT, SI, ES<sup>18</sup>;

<sup>14</sup> See Table 1 of the Commission working document accompanying the Green Paper, originally prepared by the OPC.

<sup>15</sup> [BG] Пенсионно-осигурително дружество, [HU] magánnyugdíj pénztár, [IT] Enti privati di previdenza obbligatoria dei liberi professionisti, [LI] Pension Funds (Pensionskasse), [LT] Valdymo įmonė, Gyvybės draudimo įmonė. [LV] State funded pension scheme, [NO] Statens Pensjonskasse, [PL] Otwarty fundusz emerytalny, [RO] Administrator al unui fond de pensii administrat privat, [SK] dôchodková správcovská spoločnosť.

<sup>16</sup> Table 1 of the Commission working document accompanying the Green Paper, originally prepared by the OPC as part of its Report on pension institutions outside the statutorily managed first pillar, CEIOPS-OP-32-09 (fin), 30 October 2009.

<sup>17</sup> [BG] Пенсионно-осигурително дружество, [CZ] penzijní fond, [HU] önkéntes nyugdíjpénztár.

- c) mandatory personal pension plans in which the employer can make contributions: IS<sup>19</sup>.

4.2.9. Finally, OPC analysis shows that a few member states (IT, LV, RO) voluntarily apply the IORP Directive to pension schemes/institutions with dual occupational and individual character. Some member states (ES, PT, RO) apply the IORP Directive on a voluntary basis to personal schemes.

4.2.10. The following MS have made use of the option provided in Art. 4 : FR, LI, LT, SE.

### **4.3. Explanatory text**

#### **EIOPA's view on issues in the CfA**

##### Current scope of the IORP directive

- 4.3.1. The purpose of the IORP directive is to create an internal market for occupational retirement provision by setting the prudent person rule and making it possible to operate across borders. The directive is construed on the basis of a relationship between employers, employees/members and the IORP and the operation of the IORP on a funded basis. The employer plays an essential role, not only in establishing the pension scheme, but also in its funding.
- 4.3.2. The IORP Directive also allows the participation of self-employed persons in an IORP if that possibility is permitted by national law. In that case the self-employed person is treated similarly to a sponsoring undertaking. This advice does not touch upon this.
- 4.3.3. In the introduction to the Call for Advice n° 1 the Commission refers to two types of institutions that are not covered by the current IORP Directive:
  - a) book reserve schemes and
  - b) DC schemes existing in some member states that do not fall under any EU prudential regulation.
- 4.3.4. With respect to the book reserve schemes, the Commission concludes that Member states are required to protect the employee's rights on the basis of Directive 2008/94/EC<sup>20</sup> and that the Commission is now in the process of analysing the need to review this Directive. EIOPA will therefore not address these institutions in its response and will concentrate its analysis on the latter category of institutions, i.e. DC schemes outside any EU prudential regulation.
- 4.3.5. There are two sub-categories of DC schemes/institutions that do not fall under any EU prudential regulation:

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<sup>18</sup> [MT] Personal Retirement Scheme, [PT] Planos depoupança-reforma (saving-retirement schemes) - Fundos de pensões, [SI] Sklad obrtnikov in podjetnikov - SOP, [ES] Fondo de Pensiones Personal

<sup>19</sup> [IS] Lífeyrissjóður.

<sup>20</sup> Directive 2008/94/EC of the European Parliament and of the Council of 22 October 2008 on the protection of employees in the event of the insolvency of their employer

- a) Schemes/institutions excluded from the scope of IORP Directive on the basis of article 2(2)(a). The list of member states and institutions concerned is provided in paragraph 4.2.7 a) above.
- b) Schemes/institutions falling outside the scope of IORP Directive without being explicitly excluded from its scope by article 2. The list of member states and institutions concerned is provided in paragraph 4.2.8 above.

#### Schemes excluded under article 2(2)(a) of the IORP directive

- 4.3.6. As far as schemes/institutions excluded from the scope of IORP Directive on the basis of its article 2(2)(a) are concerned, EIOPA notes that the IORP directive was drafted in the context of the existing pensions systems of the then member states of the EU. However, since the entry into force of the IORP directive (2003) new member states have joined the EU which have pension models different from those in old member states. Most of these new member states have developed a pensions model which includes among other things a mandatory pension pillar. These mandatory pension pillars (referred to as 1<sup>st</sup> bis pillar) have been established by a so called carve-out approach, by dividing the former state pension contribution between the first PAYG pillar and the new 1<sup>st</sup> pillar bis. Employees' contributions are collected by the employer and/or by the social security network and directed to personal accounts managed by private financial institutions chosen by the employees. In some of these member states employees' contributions are transferred to pension schemes/institutions by employers. The relations between pension institution and employee are based on a contract.
- 4.3.7. Although, in these systems, contributions are made in relation to an occupational activity and the pension schemes are managed by private financial institutions, there are major differences between these schemes/institutions and IORPs, particularly:
- a) mandatory system (although in several of the member states concerned it is voluntary),
  - b) collection of contributions through the social security network (although in some countries the collection of contributions is made by the employer),
  - c) personal choice by the employee of the financial institution providing the scheme,
  - d) the employer does not play a role in establishing institutions/schemes, instead the establishment is made under statute,
  - e) the employer cannot contribute to the scheme,
  - f) there is no relation between the employer and the pension scheme/institution.
- 4.3.8. One could argue that these elements are not in contradiction with the main elements of an occupational pension scheme, i.e. providing retirement savings by private providers through capital markets and based on an occupational activity of members. However, these elements can also justify classification as a personal pension plan. The main factor, however, is the absence of the role of the employer in establishing and funding the pension scheme.

- 4.3.9. The dividing line between 1st, 2nd and 3rd pillar is not always clear. Clarification of the borderlines could enhance a consistent application of the Directive.
- 4.3.10. However, such clarification is of a highly political nature because it touches on the principle of subsidiarity. According to this principle, Member States retain full responsibility for the organisation of their pension systems as well as for the decision on the role of each of the three "pillars" of the retirement system in individual Member States.

Schemes/institutions falling outside the scope of the IORP directive without being explicitly excluded from its scope

- 4.3.11. As concerns the schemes/institutions listed in paragraph 4.2.8, they fall outside the IORP directive because on current evidence they are of a personal nature. Consequently they do not fall under the definition of IORP provided in Article 6 (a) <sup>21</sup> of the IORP Directive.

Extending the scope to include DC schemes existing in some Member States that do not fall under any EU prudential regulation

- 4.3.12. According to the above analysis no occupational DC schemes (in the meaning that there is no role for an employer to establish, nor to fund these schemes) have been identified that currently do not fall in the scope of the IORP directive<sup>22</sup>. Bringing DC schemes such as 1st pillar bis or personal, under the scope would mean removing or changing the reference to 'occupational'.
- 4.3.13. However, removing or changing this reference would mean that the directive needs to be reviewed to consider the cases with and the cases without a sponsoring undertaking. Many requirements would need to be reviewed or introduced to take into account the specificities of these DC systems. Many other requirements would not be applicable. It would also mean that the competences of EIOPA need to be reviewed. EIOPA has no evidence that this process will facilitate or will obstruct the harmonisation of the prudential regime for IORPs. EIOPA notes, however, that the remainder of the advice, more specifically the holistic balance sheet (cfr. CfA 5 & 6) has the existence of a sponsoring undertaking as a key element.
- 4.3.14. Nonetheless, EIOPA considers that members and beneficiaries of all types of pension schemes should be protected by high standards of governance by the institutions operating pension schemes and by appropriate regulatory and supervisory standards.
- 4.3.15. EIOPA has not done any detailed work for the purposes of this advice on the regulatory and supervisory framework of pension institutions/schemes excluded from the IORP Directive on the basis of Article 2(2)(a), as this falls outside its mandate. Therefore EIOPA is not in a position to give conclusive advice on the level of protection provided for by national frameworks for these pension schemes/institutions, although it is aware that many of these frameworks have been inspired by the UCITS Directive.

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<sup>21</sup> Under this article, IORPs are institutions providing retirement benefits in the context of an occupational activity on the basis of an agreement or a contract agreed between the employer(s) and the employee(s) or their respective representative.

<sup>22</sup> Possibly with the exceptions of schemes listed in paragraph 2.94.2.9.  
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4.3.16. EIOPA therefore recommends that the Commission explores the prudential regulatory and supervisory regimes for pensions other than “occupational” and take suitable legal initiative if it concludes that the protection offered by national/EU frameworks is not appropriate.

#### Article 4

4.3.17. Article 4 of the IORP Directive allows Member States to apply the provisions of Articles 9 to 16 and Articles 18 to 20 of this Directive to the occupational-retirement-provision business of insurance undertakings covered by Directive 2002/83/EC. These provisions deal with the main following topics: conditions of operation, information, investment policy and technical provisions.

4.3.18. On the other hand, Member States are not allowed to apply Article 17 on regulatory own funds to these insurance undertakings. Consequently, they fall under Directive 2002/83/EC for the calculation of the regulatory own funds. But Directive 2002/83/EC will be abrogated as soon as Directive 2009/138/EC enters into force<sup>23</sup>. So, as long as IORP Directive is not reviewed, they would have to apply the provisions of Directive 2009/138/EC on the regulatory own funds while the institutions for occupational retirement provision would apply Article 17 of IORP Directive amended by Article 303 of Directive 2009/138/EC<sup>24</sup>.

4.3.19. EIOPA considers that the Commission should examine the issues that may arise with regard to the application of Article 4 of IORP Directive in the context of its review and the entry into force of the Solvency II Directive, especially with regard to the insurance companies which are operating under this article (in FR, LI, LT and SE).

### **Policy options**

4.3.20. EIOPA acknowledges that the decision to review the scope of the IORP Directive is of a highly political nature. EIOPA is therefore not in a position to advise the Commission on necessary extensions, but only to advise from a technical perspective on the issues. Therefore, EIOPA has identified a number of options that can feed into the political decision-making process, highlighting the respective implications and how an option could be realised in practice.

#### Option 1: Leave the IORP directive unchanged

4.3.21. The IORP directive is focused on IORPs established by an employer and/or where the employer plays an essential role in the funding of the IORP. Introducing an EU prudential regime for pension schemes where there is no such role for the employer would probably be more effective if done outside the IORP directive, for instance by developing a separate prudential regime.

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<sup>23</sup> The current version of the draft Directive Omnibus II which amends Directive 2009/138/EC foresees that Directive 2009/138/EC shall be applicable from 1 January 2014.

<sup>24</sup> The amendments consist in a copy/paste of the provisions of Articles 27 to 29 of the Life Insurance Directive (2002/83/EC). The only difference compared to the current IORP Directive, which refers to Article 27 and 28 of the Life Insurance Directive, is the introduction of provisions concerning the “guarantee fund” (art. 29 of the Life Insurance Directive).

4.3.22. EIOPA is not convinced that the current exclusions of the IORP directive should be altered on the grounds that the DC schemes concerned:

- are subject to the social security policy where –under the Treaty on functioning of the European Union– the Union does not seem to possess necessary competence for harmonisation of national measures<sup>25</sup>; or
- are of personal nature (i.e. not occupational), the European Commission has not indicated any intent to explore the possibility of including personal institutions/schemes currently excluded from the scope of the IORP Directive and has not requested EIOPA to do so in the context of the Call for Advice.

4.3.23. EIOPA therefore proposes to maintain the current exclusions. Irrespective of these exclusions, Member States usually have the power to apply a directive on a voluntary basis. For the IORP Directive this would mean the possibility to use the Directive (fully or partially) as an inspiration for their national legislation for the operation and/or supervision of those institutions which fall outside the scope of the IORP Directive<sup>26</sup>.

4.3.24. EIOPA is aware that borderline cases exist<sup>27</sup> where it is not clear if and to what extent the Directive applies. However, EIOPA notes that these issues are probably a matter of the implementation of the Directive and not of the scope per se. Nevertheless, the emergence of borderline cases should be avoided as this creates legal risks for the parties involved and could lead to potential conflicts between parties (the home supervisory authority and the institution, as well as between supervisory authorities in case of potential cross-border activity) on f.i. the applicability of the Directive on the institution and hence the eligibility of the institution to operate cross-border.

4.3.25. Implementation could be improved by redrafting relevant articles of the Directive to remove any ambiguity and to avoid the risk that institutions are excluded from the Directive for the wrong reasons.

#### Option 2: Partial application of the IORP directive to DC schemes existing in some Member States that do not fall under any EU prudential regulation

4.3.26. If the preference of the Commission were to extend the scope of the IORP Directive, then EIOPA proposes that the directive should only be partially applied to avoid applying requirements which are specific to occupational pension schemes. A selection would need to be made of those articles that can be applied with no or limited change.

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<sup>25</sup> The Treaty on Functioning of European Union states that social policy (as defined in the Treaty) is an area of shared competence between the Union and the Member States (Article 4(b) TFEU). The social policy is defined in Article 156 which states that the role of Commission is to "encourage cooperation between the Member States and facilitate the coordination of their action" inter alia in the area of social security. At the same time, according to Declaration No. 31 on Article 156 TFEU "the policies described in Article 156 fall essentially within the competence of the Member States. Measures to provide encouragement and promote coordination to be taken at Union level in accordance with this Article shall be of a complementary nature. They shall serve to strengthen cooperation between Member States and not to harmonise national systems."

<sup>26</sup> Such a voluntary application, however, does not result in a European passport.

<sup>27</sup> Some of the schemes listed under paragraph 2.94.2.9 are an example of these borderline cases.

4.3.27. EIOPA proposes that such a partial application be done on the basis of a national option, where the scope of the IORP Directive would remain as currently but Member States would have the option to include such schemes in the scope of certain prescribed articles.

Option 3: Full application of the IORP directive to DC schemes existing in some Member States that do not fall under any EU prudential regulation

4.3.28. If the Commission wants to bring all 1st pillar bis or personal DC schemes under the scope of the IORP Directive, then the reference to 'occupational' would need to be removed or the notion of 'occupational' would need to be extended to cover a wide spectrum of pension products, from those schemes where the employer only collects and/or transfers the personal contributions to an institution, through those where an employer establishes and funds a pension scheme for its own employees (whether DB or DC), to retail products such as personal pensions which are open to the whole market. This would mean going beyond what is being defined as the sponsoring undertaking in the advice to the Call for Advice n°2.

4.3.29. To avoid the risk that pure social security institutions (with a guarantee by a public authority) fall under the scope of the revised directive, its scope should be limited to institutions operating at their own risk in the meaning of Article 2.3 of the Life Directive 2002/83/EC and case law<sup>28</sup>.

4.3.30. Removing or changing the reference to occupational would mean that the directive needs to be reviewed to consider the cases with and the cases without a sponsoring undertaking. The definition of sponsoring undertaking would need to be reviewed itself as well, which would have complicated implications for the notification process in case of cross-border activity (Call for Advice n°2) and the holistic balance sheet approach as defined in the advice on the solvency matters (Calls for Advice n°5 and 6). Many other requirements would need to be reviewed or introduced to take into account the specificities of these DC systems. Many other requirements would not be applicable. It would also mean that the competences of EIOPA need to be reviewed.

## **4.4. Impact assessment**

4.4.1 Having in mind that the baseline scenario is constituted by the current IORP Directive, the following impacts have been identified.

Option 2: partial application of the IORP directive to DC schemes existing in some Member States that do not fall under any EU prudential regulation

Positive impacts

- *IORP members:* Not possible to estimate since this would depend on the level of protection and the existence of appropriate national regulatory and supervisory standards at the national level compared to the European level. Such analysis has not been conducted yet.

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<sup>28</sup> Decision of the Court of Justice in the case C-209/98 Commission v Kingdom of Belgium 23/515

- *IORP and sponsoring undertaking*: Not possible to estimate since this would depend on the role of the sponsor and the existence of appropriate national regulatory and supervisory standards at the national level compared to the European level. Such analysis has not been conducted yet.
- *Supervisor*: Not possible to estimate since this would depend on the existence of appropriate national regulatory and supervisory standards at the national level compared to the European level. Such analysis has not been conducted yet.
- *Member State*: The optional application of the IORP directive to other types of pension schemes provides flexibility for Member States to create a national level playing field.
- *Internal market*: Would increase convergence in prudential regulation and supervision.

### Negative impacts

- *IORP members*: Not possible to estimate since this would depend on the level of protection and the existence of appropriate national regulatory and supervisory standards at the national level compared to the European level. Such analysis has not been conducted yet.
- *IORP and sponsoring undertaking*: Not possible to estimate since this would depend on the role of the sponsor and the existence of appropriate national regulatory and supervisory standards at the national level compared to the European level. Such analysis has not been conducted yet.
- *Supervisor*: Not possible to estimate since this would depend on the existence of appropriate national regulatory and supervisory standards on national level compared to the European level. Such analysis has not been conducted yet.
- *Member State*: None foreseen.
- *Internal Market*: Optional and partial application would still make a full level playing field unlikely to happen.

### **Option 3: full application of the IORP directive to DC schemes existing in some Member States that do not fall under any EU prudential regulation**

#### Positive impacts

- *IORP members*: May be better protected if the EU regulation is more demanding than the national regulatory standards currently existing, if any. Impossible to estimate the impact because such analysis has not been conducted yet.
- *IORP and sponsoring undertaking*: Not possible to estimate since this would depend on the role of the sponsor and the existence of appropriate national

regulatory and supervisory standards at the national level compared to the European level. Such analysis has not been conducted yet.

- *Supervisor:* Not possible to estimate since this would depend on the existence of appropriate national regulatory and supervisory standards at the national level compared to the European level. Such analysis has not been conducted yet.
- *Member State:* None foreseen.
- *Internal Market:* All funded pension schemes would be covered by the same EU prudential regulation. A wider scope has the advantage of a better structuring of the pension systems across the EU and a consistent application of EU regulation.

### Negative impacts

- *IORP members:* May be less protected if more demanding national regulatory standards currently exist compared to EU regulation. Impossible to estimate the impact because such analysis has not been conducted yet.
- *IORP and sponsoring undertaking:* Not possible to estimate since this would depend on the role of the sponsor and the existence of appropriate national regulatory and supervisory standards at the national level compared to the European level. Such analysis has not been conducted yet.
- *Supervisor:* Not possible to estimate since this would depend on the existence of appropriate national regulatory and supervisory standards at the national level compared to the European level. Such analysis has not been conducted yet.
- *Member State:* No longer the possibility to create a private funded pensions system regulated by specific national regulatory and supervisory framework. Interference with national prerogatives on social security policy.
- *Internal Market:* *Many provisions of the Directive would not be applicable and specific requirements would be needed. This will lead to an increased complexity of the Directive and would make it difficult to achieve harmonisation and therefore will not lead to a full level playing field. EIOPA's competence would need to be reviewed to include also non-occupational pension retirement provision.*

### **Comparison of policy options**

Given the potential impacts of extending the scope of the current Directive and due to the potential political implications of the proposed options, EIOPA proposes to keep the current scope of the Directive (option 1).

## 4.5. EIOPA advice

**The Commission Services would like EIOPA to advise on the scope of the IORP Directive, covering at least the following issues:**

**– The possibility to extend the scope of the IORP Directive to other occupational pension funds that operate on a funded basis.**

EIOPA is of the opinion that the clarification of the dividing lines between 1st, 2nd and 3rd pillar could enhance a consistent application. However, such clarification is a highly political issue because it touches on the premise that Member States have full responsibility for the organisation of their pension systems (principle of subsidiarity).

For the purpose of this advice EIOPA assumes that 2<sup>nd</sup> pillar schemes are schemes where the employer has a role in the establishment and/or funding of the scheme (occupational schemes).

The employer can be a single employer or groups thereof (e.g. industry associations) and labour or professional associations.

On the basis of analysis of available data no occupational DC schemes (in the meaning that there is no role for an employer to establish, nor to fund these schemes) could be clearly identified that currently do not fall in the scope of the IORP directive. EIOPA is aware that there are borderline cases and that other cases could emerge. Therefore EIOPA commits to continuously update its data and pursue its task of enhancing the understanding of the Directive. EIOPA notes that these cases might be a matter of implementation and not of the scope per se. Nonetheless EIOPA advises to redraft the articles on scope to avoid any ambiguity with regard to their application.

The DC schemes that do currently fall outside the scope are not occupational, in the meaning that there is no role for an employer to establish, nor to fund these schemes.

If the Commission wants to bring these DC schemes, pillar 1 bis or personal, under the scope, then the reference to 'occupational' would need to be removed or changed.

This would mean that the directive needs to be reviewed to consider the cases with and the cases without a sponsoring undertaking. The definition of sponsoring undertaking itself would need to be reviewed as well, which would have complicated implications for the notification process in case of cross-border activity (Call for Advice n°2) and the holistic balance sheet approach as defined in the advice on the solvency matters (Calls for Advice n°5 and 6). Many other requirements would need to be reviewed as well or introduced to take into account the specificities of these DC systems. Many other requirements would not be applicable. It would also mean that the competences of EIOPA need to be reviewed.

EIOPA has no evidence that this process will facilitate or will obstruct the harmonisation of the prudential regime for IORPs. EIOPA notes, however, that the remainder of the advice, and more specifically the holistic balance sheet (cfr. CfA 5 &6) has the existence of a sponsoring undertaking as a key element.

EIOPA considers that the IORP directive should remain a directive focused on occupational pension schemes operated by IORPs established by the employer and/or

where the employer plays an essential role in the funding of the IORP and therefore proposes option 1.

Introducing an EU prudential regime for non-occupational pension schemes, e.g. where there is no such role for the employer, would probably be more effective if done outside the IORP directive, for example by developing a separate prudential regime. See further below.

Nonetheless, it would be useful to introduce a recital clarifying that irrespective of the scope of the Directive, Member States can choose to apply the Directive on a voluntary basis to those institutions falling outside the scope except of course where the Directive (or other EU regulation) states otherwise.

**– The provisions that would need to be amended or added (if any) in order to suit the needs for the supervision of those occupational pension funds.**

N/A

**– Other advice, if any.**

EIOPA considers that the Commission should examine the issues that may arise with regard to the application of Article 4 of IORP Directive in the context of its review and the entry into force of Directive Solvency II.

While EIOPA proposes that the current scope of the IORP directive is not to be extended, EIOPA is of the opinion that it is desirable that members and beneficiaries of all types of pension schemes should be protected by high standards of governance by the institutions operating pension schemes and by appropriate regulatory and supervisory standards. EIOPA therefore recommends that the Commission considers the nature of the member protection in pension schemes falling outside the current scope and takes legislative initiative if it concludes that the protection offered by national/EU frameworks is not adequate.

## 5. CfA 2: Definition of cross-border activity

### 5.1. Extract from the call for advice

The Commission Services would like EIOPA to advise on how the wording of the IORP Directive needs to be amended in order to clarify that cross border activity arises only when the sponsoring undertaking and the IORP are located in two different Member States.

### 5.2. Background

#### Current legal requirements (IORP Directive)

5.2.1. Under the IORP Directive, institutions for occupational retirement provision (IORPs) have the possibility of providing their services in other Member States, thereby allowing them to operate pension schemes with members and beneficiaries in more than one Member State. The Directive provides in Article 20 the basic framework for IORPs that wish to operate cross-border, including the procedure that needs to be followed before cross-border activity can be started.

#### OPC reports

5.2.2. OPC research has shown that cross border activity has been defined differently in member states with three interpretations (member states which fall within the interpretations are identified in brackets):

- **Location of the sponsoring undertaking** (AT, BG, DE, LI, NO, CZ);

A Member State that uses the location of the sponsoring undertaking as the decisive criterion, considers an activity to be cross-border if the sponsoring undertaking is located in another Member State than the IORP.

- **Nationality of the Social and Labour Law** (BE<sup>29</sup>, PT, IE, UK, FI);

A Member State that uses the nationality of the social and labour law as the decisive criterion, considers an activity to be cross-border if the applicable social and labour law originates from a Member State other than the Member State where the IORP is established.

- **Nationality of the scheme** (LU, NL);

A Member State that uses the nationality of the scheme as the decisive criterion, considers an activity to be cross-border if the scheme is from a different Member State to where the IORP is established.

### 5.3. Explanatory text

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<sup>29</sup> However, the criterion for notification is based on the location of the sponsoring undertaking.

## **EIOPA's view on issues in the CfA**

- 5.3.1. It should be noted that EIOPA has not been asked to provide the Commission with advice on how to amend the IORP Directive in order to arrive at the most suitable definition of cross border. It has however been asked to provide advice as to how the Directive should be amended to reflect the position that cross border activity arises only when the sponsor and IORP are located in two different Member States. The option of no change is also included for completeness.
- 5.3.2. The use of different definitions that exist today has led to a number of cases where two (or more) Member States potentially involved in a cross-border activity have come to different conclusions on whether the proposed activity is cross border or not. This has created considerable difficulties in both the operation of cross border IORPs and the notification, authorisation and approval processes.
- 5.3.3. The lack of clarity about the different scope of the member states social and labour law and the prudential law has also been identified as a significant hurdle to cross border IORPs. Call for Advice 4 (Prudential regulation and social and labour law) is looking at creating greater certainty in what constitutes applicable prudential regulation in the case of a cross border IORP. Member States themselves should define what constitutes applicable social and labour law.
- 5.3.4. The cross border market is very small with only 84<sup>30</sup> cross border schemes to date. As the Commission highlighted in the CfA, the differences in definition may hamper IORPs' willingness to engage in cross border activity. A more consistent interpretation of what a cross border activity is may help address this issue.
- 5.3.5. Another reason for this lack of demand may be that pension arrangements must operate as part of each Member State's overall legal systems in respect of occupational pensions, for example taxation and social and labour law. It is difficult for a foreign IORP to, firstly, obtain the relevant requirements, secondly, to understand these and, finally, to manage arrangements according to these requirements. This complexity and uncertainty can absorb much management and consultancy time, especially in the preparatory phase, making cross border provision unattractive from the cost perspective. Also, it is to be noted that cross-border activity requires full funding at all times, which is perceived as an additional hurdle in the cross-border provision of services. Other reasons, but not less important, are cultural and language barriers.
- 5.3.6. As regards the benefits of single markets, schemes do receive much of the benefits of this already through the ability to pool assets and investment risks.

## **Policy options**

### Option 1: Leave the IORP directive unchanged

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<sup>30</sup> EIOPA-BoS-11/023 (14 July 2011)

- 5.3.7. While the current legal environment may not be perfect, it is adequate for at least some cross-border activity to take place. It is possible that the lack of take-up is not due to failings of the Directive or Member States' interpretations, but to other reasons such as a basic lack of demand.
- 5.3.8. However, the cross border market is very small by comparison with the number of IORPs across the EU in total. A more consistent interpretation of what is a cross border activity may be necessary to increase IORPs' willingness to engage in these activities.
- 5.3.9. Leaving the IORP directive unchanged results in difficulties in both the operation of cross border IORPs and the notification, authorisation and approval processes.

Option 2: Amend the wording of the IORP directive to reflect the position that cross border activity arises only when the sponsor and the IORP are located in two different Member States

5.3.10. In order to achieve this, there are a number of elements that need to be considered.

5.3.11. Firstly, the definition of home and host state and that of the sponsoring undertaking in Articles, 6 (c), 6 (i) and 6 (j) of the IORP Directive:

*6 (i) "home Member State" means the Member State in which the institution has its registered office and its main administration or, if it does not have a registered office, its main administration<sup>31</sup>;*

*6 (j) "host Member State" means the Member State whose social and labour law relevant to the field of occupational pension schemes is applicable to the relationship between the sponsoring undertaking and members.*

5.3.12. The wording of home state is clear: this is the location of the IORP. The challenge lies in defining the host state. The current wording brings in the location of the applicable social and labour law. This has led to some member states defining an IORP as operating on a cross border basis where it has members which are working in, and subject to the SLL, of another Member State.

5.3.13. The simplest method to resolve this would be to adjust the definition of host state to reflect the position in respect of location of the sponsoring undertaking:

*"host member state" means the Member State where the sponsoring undertaking is located.*

5.3.14. The second element that would need to be clarified is the definition of the sponsoring undertaking. The IORP directive currently states that:

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<sup>31</sup> It should be noted that EIOPA, in its advice on CfA 12, proposes to amend the definition of Home Member State, without however changing the fundamental aspect, i.e. being the location of the IORP.

6 (c) "*sponsoring undertaking*" means any undertaking or other body, regardless of whether it includes or consists of one or more legal or natural persons, which acts as an employer or in a self-employed capacity or any combination thereof and which pays contributions into an institution for occupational retirement provision;

5.3.15. This leaves open the general issue of what is meant by sponsoring undertaking: can it be a branch, a subsidiary, or is it the head office ultimately paying the contribution, or any other entity. This may particularly not be clear in the case of companies within a group.

5.3.16. EIOPA has considered possible improvements to the definition of sponsoring undertaking but has concluded that further analysis is needed. EIOPA identified that at least the following elements should be considered when defining the sponsoring undertaking:

- Who signs the agreement with the IORP and/or members?;
- Who establishes the pension scheme?
- Who pays contributions into the IORP?
- Who has the contractual or legal obligation to cover funding deficits?
- Who provides the sponsor covenant (cfr. holistic balance sheet as set out in Chapter 8)?.

5.3.17. It should be noted that when defining the sponsoring undertaking, problems of overlapping or contradicting regulation between member states could emerge. Even if the definition of sponsoring undertaking could be improved, it is impossible for the Directive to anticipate all the circumstances that could give rise to uncertainty over the regulation of cross-border schemes. Therefore, the revised Directive should not include detailed procedures to settle problems between the home and the host member states, but should instead provide for the possibility of a case-by-case consideration by supervisory authorities concerned (the Budapest Protocol provides an appropriate starting point for this) followed by, in the absence of agreement, EIOPA's mediation mechanism as provided for by Article 19 of the EIOPA Regulation<sup>32</sup>.

5.3.18. Equally, information procedures should be introduced at Level 3 to notify the Competent Authority of the Member State of the applicable social and labour law, if that Member State is not the Host Member State under the new single definition, of the existence of an occupational pensions activity subject to its legislation and supervision. It is also worth bearing in mind that there are references to the host state elsewhere in the Directive that relate to cross border activity, specifically in Recitals 34 and 37 and in Articles 6, 14, 18, 20 and 21. While these references do not need to be changed in order to achieve the objective required by the CfA, the consequences of these requirements create a number of issues.

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<sup>32</sup> Regulation (EU) No 1094/2010

- 5.3.19. Indeed, the most important consequence of the notification procedure is that it gives the ability to the authorities of the member state of the social and labour law to supervise the correct application of its law and, if necessary, to take measures against the IORP in the event of a breach of the SLL on the basis of art. 20(9) and 20(10) of the directive. This article also sets out the procedures to be followed by the Host and Home Member States:
- a. The Host supervisor must inform the Home supervisor when it detects a breach of its SLL;
  - b. The Home supervisor shall, in coordination with the Host supervisor, take the necessary measures;
  - c. If, despite the measures taken by the Home supervisor or in the absence of appropriate measures by the Home supervisor, the IORP persists in breaching the SLL, the Host supervisor may, after informing the Home supervisor, take itself the necessary measures to prevent or penalise further breaches of its SLL.
- 5.3.20. This ability disappears when only the member state of the location of the sponsoring undertaking can be considered as the host member state without taking into consideration the nationality of the applicable SLL.
- 5.3.21. A solution could be to amend article 20(9) and 20(10)<sup>33</sup> to maintain the ability of the authorities of the member state of the SLL (i.e. another member state than the home and the host Member States, in the context of the revised definition of Host Member State) to conduct its ongoing supervision and to take measures against the IORP. This would give a similar protection for members and beneficiaries to the current version of the directive. But it is a complex solution because several competent authorities could act against the same IORP.
- 5.3.22. Such amendments should be coupled with the requirement that IORPs should respect the relevant SLL, irrespective of whether that is the law of the Host Member State under the proposed single definition.
- 5.3.23. At any rate it is not clear whether under the current definition of cross border activity there is a single definitive link between the social and labour law and the location of the worker. This can depend on the workers contract of employment and any mandatory rules that hang off the place of performance of service. So it is already possible to have three member states involved, one home, one host and a third with some mandatory rules engaged. Equally, a number of member states have already implemented the definition based on the location of the IORP and the sponsoring undertaking so this is clearly possible.

## **5.4. Impact assessment**

- 5.4.1. Having in mind that the baseline scenario is constituted by the current IORP Directive, the following impacts have been identified.

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<sup>33</sup> Including the changes to Art. 20.10 as proposed under CfA 10.

**Option 2:** Amend the wording of the IORP directive to reflect the position that cross border activity arises only when the sponsor and the IORP are located in two different Member States.

Positive impacts:

- *IORP members:* None foreseen.
- *IORP and sponsoring undertaking:* A single definition may provide clarity to IORPs and sponsoring employers and in doing so allow multinational companies to have a solution to centralising their local retirement schemes and allow for a reduction in costs by exploiting economies of scale in pension administration and investment management.
- *Supervisor:* A single definition may introduce clarity in the process and this would solve the problem that because of the current differing national approaches, situations can arise where two (or more) Member States potentially involved in a cross-border activity come to different conclusions on whether the proposed activity is cross border or not, which leads to different notification practices and the possibility of states having competing views as to who the Host state is.
- *Member State:* None foreseen.
- *Internal Market:* A clear definition may help develop the cross border market which can in turn lead to a strong internal market for pensions.

Negative impacts:

- *IORP members:* It is not clear this definition would ensure comparable level of protection if it breaks the link between the host state and the applicable social and labour law. If the status of the Member State of the applicable SLL would not be clarified, this could create a situation where host state requirements for IORPs (SLL and any other requirements as allowed by the Directive, i.e. additional investment or disclosure rules) would have a direct impact on members located in another Member State entirely and any requirements in the Member State where the member is located would have no impact. A definition based on the sponsoring undertaking takes into account the free market element of cross border activities but not the member protection element. EIOPA sees no possibility of serving both aims by drafting one definition based on the 'sponsoring undertaking'.
- *IORP and sponsoring undertaking:* The definition could make an IORP cross border even when the IORP and its members are located in the same member state. This could occur where a domestic branch with a foreign parent company had established a IORP for its domestic members so both the members and the IORP would be in the same member state but the sponsoring undertaking (the parent company) would be in another state. Equally this does not address any of the other factors that have limited the growth of cross border provisions such as the complexities of operating under different taxation and social and labour law regimes. There is also a cost for all existing cross border IORPs and all potential cross border IORPs to evaluate whether they do fall into cross border

provisions under the new definition. In some Member states this is likely to lead to changing the status of current (cross-border) IORPs with the associated cost impacts (notification process, fully funding requirement). It could also lead to withdrawing the pension scheme altogether or restructuring the group arrangements to remain a domestic IORP.

- *Supervisory authorities:* By breaking the link to SLL the supervisory authority of that Member State would not be involved in the notifications process as detailed in Article 20 and so would not play a role in the supervision of the IORP. To solve this it could complicate the notifications process as detailed in Article 20 and may lead to more time consuming procedures to settle problems between the Home and Host Member States.
- *Member States:* Redefining the Host Member States implies that Member States should review their legislation. The impact of this will need to be assessed.
- *Internal Market:* None foreseen.

### **Comparison of policy options**

5.4.2. In view of the specific request in the CfA, EIOPA proposes option 2.

## 5.5. EIOPA advice

**The Commission Services would like EIOPA to advise on how the wording of the IORP Directive needs to be amended in order to clarify that cross border activity arises only when the sponsoring undertaking and the IORP are located in two different Member States.**

EIOPA notes that the advice requested is limited to the definition of cross-border activity as put forward by the Commission. In order to achieve the clarification requested by the Commission, EIOPA proposes to amend Article 6 (j) as follows:

*6 (j) "host member state" means the Member State where the sponsoring undertaking is located*

EIOPA also considers that the definition of sponsoring undertaking (Article 6 c) should be improved to avoid situations where undertakings could be unintentionally identified as being a sponsoring undertaking, or the other way around, with unintended consequences on the cross-border status of the IORP.

EIOPA has considered possible improvements to the definition of sponsoring undertaking and identified several elements that should at least be considered when defining the sponsoring undertaking. However, a conclusive definition could not be determined without further analysis on this issue.

It should be noted that when defining the sponsoring undertaking, problems of overlapping or contradicting regulation between member states could emerge. Even if the definition of sponsoring undertaking could be improved, it is impossible for the Directive to anticipate all the circumstances that could give rise to uncertainty over the regulation of cross-border schemes. Therefore, the revised Directive should not include detailed procedures to settle problems between the home and the host member states, but should instead provide for the possibility of a case-by-case consideration by supervisory authorities concerned (the Budapest Protocol provides an appropriate starting point for this) followed by, in the absence of agreement, EIOPA's mediation mechanism as provided for by Article 19 of the EIOPA Regulation.

In addition EIOPA advises to amend article 20 to maintain the ability of the authorities of the member state of the SLL (i.e. a member state other than the home and the host member states) to conduct its ongoing supervision of SLL and to take measures against the IORP, according to the procedures currently foreseen in article 20(9) and 20(10)<sup>34</sup>.

In addition, a requirement should be introduced that IORPs should respect the applicable SLL, irrespective of whether that is the law of the Host Member State. This should be coupled with developing notification procedures at Level 3 to inform the Competent Authority of the Member State of the applicable SLL.

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<sup>34</sup> Including the changes suggested to Art. 20.10 under CfA 10.

## 6. CfA 3: Ring fencing

### 6.1. Extract from the call for advice

The EIOPA advice should address at least the following subjects:

- *The scope of ring-fencing measures needs to be clarified in the context of cross-border activity of IORPs.*
- *The text of an article to be inserted into the Directive with the aim of establishing the general principles which warrant ring-fencing measures in the case of stress situations, including the legal implications and common safeguards, which would improve adequate protection of pension benefits.*

### 6.2. Background

#### Current legal requirements (IORP Directive)

- 6.2.1. Directive 2003/41/EC of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision (*"the IORP Directive"*) contains various references to ring-fencing (Recital 38 and Articles 3, 4, 7, 16(3), 18(7) and 21(5)). Article 8 is also of relevance given that ring-fencing is often associated with some form of legal separation between sponsoring undertakings and IORPs.

##### Article 3

Application to institutions operating social-security schemes

Institutions for occupational retirement provision which also operate compulsory employment-related pension schemes which are considered to be social-security schemes covered by Regulations (EEC) No 1408/71 and (EEC) No 574/72 shall be covered by this Directive in respect of their non-compulsory occupational retirement provision business. In that case, the liabilities and the corresponding assets shall be ring-fenced and it shall not be possible to transfer them to the compulsory pension schemes which are considered as social-security schemes or vice versa.

##### Article 4

Optional application to institutions covered by Directive 2002/83/EC

Home Member States may choose to apply the provisions of Articles 9 to 16 and Articles 18 to 20 of this Directive to the occupational-retirement-provision business of insurance undertakings which are covered by Directive 2002/83/EC. In that case, all assets and liabilities corresponding to the said business shall be ring-fenced, managed and organised separately from the other activities of the insurance undertakings, without any possibility of transfer.

In such case, and only as far as their occupational retirement provision business is concerned, insurance undertakings shall not be subject to Articles 20 to 26, 31 and 36 of Directive 2002/83/EC.

The home Member State shall ensure that either the competent authorities, or the authorities responsible for supervision of insurance undertakings covered by Directive 2002/83/EC, as part of their supervisory work, verify the strict separation of the relevant occupational retirement provision business.

## Article 7

### Activities of an institution

Each Member State shall require institutions located within its territory to limit their activities to retirement-benefit related operations and activities arising therefrom.

When, in accordance with Article 4, an insurance undertaking manages its occupational retirement provision business by ring-fencing its assets and liabilities, the ring-fenced assets and liabilities shall be restricted to retirement-benefit related operations and activities directly arising therefrom.

## Article 8

### Legal separation between sponsoring undertakings and institutions for occupational retirement provision

Each Member State shall ensure that there is a legal separation between a sponsoring undertaking and an institution for occupational retirement provision in order that the assets of the institution are safeguarded in the interests of members and beneficiaries in the event of bankruptcy of the sponsoring undertaking.

## Article 16

### Funding of technical provisions

3. In the event of cross-border activity as referred to in Article 20, the technical provisions shall at all times be fully funded in respect of the total range of pension schemes operated. If these conditions are not met, the competent authorities of the home Member State shall intervene in accordance with Article 14. To comply with this requirement the home Member State may require ring-fencing of the assets and liabilities.

## Article 18

### Investment rules

7. In the event of cross-border activity as referred in Article 20, the competent authorities of each host Member State may require that the rules set out in the second subparagraph apply to the institution in the home Member State. In such case, these rules shall apply only to the part of the assets of the institution that corresponds to the activities carried out in the particular host Member State. Furthermore, they shall only be applied if the same or stricter rules also apply to institutions located in the host Member State.

The rules referred to in the first subparagraph are as follows:

(a) the institution shall not invest more than 30 % of these assets in shares, other securities treated as shares and debt securities which are not admitted to trading on a regulated market, or the institution shall invest at least 70 % of these assets in shares, other securities treated as shares, and debt securities which are admitted to trading on a regulated market;

(b) the institution shall invest no more than 5 % of these assets in shares and other securities treated as shares, bonds, debt securities and other money and capital-market instruments issued by the same undertaking and no more than 10 % of these assets in shares and other securities treated as shares, bonds, debt securities and other money and capital market instruments issued by undertakings belonging to a single group;

(c) the institution shall not invest more than 30 % of these assets in assets denominated in currencies other than those in which the liabilities are expressed.

To comply with these requirements, the home Member State may require ring-fencing of the

assets.

## Article 21

### Cooperation between Member States and the Commission

5. The competent authorities of the host Member State may ask the competent authorities of the home Member State to decide on the ring-fencing of the institution's assets and liabilities, as provided for in Article 16(3) and Article 18(7).

- 6.2.2. The above Articles refer to different forms and consequences of ring-fencing in specific contexts. This notwithstanding, the IORP Directive does not include a definition of ring-fencing nor the techniques that should be applied in order to achieve the different forms and consequences of ring-fencing referred to in the IORP Directive in the contexts in question. In addition, the application of ring-fencing is not obligatory other than in the context of Articles 3 and 4 of this directive.

## Solvency II Directive

- 6.2.3. The CfA refers to Art. 99 and recital 49 of Directive 2009/138/EC (Solvency II Directive) in respect of ring-fencing. However, other articles of Solvency II could be relevant as well, such as Art. 74 on the separation of life and non-life insurance management and Art. 276 on the special register. Art. 304 regarding the duration-based equity risk sub-module also refers to ring-fencing, but this is a copy paste of Art. 4 of the IORP Directive.

(49) Not all assets within an undertaking are unrestricted. In some Member States, specific products result in ring-fenced fund structures which give one class of policy holders greater rights to assets within their own fund. Although those assets are included in computing the excess of assets over liabilities for own-fund purposes they cannot in fact be made available to meet the risks outside the ring-fenced fund. To be consistent with the economic approach, the assessment of own funds needs to be adjusted to reflect the different nature of assets, which form part of a ring-fenced arrangement. Similarly, the Solvency Capital Requirement calculation should reflect the reduction in pooling or diversification related to those ring-fenced funds.

## Article 74

### Separation of life and non-life insurance management

1. The separate management referred to in Article 73 shall be organised in such a way that the life insurance activity is distinct from non-life insurance activity.

The respective interests of life and non-life policy holders shall not be prejudiced and, in particular, profits from life insurance shall benefit life policy holders as if the life insurance undertaking only pursued the activity of life insurance.

2. Without prejudice to Articles 100 and 128, the insurance undertakings referred to in Article 73(2) and (5) shall calculate:

(a) a notional life Minimum Capital Requirement with respect to their life insurance or reinsurance activity, calculated as if the undertaking concerned only pursued that activity, on the basis of the separate accounts referred to in paragraph 6; and

(b) a notional non-life Minimum Capital Requirement with respect to their non-life insurance or reinsurance activity, calculated as if the undertaking concerned only pursued that activity, on the

basis of the separate accounts referred to in paragraph 6.

3. As a minimum, the insurance undertakings referred to in Article 73(2) and (5) shall cover the following by an equivalent amount of eligible basic own-fund items:

(a) the notional life Minimum Capital Requirement, in respect of the life activity;

(b) the notional non-life Minimum Capital Requirement, in respect of the non-life activity.

The minimum financial obligations referred to in the first subparagraph, in respect of the life insurance activity and the non-life insurance activity, shall not be borne by the other activity.

4. As long as the minimum financial obligations referred to in paragraph 3 are fulfilled and provided the supervisory authority is informed, the undertaking may use to cover the Solvency Capital Requirement referred to in Article 100, the explicit eligible own-fund items which are still available for one or the other activity.

5. The supervisory authorities shall analyse the results in both life and non-life insurance activities so as to ensure that the requirements of paragraphs 1 to 4 are fulfilled.

6. Accounts shall be drawn up so as to show the sources of the results for life and non-life insurance separately. All income, in particular premiums, payments by reinsurers and investment income, and expenditure, in particular insurance settlements, additions to technical provisions, reinsurance premiums and operating expenses in respect of insurance business, shall be broken down according to origin. Items common to both activities shall be entered in the accounts in accordance with methods of apportionment to be accepted by the supervisory authority.

Insurance undertakings shall, on the basis of the accounts, prepare a statement in which the eligible basic own-fund items covering each notional Minimum Capital Requirement as referred to in paragraph 2 are clearly identified, in accordance with Article 98(4).

7. If the amount of eligible basic own-fund items with respect to one of the activities is insufficient to cover the minimum financial obligations referred to in first subparagraph of paragraph 3, the supervisory authorities shall apply to the deficient activity the measures provided for in this Directive, whatever the results in the other activity.

By way of derogation from the second subparagraph of paragraph 3, those measures may involve the authorisation of a transfer of explicit eligible basic own-fund items from one activity to the other.

## Article 99

### Implementing measures

The Commission shall adopt implementing measures laying down:

(a) the quantitative limits referred to in Article 98(1) and (2);

(b) the adjustments that should be made to reflect the lack of transferability of those own-fund items that can only be used to cover losses arising from a particular segment of liabilities or from particular risks (ring-fenced funds).

Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).

## **International standards (OECD/IOPS, etc)**

6.2.4. There are no international standards existing on ring-fencing.

## **OPC reports and studies**

6.2.5. Research has been effectuated by EIOPA on this matter which resulted in the Report on ring-fencing in stress situations<sup>35</sup>. One particular objective was to assess how ring-fenced assets are affected in the event of problematic financial situations such as default, bankruptcy, insolvency and deficits and determining the legal consequences arising in such circumstances. The following is a summary of the salient findings of this research:

- ring-fencing is, to some extent, a subjective area given that: [i] countries can adopt different approaches to ring-fencing; and [ii] ring-fencing is an optional rather than an obligatory measure in particular scenarios;
- there are countries where ring-fencing is optional and in others where it is prohibited;
- there exist variances in the levels of protection afforded to ring-fenced assets amongst countries; and
- as a result, the safeguards expected from ring-fencing may in practice not work as expected in certain scenarios or in certain countries, thus potentially raising issues for cross-border pension provisioning (particularly in terms of Article 16(3) of the IORP Directive) should a stress scenario develop.

6.2.6. In that report two main types of ring-fencing were identified on the basis of the legal implications: administrative ring-fencing and patrimony protection rules.

6.2.7. Administrative ring-fencing separates the assets and liabilities of different pension schemes operated by the same IORP only 'on paper', and is most commonly used for the calculation of scheme-specific contribution levels, the granting of indexation, etc. Such ring-fencing is of an administrative nature only, and the consequent separation achieved by such measures may not necessarily be recognised in law in stress scenarios, contrary to Patrimony Protection rules.

6.2.8. Patrimony protection rules provide for a full legal and financial separation of assets and liabilities belonging to different pension schemes operated by the same IORP, or to other parts of the IORP's operations. Patrimony Protection rules are considered to be part of the legal framework of a Member State, providing legal recognition to the separation afforded by administrative ring-fencing and which result in protecting the assets and liabilities held by an IORP on behalf of the members and beneficiaries<sup>36</sup> of the pension scheme from access thereto by the creditors of the IORP or the creditors or

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<sup>35</sup> CEIOPS-OP-08-09 Rev 6, 10 May 2010

<sup>36</sup> For the remainder of this document, every reference to "members" should be read as "members and beneficiaries".

members of the other pension schemes whose assets are also held by the IORP. Patrimony protection rules therefore assume administrative ring-fencing measures are in place.

- 6.2.9. Privilege rules were also identified as being a way to increase member protection. They can be considered as a special type of patrimony protection rules. They are rules in the legal framework of the Member State which determine whether, and if so to what extent, members of Pension Schemes enjoy priority in respect of the IORP's assets against other creditors in the event of a default of the IORP.
- 6.2.10. As part of the report on ring-fencing, EIOPA analysed the effectiveness of ring-fencing measures in protecting pension benefits in different stress situations (underfunding of the pension scheme and default of the pension scheme, the IORP or the service provider). The conclusions are that in situations of underfunding of the pension scheme, administrative ring-fencing could be sufficient to allow for distinct supervisory measures (e.g. the freezing of assets), but pension benefits could still be affected if, for example, the supervisor imposes supervisory measures on the whole IORP irrespective of the administrative ring-fencing. And especially, in the case of default (of the pension scheme, IORP or service provider) administrative ring-fencing measures are not sufficient. Some protection could be offered by introducing privilege rules, but full protection is only offered by patrimony protection rules.
- 6.2.11. Earlier research, as part of the CEIOPS Report on the implementation of the IORP Directive<sup>37</sup> has identified the following rationale for the different articles referring to ring-fencing:
- 6.2.12. Art. 3 (1st and 2nd pillar): The main rationale is to maintain the independence of the second pillar from the first pillar and vice versa as this is considered important from a member and beneficiaries' protection perspective given that the assets of the first pillar cannot be used to fund the liabilities of the second pillar and vice versa. Other reasons are the need to avoid distortion of competition between IORPs who manage both first and second pillar pensions and IORPs which manage solely second pillar pensions as well as to avoid problems regarding which regulation to be imposed on which part of the business.
- 6.2.13. Art. 4 (optional application of the Directive to insurance companies operating occupational pensions): The main rationale is to maintain the independence of the pensions business of the insurance undertaking because this was considered important from a member and beneficiaries' protection perspective as the assets of the pensions business cannot be used to fund the liabilities of the other business of the insurance undertaking and vice versa. Another common rationale indicated is to allow the separate application of different investment rules and tax treatment to the corresponding assets of the pensions and insurance business.

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<sup>37</sup> CEIOPS-OP-17-07 v2, Report on the results of the ring-fencing questionnaire, July 2007  
41/515

- 6.2.14. Art. 16.3 (fully funding requirement in a cross-border situation): The main rationale is to safeguard the interest of scheme members and to facilitate compliance.
- 6.2.15. Art. 18.7 (investment rules in a cross-border situation): The main rationale is to ensure that an IORP operating on a cross-border basis complies with investment restrictions required by the Host Member State and in order to avoid spill over effects to that part of the IORP which is not subject to the same investment restrictions.

### **Other CEIOPS reports and studies**

- 6.2.16. Although CEIOPS in its advice on ring-fenced funds for Level 2 implementing measures on Articles 99.b and 111.h of Solvency II<sup>38</sup> focuses on providing an answer to the question of the availability of own funds in the presence of ring-fenced funds to cover the SCR, it also highlights some aspects which are useful for this advice:
- 6.2.17. "CEIOPS is aware that there is a large variety of ring-fenced type funds across the EEA, and also that the issue is not of equal relevance in all Member States."
- 6.2.18. "Different arrangements in different Member States may fall within the scope of the proposals. CEIOPS is aiming at providing an appropriate pragmatic and principles-based treatment for ring-fenced-type funds across the EEA, and should not seek to harmonise the legal or contractual structure of ring-fenced funds nor the products which could give rise to them through its approach."
- 6.2.19. Furthermore, the advice defines the nature of ring-fenced funds on the basis of high level principles (no sharing of profits, reduction in diversification, restricted loss absorbency capacity), recognising at the same time that further guidance on Level 3 could be helpful to "make clear how and why ring fencing might be appropriate rather than merely taking the form of a list, not least to assist in the identification of ring fencing implications of any future arrangements."

## **6.3. Explanatory text**

### **EIOPA view on issues in the CfA**

- 6.3.1. Ring-fencing exists in many forms and can serve many purposes. The main denominator is some form of separation (e.g. separation of assets and liabilities, separation of management, separation of operations etc...) intended to address specific risks in particular contexts. The required separation can be achieved through, for example:
- allocation rules to identify separate parts;
  - maintaining special registers for each ring-fenced part;

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<sup>38</sup> former consultation paper 68,

[https://eiopa.europa.eu/fileadmin/tx\\_dam/files/consultations/consultationpapers/CP68/CEIOPS-L2-Advice-Treatment-of-ring-fenced-funds.pdf](https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/CP68/CEIOPS-L2-Advice-Treatment-of-ring-fenced-funds.pdf)

- the retention of separate accounting records;
- the maintenance of separate bank accounts;
- separation of business areas with own management and administration.

- 6.3.2. The legal implications of ring-fencing vary with the type of ring-fencing measures applied and are also largely dependent, particularly as regards the protection of the rights of pension scheme members and beneficiaries in stress situations, on the national legal framework existing in each MS e.g. in the field of liquidation and insolvency procedures.
- 6.3.3. For the purpose of this advice, EIOPA builds on the concepts of administrative ring-fencing, patrimony protection rules and privilege rules as identified in previous OPC reports, but adapts them to provide a solution for what is requested in the CfA.

#### RING-FENCING MEASURES IN THE CONTEXT OF CROSS-BORDER ACTIVITY

- 6.3.4. The CfA asks EIOPA to clarify the scope of ring-fencing measures in the case of cross-border activity. The current directive mentions the notion of ring-fencing in the context of cross-border activity in Art. 16.3 and 18.7.
- 6.3.5. Art. 16.3 is about the fully funding requirement, whereas 18.7 is about the investment requirements of the Host Member State.
- 6.3.6. The reference to ring-fencing in **Art. 16.3** *"To comply with this requirement the home Member State may require ring-fencing of the assets and liabilities."* gives rise to different interpretations in relation to the fully funding requirement: *"In the event of cross-border activity as referred to in Article 20, the technical provisions shall at all times be fully funded in respect of the total range of pension schemes operated."* and in relation to the powers of intervention: *"If these conditions are not met, the competent authorities of the home Member State shall intervene in accordance with Article 14."*
- 6.3.7. The first interpretation is that all technical provisions, for both local and cross-border activity, should be fully funded at all times, and therefore, if a situation of underfunding occurs, at least at that moment the assets and liabilities of each local and cross-border activity could be ring-fenced. This would allow the supervisory authority, if necessary, to take specific measures under Art. 14 for each of the ring-fenced parts taking into account the specificities of the local versus the cross-border activities. It would also allow the IORP to set up recovery plans which are specific to the nature of each of the ring-fenced parts.
- 6.3.8. The second interpretation is that ring-fencing of the cross-border activity should be decided upfront, i.e. at the start of the cross-border activity, and therefore, if a situation of underfunding occurred, the origin of the underfunding would be easily identifiable and may allow for distinct recovery and supervisory measures to be taken in relation to the underfunded ring-fenced part taking into account the specificities of that ring-fenced part, without affecting the other ring-fenced parts if not otherwise agreed.

- 6.3.9. EIOPA considers that removing the reference to ring-fencing will improve the clarity of the fully funding requirement without impacting on the general powers for the Home Member State to impose ring-fencing.
- 6.3.10. Whereas Art 16.3 mentions ring-fencing of both assets and liabilities, **Art 18.7** only mentions ring-fencing of the assets. However, in order to determine the assets to be ring-fenced, it should be identified which and how much of the assets should be ring-fenced, i.e. the assets that are related to the liabilities of the cross-border activity. This is supported by the reference to "*the part of the assets of the institution that corresponds to the activities carried out in the particular Host MS*" in the first paragraph of Art. 18.7.
- 6.3.11. Application of different investment rules in the context of Art. 18.7 can be assured through administrative ring-fencing measures which would allow easy identification of the parts of the assets subject to the investment rules of the Host Member State. In this case, ring-fencing could be necessary if the investment rules of the Host Member State are not compatible with the investment rules of the Home Member State, and more specifically ring-fencing would be necessary if the internal investment rules (which are expected of course to respect the investment rules imposed by the Home/Host Member State(s)) applied by the IORP are not compatible between activities.
- 6.3.12. Additionally, in order to avoid spill-over effects from parts which are not subject to the same rules, ring-fenced parts should be respected in all circumstances and till the liquidation of the IORP. This implies that the patrimony protection rules as set out in par. 6.3.18.b should apply.

#### PRINCIPLES FOR RING-FENCING MEASURES

- 6.3.13. The CfA asks EIOPA to address the general principles which warrant ring-fencing measures in the case of stress situations to improve the protection of pension benefits. The advice must also include the legal implications and common safeguards of such ring-fencing measures. The main call for advice in par. 3.3 states that the "legal clarity of the concept of ring-fencing may enhance the effectiveness of ring-fencing measures in the case of cross-border activity of IORPs and in stress situations". This seems to ask EIOPA to look beyond just what is currently contained in the IORP Directive.
- 6.3.14. For the purpose of this advice, stress situations should be considered as situations in which pension benefits are at risk, i.e. situations where benefits could be reduced as a result of recovery measures or in case of liquidation of the IORP or part of the IORP. Situations of temporary underfunding where pension benefits are not being reduced should not be considered as a stress situation.
- 6.3.15. EIOPA does not consider that a stress situation should be a trigger for ring-fencing, however, if there is ring-fencing (either mandatory or optional) EIOPA proposes a minimum set of requirements to ensure that the ring-fencing measures are effective in stress situations.

- 6.3.16. If ring-fencing is decided on, the extent to which members' rights are protected depends on when the ring-fencing is decided upon and how the assets available at the time of ring-fencing are allocated.
- 6.3.17. As long as the IORP is operating on an ongoing basis, administrative ring-fencing measures applied in line with the principles outlined above could be sufficient in the context of a cross-border activity. However, in case of default, the protection of scheme members from other creditors would depend on the privilege rules and patrimony protection rules in place in the Home Member State.
- 6.3.18. The effectiveness of ring-fencing should be measured with regard to the aim of the ring-fencing. If the aim of ring-fencing is to provide a separation 'in all circumstances and till the end' and thus also during stressed situations, i.e. in circumstances where pension benefits could be reduced or in the case of liquidation, then specific ring-fencing measures are needed, supplemented by legal protection of the ring-fenced parts:
- a. To ensure that the fences around the rings will be recognised and can be respected in case of stress, the following ring-fencing measures should be in place in the IORP (these can be considered as **administrative ring-fencing measures**):
    - clear identification of the liabilities and corresponding assets of each ring-fenced part;
    - maintenance of special registers of assets for each ring-fenced part;
    - allocation of the income and expenditure according to origin;
    - allocation of common items on the basis of predetermined methods of apportionment;
    - in principle no allowance for transfer of assets; and
    - distinct recovery and/or supervisory measures<sup>39</sup> respecting the existence and extent of ring-fencing.
  - b. In order to have full protection of ring-fenced parts in law, the legal framework should consist of at least the following **patrimony protection rules**:
    - the protection of ring-fenced parts from claims made by creditors of other ring-fenced parts;
    - the protection of ring-fenced parts from any reduction in benefits payable under another ring-fenced part in default;
    - no allowance for transfer of assets as soon as default occurs, as the composition of the assets entered in the special register should no longer be changed.
- 6.3.19. Protection of pension benefits can, however, not be absolute, even if such patrimony protection rules exist. Such rules can only protect the members' pension benefits against creditors (e.g. service provider, fiscal authority,...) or members of other ring-fenced parts but they cannot protect members from the consequences of underfunding.

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<sup>39</sup> Recovery measures are considered to be measures taken by the IORP itself to recover its situation of underfunding, whereas supervisory measures are measures taken by the supervisor with regard to the IORP.

- 6.3.20. In situations **where ring-fencing is mandatory** (either obligation from the directive or the Member State) the ring-fenced parts should be protected in all circumstances. Therefore the principles set above in par. 6.3.18 should apply to these situations and administrative ring-fencing measures should be in place upfront.
- 6.3.21. In situations **where ring-fencing is optional** it is up to the IORP and where relevant<sup>40</sup> the sponsoring undertaking and/or members, to determine the aim of ring-fencing and how it will function. However, the IORP should provide a clear description of the aim and the functioning so as to be fully transparent to all relevant stakeholders (members, beneficiaries, sponsoring undertaking and supervisory authority). This description should include among others the level of risk sharing between ring-fenced parts, i.e. the height of the fences, and the extent to which transfer of assets is possible. This description should be included in the IORP's statutory rules and/or in the pension plan rules.
- 6.3.22. Also the ring-fencing measures put in place in the IORP should be fit for the purpose. If the aim of the ring-fencing is to provide a separation 'in all circumstances and till the end' then the above principles apply and the legal framework should respect this by providing the same protection as in case of mandatory ring-fencing (full application of the principles set out in par. 6.3.6).
- 6.3.23. If and when ring-fencing measures are applied, the assets available at the time of ring-fencing should be allocated to the ring-fenced parts in proportion to the pension liabilities borne by that part.
- 6.3.24. Irrespective of the above, ring-fencing should not preclude the possibility for the IORP to manage ring-fenced parts in the same management structure, as long as the above principles are respected. There are, however, instances currently foreseen by the IORP Directive, where transfers between ring-fenced parts are strictly prohibited (Art. 3 and 4) and where ring-fenced parts should be managed separately (Art. 4). This is further set out below (see Ring-fencing measures in the context of Art. 3 and 4).
- 6.3.25. If the Member State does not prohibit ring-fencing, the supervisory authority should, as part of its general supervisory powers and irrespective of the existence of administrative ring-fencing measures, have the power to impose ring-fencing measures or impose additional ring-fencing measures to guarantee the protection of the members and beneficiaries.
- 6.3.26. In the context of cross-border activity, any ring-fencing measures must not lead to unfair treatment of the members on the basis of their location. There should be no advantage for cross-border members compared to local members and vice versa. Equally, the patrimony protection rules put in place in the legal framework the Home Member State should not discriminate among members on the basis of their location (local versus cross-border).

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<sup>40</sup> Depending on the institutional framework, the set-up of the IORP and the decision-taking procedures.

- 6.3.27. The principles above should be entered in the Level 1 text. Depending on the level of harmonisation sought under a new regulatory framework for IORPs it needs to be assessed if further detailed rules, either at Level 2 or 3, would need to be developed. EIOPA does not consider it necessary under the current regulatory framework. The detailed transposition of the above principles could be left to each Member State.
- 6.3.28. Irrespective of the existence or not of ring-fencing, some additional protection can be offered by **privilege rules**, even in situations where ring-fencing is prohibited by the Member State. Privilege rules refer to the rules in the legal framework which determine whether members of pension schemes enjoy priority in respect of the IORP's assets against other creditors in the event of the liquidation of the IORP.
- 6.3.29. In order for these to be effective in case of default the legal framework should consist of at least the following elements:
- maintenance of special register of assets;
  - precedence of members of the IORP over some or all creditors with regard to the assets.
- 6.3.30. Privilege rules can also provide for additional protection on top of administrative ring-fencing, e.g. if a ring-fenced part would have other creditors besides the members, but privilege rules, similarly to patrimony protection rules, will not prevent benefits from being reduced (in case the assets are not sufficient to cover all the pension benefits in the ring-fenced part). The introduction of privilege rules could, however, increase costs for IORPs, which could be reflected in lower benefits, as creditors may want to be compensated for the increased counterparty credit risk.
- 6.3.31. Privilege rules take effect only on the liquidation of an IORP and would only make a difference in case the IORP is underfunded and in the absence of sufficient sponsor support. This means that in situations where default of an IORP is avoided by all means, notably by reducing the benefits as a measure of last resort, the protection provided by privilege rules is void.
- 6.3.32. In the context of cross-border activity, the privilege rules put in place in the legal framework of the Home Member State should not discriminate among members on the basis of their location (local versus cross-border).
- 6.3.33. With regard to introducing privilege rules in national law there are two views. One view is that Member states should be obliged to introduce privilege rules in the national legal framework. The other view is that Member States should have the option to introduce such rules.
- 6.3.34. The Level 1 text should contain the principles on privilege rules but leave the option for Member States to introduce these principles in national law. The Level 1 text could include some more detailed requirements inspired by Solvency II, e.g. on privilege rules (Art. 275), the rules on the special register (Art. 276) ) and the rules in case of guarantee schemes (Art. 277).

#### RING-FENCING MEASURES IN THE CONTEXT OF ART. 3 AND 4

- 6.3.35. The requirements in Art. 3 and 4 are different from Art. 16.3 and 18.7 with respect to the nature of ring-fencing. These articles prohibit the transfer of assets and liabilities, either between 1st and 2nd pillar business (Art. 3) or between insurance and IORP business (Art. 4).
- 6.3.36. Art. 4 also imposes the requirement for a separate management and organisation. This implies that both activities need to be run on a distinct basis, that the respective interests should not be prejudiced, in particular profit/burden sharing, and that capital requirements should be calculated as if the businesses were run separately.
- 6.3.37. For these articles, the principles set out above with regard to administrative ring-fencing, privilege rules and patrimony protection rules, should equally apply and the prohibition of transfer should remain. A derogation similar to the one provided for in SII (Art. 74.7) could be considered; for example, in exceptional circumstances, supervisory measures with regard to the capital requirements may involve the prior authorisation of a transfer of eligible capital from one activity to another.
- 6.3.38. The requirement for separate management and organisation involves at least the retention of separate accounting records. The requirements as set out in Art. 74 of Solvency II could serve as a good basis.

#### RING-FENCING MEASURES IN THE CONTEXT OF DC SCHEMES

- 6.3.39. With regard to DC type of schemes, the issue of ring-fencing is of another kind. Some form of ring-fencing is often embedded in the set-up of the scheme, f.i. through individual accounts. However, there are also collective DC schemes. Depending on the set-up, ring-fencing measures (according to the principles for ring-fencing measures above) might be relevant for the protection of members and beneficiaries.
- 6.3.40. In the context of Art. 18.7 if different investment rules need to be complied with, ring-fencing (according to the principles for ring-fencing above) should be mandatory.
- 6.3.41. Privilege rules are equally of relevance in case of DC schemes. These rules protect the accumulated reserves of members and beneficiaries from other creditors in the event of liquidation of the IORP.

#### **Policy options**

- 6.3.42. EIOPA's response to the CfA does not suggest a maximum harmonisation in this field, in view of the interrelationship with national legal frameworks and therefore its response does not prejudice Member States' ability to require additional measures to safeguard the rights of the members, nor to allow the option to prohibit ring-fencing (if not specifically obliged by the Directive or by the proposals in this response), in order to, for example, maintain a certain level of solidarity in the pensions system.

#### RING-FENCING MEASURES IN THE CONTEXT OF CROSS-BORDER ACTIVITY, ART. 16.3

Option 1: Leave the IORP Directive unchanged.

Option 2: Delete the reference to ring-fencing in Art. 16.3.

#### RING-FENCING MEASURES IN THE CONTEXT OF CROSS-BORDER ACTIVITY, ART. 18.7

Option 1: Leave the IORP Directive unchanged.

Option 2: Mandatory ring-fencing in case the investment rules of the Host Member State are not compatible with the (internal) investment rules applied to the local or other cross-border activities of the IORP.

#### PRINCIPLES FOR RING-FENCING MEASURES

Option 1: Leave the IORP Directive unchanged.

Option 2: Include a minimum set of administrative ring-fencing measures and patrimony protection rules in Level 1 text. The detailed transposition could be left to the Member State. Mandatory introduction of privilege rules in the national legal framework.

Option 3: Include a minimum set of administrative ring-fencing measures and patrimony protection rules in Level 1 text. The detailed transposition could be left to the Member State. Option for Member States to introduce privilege rules in the national legal framework.

### **6.4. Impact assessment**

6.4.1. Having in mind that the baseline scenario is constituted by the current IORP Directive, the following impacts have been identified.

#### RING-FENCING MEASURES IN THE CONTEXT OF CROSS-BORDER ACTIVITY, ART. 16.3

**Option 2:** Delete the reference to ring-fencing in Art. 16.3.

Positive impacts:

- *IORP members:* none foreseen
- *IORP and sponsoring undertaking:* none foreseen
- *Supervisor:* none foreseen
- *Member State:* improved clarity of the article
- *Internal Market:* improved common understanding of the article

Negative impacts:

- *IORP members:* none foreseen
- *IORP and sponsoring undertaking:* none foreseen
- *Supervisor:* none foreseen
- *Member State:* none foreseen
- *Internal Market:* none foreseen

#### RING-FENCING MEASURES IN THE CONTEXT OF CROSS-BORDER ACTIVITY, ART. 18.7

**Option 2:** mandatory ring-fencing in case the investment rules of the Host Member State are not compatible with the (internal) investment rules applied to the local or other cross-border activities of the IORP.

Positive impacts:

- *IORP members:* protection of members from investment risk in other ring-fenced parts.
- *IORP and sponsoring undertaking:* easier application of different investment rules.
- *Supervisor:* easier to check compliance with investment rules.
- *Member State:* Will ensure better compliance of Host Member State investment rules.
- *Internal Market:* None foreseen.

Negative impacts:

- *IORP members:* None foreseen.
- *IORP and sponsoring undertaking:* reduced risk diversification, impact on calculation SCR and eligibility of own funds, higher administration costs.
- *Supervisor:* Need for increased supervisory reporting, for each ring-fenced part.
- *Member State:* None foreseen.
- *Internal Market:* None foreseen.

## PRINCIPLES FOR RING-FENCING MEASURES

**Option 2:** Include a minimum set of administrative ring-fencing measures and patrimony protection rules in Level 1 text. The detailed transposition could be left to the Member State. Mandatory introduction of privilege rules in the national legal framework.

Positive impacts:

- *IORP members:* improved effectiveness of ring-fencing, improved understanding of the ring-fencing measures and its consequences, improved protection because they have privileged rights compared to some other creditors.
- *IORP and sponsoring undertaking:* improved effectiveness of ring-fencing, improved legal certainty.
- *Supervisor:* improved effectiveness of ring-fencing.
- *Member State:* improved legal certainty.
- *Internal Market:* Same rules would apply to all IORPs.

Negative impacts:

- *IORP members:* none foreseen.
- *IORP and sponsoring undertaking:* none foreseen.
- *Supervisor:* none foreseen.
- *Member State:* No longer full discretion to determine order of priority for creditors of IORPs.
- *Other:* Some creditors of IORPs can have subordinated rights compared to the members.

**Option 3:** Include a minimum set of administrative ring-fencing measures and patrimony protection rules in Level 1 text. The detailed transposition could be left to the Member State. Option for Member States to introduce privilege rules in the national legal framework.

Positive impacts:

- *IORP members:* improved effectiveness of ring-fencing, improved understanding of the ring-fencing measures and its consequences.
- *IORP and sponsoring undertaking:* improved effectiveness of ring-fencing, improved legal certainty.
- *Supervisor:* improved effectiveness of ring-fencing.

- *Member State*: improved legal certainty, flexibility with regard to order of creditors.
- *Internal Market*: None foreseen.

Negative impacts:

- *IORP members*: none foreseen.
- *IORP and sponsoring undertaking*: none foreseen.
- *Supervisor*: none foreseen.
- *Member State*: none foreseen.
- *Internal Market*: none foreseen.

### Comparison of policy options

- 6.4.2. With regard to the clarification sought on ring-fencing in the context of cross-border activities, and in view of the analysis above, EIOPA proposes option 2 with regard Art. 16.3 and option 2 with regard to Art. 18.7
- 6.4.3. With regard to the establishment of principles for ring-fencing measures, EIOPA proposes option 3.

## 6.5. EIOPA advice

**The EIOPA advice should address at least the following subjects:**

***- The scope of ring-fencing measures needs to be clarified in the context of cross-border activity of IORPs.***

1. Although the aim of ring-fencing in the context of cross-border activity is the same for art. 16.3 and 18.7, i.e. facilitating compliance and protection of the rights of pension scheme members and beneficiaries, the scope of ring-fencing measures to obtain this aim is not exactly the same for both articles.

2. EIOPA suggests to make the following changes to **Art. 16.3** in order to remove the source of the different interpretations:

*"3. In the event of cross-border activity as referred to in Article 20, the technical provisions shall at all times be fully funded in respect of the total range of pension schemes operated. If these conditions are not met, the competent authorities of the home Member State shall intervene in accordance with Article 14. ~~To comply with this requirement the home Member State may require ring-fencing of the assets and liabilities.~~"*

The removal of this last sentence will, however, not impact on the possibility for the Home Member State to impose ring-fencing as part of its general powers.

3. To fulfil the aim of ring-fencing **in the context of Art. 18.7** administrative ring-fencing measures, according to the principles set out below, should be applied at the time of the start of the (a new) cross-border activity if the investment rules of the Host Member State(s) are not compatible with the (internal) investment rules applied to the local or other cross-border activities of the IORP. Additionally, patrimony protection rules, according to the principles set out below, should apply.

4. EIOPA notes, however, that the above advice is given in the context of the current Directive. If a regulatory framework is being developed on a fully harmonised basis, the current purpose for ring-fencing in the context of Art. 16.3 will probably lose its validity, whereas other reasons for ring-fencing could emerge.

***- The text of an article to be inserted into the Directive with the aim of establishing the general principles which warrant ring-fencing measures in the case of stress situations, including the legal implications and common safeguards, which would improve adequate protection of pension benefits.***

5. For the purpose of this advice stress situations should be considered as situations in which pension benefits are at risk, i.e. situations where benefits could be reduced as a result of recovery measures or in case of the liquidation of the IORP or part of the IORP. Situations of temporary underfunding where pension benefits are not being reduced should not be considered as a stress situation.

6. EIOPA does not consider that a stress situation should be a trigger for ring-fencing, however, if there is ring-fencing (either mandatory or optional) EIOPA proposes a minimum set of requirements to ensure that the ring-fencing measures are effective in stress situations.

7. In situations where ring-fencing is **mandatory** (either obligation from the directive or the Member State) the following administrative ring-fencing measures should be in place in the IORP upfront:

- clear identification of the liabilities and corresponding assets of each ring-fenced part;
- maintenance of special registers of assets for each ring-fenced part;
- allocation of the income and expenditure according to origin;
- allocation of common items on the basis of predetermined methods of apportionment;
- in principle no allowance for transfer of assets; and
- distinct recovery and/or supervisory measures<sup>41</sup> respecting the existence and extent of ring-fencing.

And the legal framework should consist of the following patrimony protection rules:

- the protection of ring-fenced parts from claims made by creditors of other ring-fenced parts;

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<sup>41</sup> Recovery measures are considered to be measures taken by the IORP itself to recover its situation of underfunding, whereas supervisory measures are measures taken by the supervisor with regard to the IORP.

- the protection of ring-fenced parts from any reduction in benefits payable under another ring-fenced part in default
- no allowance for transfer of assets as soon as default occurs, as the composition of the assets entered in the registers should no longer be changed.

8. In situations where ring-fencing is **optional** it is up to the IORP, and where relevant<sup>42</sup> the sponsoring undertaking and/or members, to determine the aim of ring-fencing and how it will function. However, the IORP should provide a clear description of the aim and the functioning so as to be fully transparent to all relevant stakeholders (members, beneficiaries, sponsoring undertaking and supervisory authority). This description should include, among others, the level of risk sharing between ring-fenced parts, i.e. the height of the fences, and the extent to which a transfer of assets is possible. This description should be included in the IORP's statutory rules and/or in the pension plan rules.

The ring-fencing measures put in place in the IORP should be fit for the purpose. If the aim of the ring-fencing is to provide a separation till the liquidation of the IORP then the same principles should apply as in case of mandatory ring-fencing (cfr. par. 7).

9. If and when ring-fencing measures are applied, the assets available at the time of ring-fencing should be allocated to the ring-fenced parts in proportion to the pension liabilities borne by that part.

10. If the Member State does not prohibit ring-fencing, the supervisory authority should have the power to impose ring-fencing measures to protect the members and beneficiaries.

11. Transfer of assets would not be possible in the cases envisaged by Art.3 and 4. In the case of mandatory ring-fencing, transfer of assets should in principle not be allowed.

12. Except in the cases envisaged by Art. 4, ring-fencing should not preclude the possibility for the IORP to manage the ring-fenced parts in the same management structure, as long as the principles set out in this advice are respected.

13. In the context of cross-border activity, any ring-fencing measures must not lead to unfair treatment of the members on the basis of their location. There should be no advantage for cross-border members compared to local members and vice versa. Equally, the patrimony protection rules put in place in the legal framework the Home Member State should not discriminate among members on the basis of their location (local versus cross-border).

14. These principles (as set out in par. 6 till 13) should be entered in the Level 1 text. Depending on the level of harmonisation sought under a new regulatory framework for IORPs it needs to be assessed if further detailed rules, either at Level 2 or 3, would need to be developed. EIOPA does not consider it necessary under the current regulatory framework. The detailed transposition of the above principles could be left to each Member State. The Level 1 text could, however, include some more detailed requirements, for example on the rules for the separation of management, for which Art. 74 of Solvency II could be an inspiration.

<sup>42</sup> Depending on the institutional framework, the set-up of the IORP and the decision-taking procedures.

15. Members' rights could be further improved in specific circumstances by introducing **privilege rules** in the national legal framework, i.e. rules which determine whether, and to what extent, members of pension schemes enjoy priority in respect of the IORP's assets against other creditors in the event of the liquidation of an underfunded IORP and in the absence of sufficient sponsor support. Member States should have the option to introduce such privilege rules and be able to determine if the precedence of members over creditors is absolute or if for example, employees of the IORP, tax authorities or social security agencies should have precedence over members. Equally they should have the option to determine if national guarantee schemes should also benefit from a privilege.

16. In the context of cross-border activity, the privilege rules put in place in the legal framework of the Home Member State should not discriminate among members on the basis of their location (local versus cross-border).

17. The principles with regard to privilege rules should be entered in the level 1 text and if the Member States take the option to introduce them, they should be secured by appropriate national law. The Level 1 text could include some more detailed requirements inspired by Solvency II, for example on privilege rules (Art.275), the rules of the special register (Art. 276) and the rules in case of guarantee schemes (Art. 277).

18. With regard to DC type of schemes, the issue of ring-fencing is of another kind. Some form of ring-fencing is often embedded in the set-up of the scheme, f.i. through individual accounts. However, there are also collective DC schemes. Depending on the set-up, ring-fencing measures (according to the ring-fencing principles above) might be relevant for the protection of members and beneficiaries. In the context of Art. 18.7, if different investment rules need to be complied with, ring-fencing (according to the same principles as above) should be mandatory.

19. Privilege rules are equally of relevance in case of DC schemes. These rules protect the accumulated reserves of members and beneficiaries from other creditors in the event of liquidation of the IORP.

## **7. CfA 4: Prudential regulation and social and labour law**

### **7.1. Extract from the call for advice**

The EIOPA advice should address at least the following subject:

- The *IORP Directive* needs to determine the scope of prudential regulation, as administered by the home Member State.

### **7.2. Background**

#### **Current legal requirements (IORP Directive)**

- 7.2.1. The current IORP directive does not determine the scope of prudential regulation. It only provides some examples in Recital (37) of what is considered to be social and labour law: "... the social and labour law in force in the host Member State insofar as it is relevant to occupational pensions, for example the definition and payment of retirement benefits and the conditions for transferability of pension rights." and in Art. 20.1 "Without prejudice to national social and labour legislation on the organisation of pension systems, including compulsory membership and the outcomes of collective bargaining agreements..."
- 7.2.2. The IORP Directive defines the Home member state as "the Member State in which the institution has its registered office and its main administration or, if it does not have a registered office, its main administration" (Art. 6.i) and the Host member state as "the Member State whose social and labour law relevant to the field of occupational pension schemes is applicable to the relationship between the sponsoring undertaking and members" (Art. 6.j).
- 7.2.3. The current IORP directive does provide for an allocation of tasks between the Home supervisor and the Host supervisor in the case of cross-border activity (Art. 20).
  - a) The Home supervisor:
    - authorises an IORP based in the Home member states to operate cross-border
    - communicates the information received from the Host to the IORP
    - supervises the IORP for all aspects except for what is listed for the Host
    - takes measures to stop any breach of social and labour law (hereinafter also "SLL");
  - b) the Host supervisor:
    - informs the Home supervisor of the Host's SLL
    - informs the Home supervisor of the Host's information requirements (cfr. Art 20.7)
    - informs the Home supervisor of the Host's investment rules (cfr. Art. 18.7)
    - supervises the IORP with regard to the compliance with the SLL
    - supervises the IORP with regard to compliance with the information requirements

- informs the Home supervisor of any breaches of the SLL and information requirements
- may take further measures to stop a breach of SLL (only if measures by the Home supervisor are insufficient)

7.2.4. The IORP directive determines the responsibilities of the member state in respect of every institution located in its territory:

- a) Art. 9 - conditions of operations
- b) Art. 10 - annual accounts and annual reports
- c) Art. 11 - information to be given to members and beneficiaries
- d) Art. 12 - statement of investment policy principles
- e) Art. 13 - information to be provided to the competent authorities
- f) Art. 14 - powers of intervention and duties of the competent authorities
- g) Art. 15 - technical provisions
- h) Art. 16 - funding of technical provisions
- i) Art. 17 - regulatory own funds
- j) Art. 18 - investment rules
- k) Art. 19 - management and custody

## **OPC reports**

7.2.5. EIOPA has conducted studies with regard to the scope of member states' social and labour law<sup>43</sup> but not with regard to the scope of member states' prudential regulation.

## **7.3. Explanatory text**

### **EIOPA view on issues in the CfA**

7.3.1. According to the responses to the Green Paper there is a lack of a clear definition of the scope of SLL and its interaction with prudential regulation. EIOPA studies have shown that there is a wide variety in the scope of SLL amongst member states and therefore it is likely that there is the same level of diversity in what constitutes prudential legislation.

7.3.2. It is expected that the requirements of the IORP Directive listed under 7.2.4 above are included in the regulation of each member state, but not necessarily in the prudential regulation.

7.3.3. The scope of the prudential legislation and the SLL can be determined by the practical experience of the supervisors and many member states do not even make a distinction between prudential regulation and SLL in their legislation. This complexity increases further, if we recognise the existence of a grey area that includes information requirements and probably also certain elements of governance and organisation, i.e. all matters that go beyond a prudential purpose and have a direct impact on the relationship between IORP and members/beneficiaries. Such a grey area can be interpreted either as an

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<sup>43</sup> [https://eiopa.europa.eu/fileadmin/tx\\_dam/files/supervisory-disclosure/CEIOPS-OPC-Survey-Law-applicable-to-Guest-IORPs.pdf](https://eiopa.europa.eu/fileadmin/tx_dam/files/supervisory-disclosure/CEIOPS-OPC-Survey-Law-applicable-to-Guest-IORPs.pdf) and [https://eiopa.europa.eu/fileadmin/tx\\_dam/files/supervisory-disclosure/CEIOPS-OPC-Survey-Law-applicable-to-IORPs-Appendix.xls](https://eiopa.europa.eu/fileadmin/tx_dam/files/supervisory-disclosure/CEIOPS-OPC-Survey-Law-applicable-to-IORPs-Appendix.xls)

overlap between prudential regulation and SLL or as a tertium genus and could create a situation of conflicting laws as well as uncertainty about Home/Host responsibilities.

- 7.3.4. With reference to those matters included in grey area, the current Directive already provides for an active participation of the Host MS (see art. 20.7 and art. 20.9 regarding the power of the Host Member State's authorities to impose additional information requirements on foreign IORPs and to supervise them accordingly). The legal ground for such intervention by the Host supervisor should not be necessarily searched in the SLL clause, but may also be found in the framework of the Directive itself, with a view to adjusting the "home country control" principle depending on the issue at stake. In fact, the distribution of competences set forth in art. 20.7 and art. 20.9 operates regardless of whether information requirements may be defined as SLL of the Host MS or not.

## **Policy options**

### Option 1: Leave the IORP directive unchanged

- 7.3.5. As can be seen from paragraph 7.2.1 and following, the current directive does not define the scope of prudential regulation but lists in several articles throughout the Directive the responsibilities of the member state in which the IORP is located.
- 7.3.6. In the absence of a review of the IORP Directive, the relevance of the problem as identified by the Commission will probably decrease by virtue of adjustment mechanisms that are part of the system.
- 7.3.7. In particular, should the above problem be perceived as significant, the interested actors will likely resolve to bring the issue before the Court of Justice. European case law will eventually set principles delineating the scope of the prudential regulation and the boundaries of SLL.
- 7.3.8. Moreover, the institutional activity of the supervisors will also contribute to this process of clarification, relying on their practical experience and proximity to market/stakeholders. For instance, offering a comprehensive summary of the applicable SLL, instead of a mere reference to the applicable legislation, represents a measure capable of increasing transparency and facilitating the implementation of cross-border activity.
- 7.3.9. It should be noted, however, that such a process, resulting in a flexible elaboration of scope, has its own costs (judicial costs for the parties involved in litigation and administrative costs for the supervisors) and requires several years to lead to tangible sensitive results.

### Option 2: Determine the scope of prudential regulation as administered by the Home member state for the purposes of cross-border activity

- 7.3.10. This option seeks inspiration from the requirements which are already considered by the current Directive as responsibilities of the member state in respect of every institution located in its territory.

- 7.3.11. This option is meant to facilitate the distribution of competences in cross-border transactions and should be read in this limited context. No attempt should be made here to propose a fit-for-all definition of prudential law.
- 7.3.12. Please note that the methodological approach in this analysis assumes for the sake of simplicity that the applicable SLL is located in the Member State qualified as “Host” according to the rules governing cross-border activity. EIOPA is aware that there could be situations where the applicable SLL is located in a third country. However, such a situation, which has been thoroughly analysed in the response to CfA 2, could not invalidate the substance of the following considerations.
- 7.3.13. Among the requirements listed under 7.2.4 a “concurrent competence” regime between the Host and the Home Member State is currently in place with respect to at least the information requirements provided for by Article 11. Such a regime (provided for by art. 20.7 of the current Directive) could be extended to other provisions falling under the “grey area”, with a view to ensuring that the interests of local members and beneficiaries are adequately protected.
- 7.3.14. Notwithstanding any reference made here to matters included in the prudential law as administered by the Home member state, it is to be noted how those matters can be somehow affected by the social and labour law of the Host Member State. The boundaries of SLL vary amongst Member States and cover a set of rules that, in principle, should be primarily enforceable regardless of the scope of prudential regulation.

## **7.4. Impact assessment**

- 7.4.1. Apparently the interaction between prudential regulation and SLL is not always clear. Supporting evidence from EIOPA studies shows that there is a wide variety in the scope of SLL amongst member states.
- 7.4.2. By remedying what could represent a regulatory failure, the Commission wishes to eliminate any unnecessary barriers to the cross-border provision of retirement benefits.
- 7.4.3. Having in mind that the baseline scenario is constituted by the current IORP Directive, the following impacts have been identified.

**Option 2:** Determine the scope of prudential regulation as administered by the Home member state for the purposes of cross-border activity.

### Positive impacts:

- *IORP members:* strengthened protection for cross-border members by virtue of a more efficient action by supervisors, focused also on issues sometimes falling under a “conflict zone”.
- *IORP and sponsoring undertaking:* there would be less doubts on which authorities to liaise with and likely a reduction of compliance costs, because of a clear delineation of applicable regulation.

- *Supervisor*: the distribution of competences between Home and Host supervisor is indubitably clearer, reducing costs associated with possible duplication of supervision and efforts of coordination.
- *Member State*: the option delineates a framework of institution-based prudential regulation which may facilitate a consistent law-making activity at the national level.
- *Internal Market*: positive impact on the volume of cross-border activities, however accompanied by a remarkable uncertainty with respect to the significance. As stated in CfA 2, the main causes of the low interest showed by IORPs in performing cross-border activity are difficult to assess but seem to involve major issues in the EU countries (social system, tax law, etc.) that go beyond this CfA and EIOPA's mandate in general.

#### Negative impacts:

- *IORP members*: none foreseen.
- *IORP and sponsoring undertaking*: the concern for SLL possibly conflicting with the prudential regulation framework is still possible, as well as uncertainty about Home/Host responsibilities in this respect.
- *Supervisor*: none foreseen.
- *Member State*: any attempt to determine precisely the scope of prudential supervision may appear as an indirect limitation of Member States' competence on Social and Labour legislation. This could bring some Member States to question the validity of the Directive before the Court of Justice, resulting in higher litigation costs.
- *Internal Market*: this change could be seen as a weak initiative compared to initial high expectations and further reduce stakeholders' trust in the good functioning of the market.

### **Comparison of policy options**

- 7.4.4. The comparison of options shows that implementation of option 2 is likely to produce overall benefits (more clarity, less duplication, more efficient supervision) slightly exceeding associated costs (possible litigations), resulting in a sensitive improvement of the baseline scenario.

## **7.5. EIOPA advice**

**The EIOPA advice should address at least the following subject:**

**– The IORP Directive needs to determine the scope of prudential regulation, as administered by the home Member State.**

**Option 2** proposes to include a new article in the directive which – based on the requirements the current directive considers as responsibilities of the member state in respect of every institution located in its territory and without prejudice to the SLL applicable in the Host Member State – assigns the following matters to the competence of the Home MS for the purposes of cross-border supervision and regulation:

Art. 9 - conditions of operations

Art. 10 - annual accounts and annual reports

Art. 12 - statement of investment policy principles

Art. 13 - information to be provided to the competent authorities

Art. 14 - powers of intervention and duties of the competent authorities

Art. 15 - technical provisions

Art. 16 - funding of technical provisions

Art. 17 - regulatory own funds

Art. 18 - investment rules (without prejudice to art. 18.7)

Art. 19 - management and custody.

In parallel, the same article should formalize the “concurrent competence” regime currently in place with respect to the information requirements pursuant to art. 11, as developed under art. 20.7 and art. 20.9 of the current Directive:

a. The IORP is subject to ongoing supervision by the Host supervisor as to compliance of its information requirements;

b. The Host supervisor must inform the Home supervisor when it detects a breach of its requirements;

c. The Home supervisor shall, in coordination with the Host supervisor, take the necessary measures.

Such a regime could be extended to any other single provisions thereof capable of falling under a “grey area”– for example some related to more general matters like governance and organization - with a view to ensuring that the interest of local members and beneficiaries are adequately protected.

It would be advisable that, in the process of the review of the directive, any new or amended article mention the competent supervising authority in case of cross-border activity in accordance with the aforesaid principles.

## **8. Quantitative requirements**

### **8.1. Introduction to CfA 5 and 6**

- 8.1.1. In addressing the response to these two specific CfA items, which form the basis for the prudential solvency framework of the revised IORP Directive, EIOPA would like to make a couple of remarks that help frame the approach taken by EIOPA in responding to these issues.
- 8.1.2. The first remark relates to the approach on the presentation of policy options. The Commission has called upon EIOPA to give technical advice on a prudential regime for IORPs that attains a level of harmonisation where EU legislation does not need additional requirement at the national level. In addition, the new framework should provide a similar (CfA Annex, p. 13), or even a uniform level of security across Europe irrespective of the security mechanisms employed.
- 8.1.3. In order to discuss and possibly achieve those goals, EIOPA finds that it is necessary to introduce its so-called "holistic balance sheet" proposal as a conceptual tool to discuss in a common framework the different security mechanisms in place across Europe. It should be noted that in the following reasoning we refer to the "holistic balance sheet" approach as the case in which the goal of the Commission is indeed achieved, by including in the harmonised framework all the different security mechanisms in a consistent way. However, the drawbacks of this approach are also discussed.
- 8.1.4. The response to the CfA reflects the views of the various national supervisors. They often came forward with different solutions to the various sub-items of CfA 5 and 6, explaining the many options presented in the main texts. Sometimes these options are not in line with the holistic balance sheet approach. They may account for security mechanisms in an implicit, instead of explicit, way or allow for Member State choice. Therefore, the policy options that are consistent with the harmonised approach have always been carried through to the blue boxes at end of each chapter. EIOPA wanted to maintain the integrity of the proposed approach satisfying the objectives set by the Commission.
- 8.1.5. According to the above, EIOPA finds it useful to consider the two broad policy options available, each representing one end of the spectrum of possibilities:
- IORP Directive – An approach that allows for choice and diversity between Member States and that often accounts for security mechanisms implicitly.
  - Holistic balance sheet – A European approach that acknowledges the existing variety of occupational pension systems yet captures all these systems into a single balance sheet by valuing all security mechanisms in an explicit way.
- 8.1.6. EIOPA is aware that this represents a black-and-white distinction and that in the end some political compromise may be inevitable. The extent to which the

holistic balance sheet will be considered a viable alternative to the existing IORP Directive will very much depend on the outcomes of a quantitative impact assessment, which in EIOPA's view is essential for any legislative proposal.

- 8.1.7. The second remark refers to the approach taken in terms of the structure of the response to these two CfAs. Instead of following the same structure as the CfA, EIOPA considered it would be helpful to have an introductory section in which it explains its proposal for the new solvency framework that could be introduced.
- 8.1.8. This introductory section is comprised of two parts. The first part discusses the parts of CfA 6 regarding the adoption of a single approach – and therefore consistent treatment – for all types of IORPs and the possibility to use a single balance sheet. The second part, which complements the first, describes the proposal for a holistic balance sheet.
- 8.1.9. The reason for addressing these parts of CfA 6 here, before all the remaining items, stems from the fact that it concludes to adopt a single approach for all types of IORPs which is then the assumption used to answer the remaining CfA items. The presentation of the holistic balance sheet follows then naturally as it provides a high-level overview of all the elements that would make up the development of a risk based supervisory framework for IORPs as intended by the Commission through the CfA to EIOPA and subsequent clarifications. It provides an overall explanation of the framework and focuses on the interconnection between the several components, which might not be fully understood just by reading the individual pieces of advice regarding each of the components.

## **8.2. CfA 6 on a similar approach for all types of IORPs**

### Specific Call for Advice

The EIOPA advice should address at least the following subjects:

Where the IORP itself covers risk (in the meaning of Article 17(1) of the IORP Directive):

- *The material elements of Article 87-99 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to own funds; the advice should include an assessment as to whether there is an advantage to keep a three-tier system;*
- *The adequacy of using subordinated debt as own funds in the light of the borrowing restriction for IORPs contained in Article 18(2) of the IORP Directive;*
- *The material elements of Articles 100-127 and 304 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the SCR (including the duration approach for the equity risk sub-module). Particular attention should be paid to the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes to take into account the specificities of pension schemes;*
- *The material elements of Article 128-131 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the MCR.*
- As a particular treatment of this, the extent to which a similar approach can be adopted for pension schemes where the risk is covered by the IORP and the sponsoring undertaking.

Where the risk (in the meaning of Article 17(1) of the IORP Directive) is covered by the sponsoring undertaking:

- The possibility to restate the value of assets in the IORP and liabilities of the sponsoring undertakings into a single balance sheet, including the possibility to recognise sponsor covenants and claims in pension protection schemes as an asset similar to reinsurance.

- 8.2.1. The current IORP Directive makes a clear distinction between IORPs that themselves cover biometric risks or guarantee certain benefits or an investment performance and IORPs where the sponsoring undertaking provides these guarantees
- 8.2.2. Recital 30 refers to situations where the IORP - and not the employer - provides guarantees to cover against certain risks. In these instances, the IORP is said to offer products similar to those of life assurance companies and should hold at least the same amount of additional own funds as required of life assurance companies. Article 17 provides for these additional requirements, notably the need to hold assets above technical provisions to serve as a buffer. This type of IORP is hereafter referred to as an Article 17(1) IORP.
- 8.2.3. Where the sponsoring undertaking bears these risks, there are no similar requirements. However, Article 9(1)(e) requires Member States to ensure that the sponsor is committed to regular financing. This is, however, not defined in more detail. This type of IORP is hereafter referred to as a sponsor backed IORP.

- 8.2.4. The case in which both the sponsoring undertaking and the IORP bear the risk is not exactly defined in the IORP Directive. One could argue that for this type of IORPs Article 17(3) applies which gives Member States the right to decide about the need to hold regulatory own funds. This type of IORP is hereafter referred to as Article 17(3) IORP.

#### Current distinction and objectives

- 8.2.5. The requirements under Article 17(1) for Article 17(1) IORPs mirror those of Solvency I aimed at ensuring regulatory consistency with insurance undertakings as detailed in Recital 30 of the current IORP Directive. Article 303 of the Solvency II Directive amended the IORP Directive in order to ensure that the Solvency I rules continue to apply to IORPs after the adoption of Solvency II.
- 8.2.6. The CfA asks EIOPA to advise on how the articles in Solvency II, which replace the current requirements of Solvency I, regarding own funds and the requirements for a minimum capital requirement (MCR) and solvency capital requirement (SCR) for insurance undertakings, can be amended to be appropriate for IORPs that fall under Article 17(1). This could be seen to reflect the desire to keep this regulatory consistency between these types of IORPs and insurance undertakings after the implementation of Solvency II.
- 8.2.7. The CfA explicitly asks EIOPA to give advice on the extent to which a similar approach can be adopted for IORPs where the risk is covered by the IORP and the sponsoring undertaking (Article 17(3) IORPs). The CfA does not ask EIOPA to give advice on these articles for sponsor backed IORPs.
- 8.2.8. Following clarification from the Commission after the publication of the CfA, it was made clear to EIOPA that the desire of the Commission and the focus for EIOPA should be to ensure the level of security offered by all IORPs is similar and ideally the same but that there can be differing ways to achieve the desired level of security.
- 8.2.9. This part of EIOPA's advice does not address the specifics of the articles in Solvency II but rather focuses on the question whether a similar approach to these issues can be adopted for IORPs that bear risks themselves or are backed by sponsor support.
- 8.2.10. Specific amendments to the articles that may need to be properly accounted for are detailed in the EIOPA advice.
- 8.2.11. Given that the current IORP Directive clearly distinguishes between these two types of IORPs and that the Commission has requested that EIOPA advice focuses on achieving the same level of protection for all IORPs, it is necessary to investigate whether from a technical perspective it is possible for one framework to apply across all IORPs.

#### Two archetypes to covering risks

- 8.2.12. For IORPs that fall under Article 17(1), since there is no guarantee provided by a sponsoring undertaking, meaning that under adverse conditions or where assumptions made about the future are not borne out in practice, it is

necessary to ensure that they hold enough assets to account for these scenarios.

- 8.2.13. This is a necessary requirement since the IORP is unable to rely on support from a sponsor and so is solely responsible for ensuring they have sufficient assets to cover against risks and meet their liabilities on an ongoing basis. The appropriate calibration of the required amount of assets and therefore the level of security is not a subject debated in this chapter (see CfA 6 on the confidence level).
- 8.2.14. It may be the case even in this scenario that the IORP can ask the sponsor for increased support, but if the sponsor does not have a legal requirement to respond positively, the IORP is unable to rely on this support.
- 8.2.15. For sponsor backed IORPs, under adverse scenarios they are able to call upon the sponsor to provide additional support. This ability therefore means that instead of relying on upfront capital to absorb losses, they can seek further financing from the sponsor to restore the required level of funding.
- 8.2.16. Without the ability of the IORP to make use of additional assets to absorb losses it is necessary for the IORP to be able to require the sponsor to make good losses incurred. In practice, the degree by which IORPs are able to do this is dependent on two factors. Firstly limits set by national law (obligation) and secondly the ability of the sponsor to provide additional assets (affordability). These issues are discussed in CfA 5, 9.3.183-213.
- 8.2.17. In effect these differing approaches are based on the same principles that risk should be measured and accounted for, but this can be achieved through different mechanisms, i.e. relying on the sponsor covenant rather than higher up front capital requirements.

#### Other relevant considerations to security

- 8.2.18. It is also worthwhile considering the ability to reduce benefits when looking at the potential differences between Article 17(1) IORPs and sponsor backed IORPs.
- 8.2.19. Where the IORP cannot rely on further support from a sponsor and cannot adjust its risk profile sufficiently to restore an appropriate level of funding within a defined time period, a reduction of benefits may occur. In practice any reduction may be limited or defined by national law. This issue is discussed in CfA 5 on the valuation of technical provisions, CfA 6 on the solvency capital requirement and the annex to CfA 6 on benefit adjustment mechanisms.
- 8.2.20. The net result however, is that the level of benefits provided to members and beneficiaries will be reduced and may only be restored if future financial conditions allow it and again this will be subject to national legal requirements.
- 8.2.21. This is in effect the intra- and intergenerational sharing of risks between sponsors, IORPs and members.

- 8.2.22. For IORPs where the sponsor provides the guarantee it is often the case that the IORP is not able to reduce the level of benefits irrespective of the level of funding reflecting the fact that the sponsor stands behind the promise made.
- 8.2.23. This means that if the sponsor does not become insolvent, members will receive the full level of benefits promised. However, if the sponsor is unable to provide the assets required to restore funding after a shock, the members suffer from the risk that assets are not sufficient to cover the liabilities at that time and are relying on a combination of future investment performance and ability of the sponsor to provide further support to correct this. If the sponsor was to become insolvent during this time, this risk would be crystallised and benefits may be reduced according to the assets available or to a level payable from a pension protection scheme.
- 8.2.24. Where IORPs are permitted to reduce benefits, the nature and the conditions of such a contract should be explicitly determined nationally. EIOPA has distinguished two (extreme) types of adjustment mechanisms.
- 8.2.25. Where IORPs are permitted to reduce benefits based on a contract concluded beforehand (Type 2 – Ex-ante reduction of benefits (embedded in the by-laws or a contract as explained in the annex to CfA 6 on benefit adjustment mechanisms), generally contingent on certain events, this represents a softer promise being made by the IORP or sponsor and gives the member less certainty of receiving their full benefits all other things being equal. The degree of softness can be decided within national social and labour law on the basis of a (national) perception of the appropriate balance between risk and reward. Clear communication of the explicit position with regard to this appraisal is essential.
- 8.2.26. In CfA 6 regarding the confidence level, EIOPA discusses how benefits can also be reduced under certain circumstances, even if the possible reduction is not based on a contract concluded beforehand (Type 1 – Ex-post reduction of benefits (trigger event)). Although EIOPA will not give advice on the exact confidence level, it could be argued that a lower confidence level than that required where they cannot be reduced should apply subject to national Social and Labour Law. This directly affects the balance made in some Member States between security and affordability where, as described above, some Member States may allow for a lower security level at the level of the IORP – together with flexibilities for other forms of security, such as sponsor support – but a higher level of benefit.

### Going forward

- 8.2.27. These two broad approaches for providing security both have technical merits as to achieving the goal of protecting member's benefits. In practice across Europe there are varying degrees of each approach and not all Member States fall perfectly into one of the two archetypes identified. Article 17(3) IORPs are an example of a combination of these approaches. There are differing balances made between the level of security that should be funded in advance for reflecting the affordability from the sponsor's perspective of providing DB schemes and the protections inherent within national legislation for issues such as reducing benefits, the level of commitment required from the sponsor and the existence or otherwise of pension protection schemes.

- 8.2.28. This balance is an issue that goes beyond technical analysis only and relies on political decisions taken at a Member State level. EIOPA is therefore of the view that it cannot give technical advice to the Commission with regards to how this balance should be struck at an EU level and similarly the level of security that is appropriate to require for pension promises made since that is a matter that will be subject to political decisions.
- 8.2.29. The level of security provided to members by IORPs that are required to hold own funds (Article 17(1) IORPs) can be reasonably assessed with reference to the level of own funds held. In order to compare this with the level of security provided by sponsor backed IORPs, it would be necessary to attach a value to the sponsor support itself and to pension protection schemes. This issue is discussed in CfA 5 and 6 respectively regarding valuing sponsor support and pension protection schemes.
- 8.2.30. In order to have a prudential framework whereby both types of IORPs can be said to provide the same level of security it is therefore vital that all forms of security to members is properly taken account of.
- 8.2.31. A further consideration worthy of mention is whether maintaining the existing distinction between Article 17(1) and sponsor backed IORPs could give rise to regulatory arbitrage within the IORP sector, i.e. whether an employer wishing to sponsor an IORP would choose a regime where they are responsible for providing the guarantees thereby reducing the need for own funds and representing a reduced up front cost.
- 8.2.32. While the overall cost of providing the benefits promised would be the same irrespective of the approach taken (all other things being equal), an approach without own funds could be seen as a cheaper alternative from the perspective of the sponsor. However, if the supervisory framework takes proper account of the value of the support from the sponsor and other security mechanisms and appropriate supervisory standards applied, these regulatory differences should not be material.
- 8.2.33. It could also be the case that sponsors would prefer to set up an IORP (or sponsor an IORP) where it is the IORP that bears the risks and the sponsor's obligations are generally exhausted by paying the necessary contributions. While, other things being equal, this would represent a higher up front cost, it would mean a higher amount of certainty from the sponsors perspective of the financing cost of providing the pension benefits.
- 8.2.34. It is also important to note that there are other factors that would come into play in this decision making process including any requirements for inflation protection which would add significantly to the cost of providing the benefits.
- 8.2.35. This also raises a further question of whether there could be arbitrage between IORPs and insurance undertakings. It could be argued that Article 17(1) IORPs do operate in a similar manner to insurance undertakings. This is also highlighted in Recital 30 of the IORP Directive where it states that the products offered by these IORPs are similar and should be subject to the same own fund requirements. Without the benefit of sponsor support, Article 17(1) IORPs are required to cover their risks in the same way as insurers and so it could be argued should have the same minimum capital requirements - as is the case until Solvency II comes into force.

8.2.36. For sponsor backed IORPs however, the ability to rely on the sponsor for further support represents a key difference from insurance and requires differing treatment.

8.2.37. It is EIOPA's view that there are two possible approaches to these issues:

- a. Firstly, to continue with the current distinction in the IORP Directive between Article 17(1) IORPs and sponsor backed IORPs and to devise suitable prudential and supervisory requirements for each separately, including the option of applying a Solvency II regime to Article 17(1) IORPs as the CFA makes explicit, while continuing with the current IORP approach for sponsor backed schemes but reviewing the existing IORP provisions to ensure a risk based framework is developed.
- b. Secondly, to create a single framework that is flexible enough to allow for both approaches to be accounted for within the same structure, ensuring that it fully reflects the different security mechanisms. Where for some security mechanisms it may not be appropriate or proportionate to require and attach a specific value for all IORPs, supervisory judgement may need to be allowed for.

8.2.38. The first option would allow for recognition of the different types of IORPs that exist and to tailor the requirements for each separately taking into account these differences. This option also allows for the regulatory consistency between IORPs that bear their own risks and insurance undertakings to be maintained without adding additional burden to those IORPs that do not function in this manner. However, it would not allow for full comparability across the different types of IORPs.

8.2.39. This second option would allow for full comparability across all IORPs and for those that do not fall perfectly into either archetype (i.e. where the risk is covered by the IORP and the sponsoring undertaking, Art. 17(3) IORPs) to make use of differing security mechanisms. For example, any limitations in the support available from a sponsor may be supplemented by greater requirements for upfront capital. This could be through greater prudence in the assumptions used to calculate technical provisions or through the need for the IORP to hold an appropriate level of own funds. That would mean that in a revised directive the recourse to sponsor support as well as the existence of other (security) mechanisms would have to be considered for all types of IORPs. Please read section 8.3 on the holistic balance sheet for a description of this option. This option would require significant adjustment to the current IORP Directive to be made and so potentially a significant impact on the supervisory requirements for IORPs.

8.2.40. EIOPA's advice is based purely technical ground taking into consideration the Commission's objectives for the revision of the IORP Directive. EIOPA acknowledges that any decision over the review of the IORP Directive, including the options regarding similar treatment of all IORPs should be taken at the political level since there might be relevant impacts over the structure and nature of occupational pension schemes in Member States.

8.2.41. Any decision for a revision of the quantitative requirements of IORPs should not be taken before a sound and thorough cost benefit analysis is undertaken.

## **Policy options**

Option 1: Maintain the existing distinction between Article 17(1), Article 17(3) and sponsor backed IORPs in the review of the IORP Directive

Option 2: Review the IORP Directive in a way that is flexible enough to allow for all kinds of IORPs through the holistic balance sheet approach

### **8.3. Holistic balance sheet approach**

- 8.3.1. In the EU Commission's Call for Advice and in subsequent discussions between the Commission and EIOPA, the Commission made it clear that they wished EIOPA's response to provide for a common level of security for benefits provided by IORPs, without challenging the prerogative of Member States to define the benefits that an IORP should provide. This common level of security should be provided irrespective of the security mechanisms employed to achieve IORP benefit security.
- 8.3.2. In order to discuss and possibly achieve the Commission's objective, it is EIOPA's view that it is necessary to establish a framework that records and compares the value of the obligations and resources of an IORP on a consistent basis. EIOPA therefore proposes the use of a holistic balance sheet for this purpose.
- 8.3.3. The holistic balance sheet is a technique to identify and quantify on a comparable basis:
  - a. the obligations under the supervisory regime of the IORP, including risk reserves; and
  - b. the resources available to the IORP to meet its obligations.
- 8.3.4. The creation of a holistic balance sheet requires
  - a. the specification of the items to be included; and
  - b. the rules which define unambiguously the calculation of the components of the holistic balance sheet.
- 8.3.5. It must be emphasised that the achievement of the Commission's objective requires the use of a holistic balance sheet or a similar framework, it has not yet been demonstrated that the calculation of the necessary values is practicable or does not involve unacceptable complexity.
- 8.3.6. A holistic balance sheet could be prepared in three ways:
  - 1. The holistic balance sheet could be used as an internal management tool by an IORP for its own assessment of its solvency according to its own criteria.

2. The holistic balance sheet could be used by a national supervisor to measure the solvency of all IORPs within its remit on a consistent basis.
  3. The holistic balance sheet could be applied to all European IORPs on a common basis.
- 8.3.7. National supervisors' practice already implicitly imposes a national holistic balance sheet approach, though it is not presented as such. However, in many member states, there is not an obligation (or even the right) to quantify all resources – for instance the strength of the support provided by a sponsoring employer or a pension protection arrangement may be implicit.
- 8.3.8. The use of the holistic balance sheet framework does not in itself imply a common European solvency standard: such a common standard result only when the framework is combined with common rules for the calculation of the elements of the holistic balance sheet.
- 8.3.9. It is EIOPA's view that the holistic balance sheet is the most practical means to achieve the Commission's objective of a common security standard, because only by including and identifying and quantifying on a consistent basis all security resources can the level of security be compared. It is a separate decision at what level a common security level can be set.
- 8.3.10. This section intends to provide a high-level overview of all the elements that would make up the development of a risk based supervisory framework for IORPs. It provides an overall explanation of the framework and focuses on the interconnection between the several components, which might not be fully understood just by reading the individual pieces of advice regarding each of the components.
- 8.3.11. Before going into the description of the balance sheet it is important to clarify upfront the principles underlying the design of this holistic balance sheet.

#### Member's perspective

- 8.3.12. Following the clarification received from the Commission about the aim of the CfA, this balance sheet views security from the perspective of the member rather than the financing vehicle (IORP) regarding the pension promise.
- 8.3.13. According to the Commission, the reasoning is that from a solvency perspective that focuses on the security of the pension promise made to the members and beneficiaries all elements (security mechanisms, such as sponsor support and pensions protection schemes, and benefit adjustment mechanisms) that have an impact on securing those promises and which may have been taken into consideration implicitly so far, should be considered when assessing the solvency situation of the IORP.
- 8.3.14. The aim of this flexibility in the holistic balance sheet is the ability to focus, if necessary, on the level of protection of the scheme members and beneficiaries which should be similar irrespective of the security mechanisms used<sup>44</sup> which means that all these existing mechanisms should be taken into account in the solvency framework.

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<sup>44</sup> Point 6.1 of the annex of the CfA

8.3.15. This would constitute a major difference from the Solvency II Directive because the solvency framework for IORPs would then consider elements that are beyond the IORP itself. This could be seen as representing the interrelation between social aspects and prudential aspects within the field of occupational pensions.

#### Supervisory tool

8.3.16. The holistic balance sheet should be seen as a prudential supervisory solvency assessment tool rather than a “usual” balance sheet based on generally agreed accounting standards. This is why the term “holistic” has been added since it also takes into consideration intangible elements like some security and benefit adjustment mechanisms, i.e., it includes all economic exposures to which IORPs are exposed, whether or not the elements would be on or off balance sheet in an accounting sense.

8.3.17. The use of a holistic balance sheet approach does not define the stages at which the supervisor may intervene or require the IORP to take action. The triggers for supervisory action would be defined in the context of the holistic balance sheet but the trigger points are a separate decision.

8.3.18. For example, in some Member States it is common for IORPs to have recourse to additional contributions from their sponsor if they become underfunded or to be able to reduce the level of indexation applied to the promised benefits. The former can be viewed economically as an ‘asset’ and the latter as a ‘liability offset’, even though neither might be recognised as such under relevant Generally Accepted Accounting Principles (‘GAAP’) and International Financial Reporting Standards.

#### Application to all types of IORPs

8.3.19. The proposal of such an approach is also based on the objective of having a single solvency framework that would be applicable for all types of IORPs regardless of who ultimately bears the risks thereof. The application of this general principle does not imply that the proposed components of the holistic balance sheet should be required for all the risk bearing situations of IORPs (e.g., IORPs where the risks are borne by members - see Figure 8.3.72).

8.3.20. This objective is highlighted in the CfA itself where it is stated that the level of protection provided by IORPs should be similar irrespective of the security mechanisms used. EIOPA also sought to clarify this issue with the Commission who confirmed that this is the intention and how they would like EIOPA to proceed.

8.3.21. Since the framework would be applicable for all types of IORPs it would not be necessary to explicitly distinguish different types of IORPs in a directive amended in this way.

#### Fair value principles in the valuation of assets and liabilities

8.3.22. As stated in the CfA, the Commission would like the valuation of assets, technical provisions and other liabilities to be market consistent and based on sound economic principles. I.e. made according to the ‘fair value’ principles

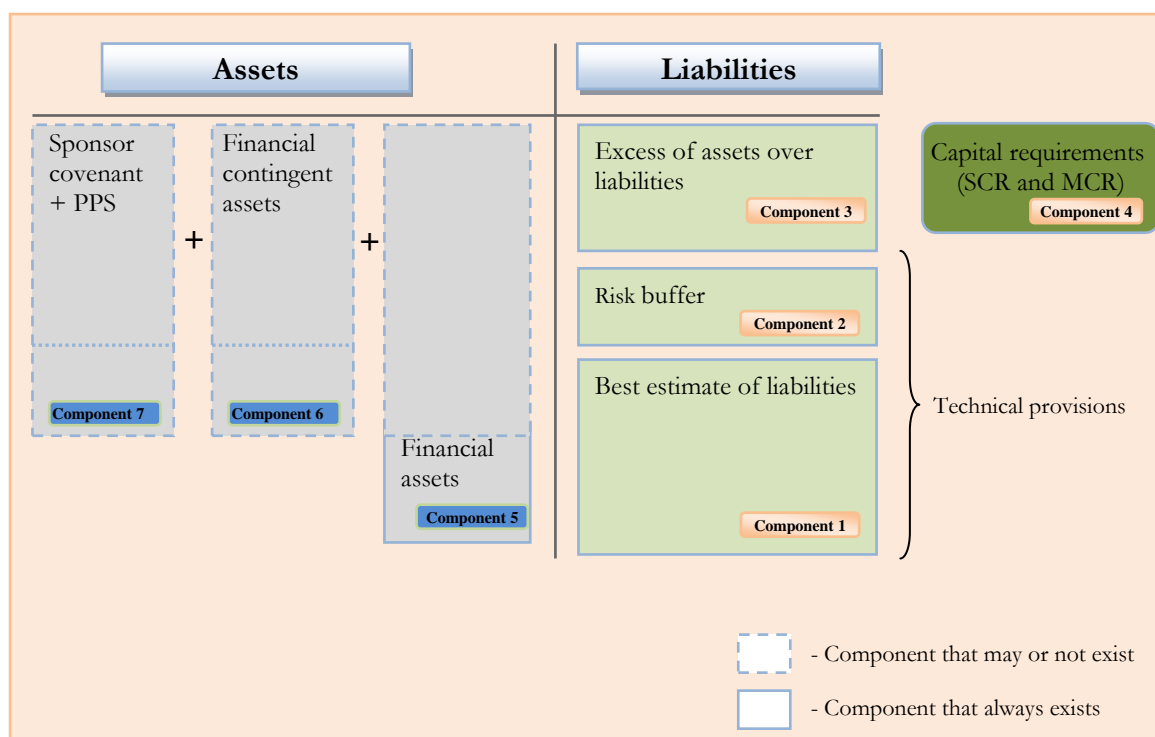
adopted for Solvency II i.e. that both assets and liabilities would have to be assessed on market consistency principles.

Level of benefits ('benefit mix') will not be harmonised

8.3.23. The 'benefit mix' of DB schemes will continue to differ among member states, as determined by national practice and by Social and Labour Law. This again highlights the social aspects and role of IORPs and the benefits they provide. Unlike insurance and other financial services, many of the rules for IORPs are set out in Social and Labour Law and can have a significant impact on the level of benefits that are provided to members and beneficiaries. It may be that Member States in their decision making took into account the nature of the benefit mix in the setting of the prudential requirements. For example, requiring a harder promise with certain minimum additions attached may have influenced the level of security that is attached to that promise. This is similar in nature to a risk-reward trade off where a greater level of risk may be acceptable if the overarching target (reward) is set at a high level. This should not prevent developing a risk-based framework for supervision.

8.3.24. Again clarity from the Commission was sought on this issue who confirmed that they would like EIOPA's advice to focus on the aim of the prudential standard to deliver that benefit with the same level of security across member states. However, acknowledgement must be made to the fact that different levels of security could be accepted by national Social and Labour Law, in particular as a result of certain types of benefit adjustment mechanisms (ex-post mechanisms of adjustment of pension benefits in national legislations - see the annex to CfA 6 discussing the benefit adjustment mechanisms) or security mechanisms (see CfA 6 on pension protection schemes).

## Conceptual presentation



## **Components of the hypothetical balance sheet**

### Component 1 – Best estimate of liabilities

- 8.3.25. This component will correspond to a valuation of pension promises taking into account the overarching objective of establishing the best estimate. This component shall not include any safety margins.
- 8.3.26. It should take into consideration the distinction between guaranteed and conditional benefits (and possibly discretionary benefits) including the existence of benefit adjustment mechanisms. A distinction between the best estimate of the guaranteed and conditional benefits should be made visible. The extent of benefits to be evaluated and the actuarial method to be used will also influence this component.
- 8.3.27. Key issues under consideration in this component are the classification of the benefits into guaranteed/conditional/discretionary and the actuarial assumptions to be used here with especial focus on the mortality tables, inflation and discount rate.
- 8.3.28. This component will be influenced by the discussions in CfA 5 on the valuation of technical provisions.

### Component 2 – Risk buffer

- 8.3.29. This component would constitute a buffer for covering risks beyond what is determined at the best estimate level (Component 1).
- 8.3.30. There are several policy options still open in this regard depending, among other issues on the application of the transfer value approach to pension liabilities as required by Solvency II in comparison to the current IORP approach and the discount rate used.
- 8.3.31. Policy options under review are:
- a. A margin for deviations calculated according to the current IORP Directive where the buffer is not related to the concept of transfer of liabilities but to the risk of adverse deviations of assumptions (expected normal fluctuations above the best estimate). Under the current IORP Directive approach this option would correspond to a situation where the technical provisions are segregated into a best estimate plus a margin for deviation whereas the prudence in the assumptions would become explicit.
  - b. Risk margin calculated according to Solvency II which is related to the concept of transfer of liabilities and its calculations is made according to the cost of capital approach.
  - c. No risk margin. This option implies that there would not be any initial buffer to cover for expected volatility and any deviations arising would have to be absorbed by the capital requirements.

8.3.32. This component will be influenced by the discussions on CfA 5 with regard to the valuation of technical provisions.

#### Component 3 – Excess of assets over liabilities

8.3.33. The name of this component is quite broad in order to encompass the different natures of the component according to type of risk sharing of the IORP. For those IORPs that assume risks and therefore need to have own funds the excess of assets over liabilities will correspond to "Own funds" with the distinction between ancillary and basic own funds. For those IORPs in which the sponsor or other stakeholder bears the risks this component corresponds to the difference between all the resources available (components 5, 6 and 7 of the asset side) and the technical provisions.

8.3.34. This component will be influenced by the discussions in CfA 6 with regard to own funds and subordinated loans.

#### Component 4 – Capital requirements

8.3.35. The calculation of the risk based capital requirements would be fundamental part of the new framework and it should be applicable for all types of risk sharing options in terms of IORPs. It would bring a whole new set of transparency to the possible outcomes in terms of amount of liabilities as it is based on the risks arising from the pension promises. This would bring the main element of Solvency II, which is designed to reflect the potential magnitude of adverse outcomes, into the IORP Directive.

8.3.36. The calculation and calibration of the MCR and SCR should use a VaR approach for an appropriate time horizon to a confidence level that is yet to be established. However, several arguments regarding the confidence level are also under discussion in order to reflect the social aspects of IORPs as discussed above.

8.3.37. Some of the security mechanisms specific to the pension contracts – such as sponsor support - should be considered as risk mitigating mechanisms for the calculation of the capital requirements.

8.3.38. For IORPs where the members bear the risks (pure DC plans) there would be a requirement to have in place additional capital to cover operational risk.

8.3.39. This component will be influenced by the discussions on CfA 6 regarding the SCR, MCR and capital requirements for operational risk and the annex to CfA 6 concerning benefit adjustment mechanisms.

#### Component 5 – Financial assets

8.3.40. This component should correspond to the market value of assets that belong to the IORP, including reinsurance recoverables.

8.3.41. This component will be influenced by the discussions on CfA 5 regarding the valuation of assets.

#### Component 6 – Financial contingent assets

- 8.3.42. This component of the asset side of the holistic balance sheet is comprised of financial contingent assets of the IORP that can be called upon in case of a pre-defined situation (e.g. an underfunding situation). These other contingent assets are related to sponsor support. Further segmentation could also be made with reference to recovery plans.<sup>45</sup>
- 8.3.43. These financial contingent assets can consist of escrow accounts or other financial assets that can be used as collateral (e.g. property).
- 8.3.44. This component will be influenced by the discussions on CfA 5 on the valuation of assets.

#### Component 7 – Sponsor covenant and pension protection scheme

- 8.3.45. This component of the asset side of the holistic balance sheet is comprised of all contingent assets other than the financial contingent assets (Component 6). It can be further sub-divided into a possible recourse to a pension protection scheme (PPS) or a sponsor covenant. The sponsor covenant corresponds to an ability and commitment from the sponsor to make good further contribution needs of the IORP or the members and beneficiaries<sup>46</sup> in order to fulfil the pension obligations, taking into full consideration the financial contingent assets (component 6) in order to avoid any double counting of sponsor support.
- 8.3.46. In terms of sponsor covenant further segmentation could also be made with reference to recovery plans. This segmentation stems from the fact that in the majority of situations a recovery plan corresponds to a pre-defined series of commitments from the sponsor to make financial contributions to the IORP in specific dates in the future. Therefore, sponsor covenants that will materialize in the form of future contributions are already earmarked in this situation in terms of amount and timing.
- 8.3.47. The type of sponsor covenant, unlimited, limited or no automatic recourse, has a significant influence in the value of the sponsor covenant and in its availability to be called upon. The strength of the sponsor commitment will also have a relevant role in the assessment of this component.
- 8.3.48. The sponsor covenant can be backed by a pension protection scheme which might be regarded as another mechanism to be considered in the holistic balance sheet approach.
- 8.3.49. This component will be influenced by the discussions on CfA 5 regarding the valuation of sponsor support and CfA 6 regarding the valuation of pension protection schemes.

### **Interconnection between components of balance sheet**

#### Components on the asset side

- 8.3.50. The asset side of the holistic balance sheet should capture all the resources that can be used to fulfil the pension promises. Some of the resources may be

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<sup>45</sup> Analogous to the description in component 7 of the segmentation to the recovery plans

<sup>46</sup> Following the subsidiary liability of the sponsor as defined in CfA 5 on the advice on the feasibility to treat sponsor covenants like reinsurance contracts

available for specific types of risk sharing IORPs but there is no requirement for all the resources to co-exist in each case.

- 8.3.51. According to the legend of the boxes component 5 (financial assets of the IORP) will exist for all IORPs regardless of the risk sharing type while component 6 and 7 will only exist in IORPs that have the ability to call upon further assets from the sponsor as is the case for in sponsor backed IORPs (i.e., those IORPs in which the sponsor bears the majority of risks). This means that some IORPs will only have component 5 in the asset side while other IORPs will have both components. Please see the last section “Examples of holistic balance sheet” for some concrete examples.
- 8.3.52. The sum of all three asset components (components 5, 6 and 7) should at least equal the sum of components 1, 2 and 3 of the liabilities.

#### Tiering of assets

- 8.3.53. The major reason for segregating the components on the asset side, and on the liability side as well, relates to the benefit that could be obtained from having flexibility to allow a sort of tiering of assets to cover different components of the liabilities. The tiering of assets will reflect the different characteristics of the assets in terms of their availability to be called upon and used to meet the liabilities:
- a. Financial assets (component 5) will have the best classification in terms of availability to meet the liabilities as they constitute the assets of the IORP.
  - b. Financial contingent assets (component 6) will rank next in terms of availability since the financial assets are completely identified and are already on behalf of the IORP although they can only be used in certain contingencies.
  - c. Sponsor covenant and pension protection schemes have the lowest classification in terms of availability because this asset corresponds to a future commitment from the sponsor to cover variations in the solvency situation in the form of future contributions. Within sponsor covenant further distinction can be made between the part already earmarked for recovery plans, in which case the amounts and timings of the future contributions are already known (although not yet collateralised), and the remaining sponsor covenant.
- 8.3.54. The advantage of identifying all these components, both on the liability and the asset sides, is that it enhances transparency and comparability to the pension landscape in Europe and it gives flexibility in the way the components of the liabilities can be covered by the asset components.
- 8.3.55. The rules on the tiering of assets will need to be established in detail as it requires further and deeper analysis and is also dependent on the decisions still outstanding in terms of the components (existence of a risk buffer for example and discount rate to use). In the following paragraphs, and in the next section of examples, several possibilities of this tiering of assets are laid down.
- 8.3.56. Best estimate of liabilities (component 1) should, in principle, be mainly covered by the financial assets of the IORP (component 5). This could

correspond to a minimum funding measure for which a whole set of rules and requirements could be established.

- 8.3.57. In case the best estimate of liabilities is higher than financial assets and a recovery plan is required then the remaining part could be covered by the recovery plan sections of the sponsor support of either component 6 and 7. Please note that there could also be situations in which a recovery plan might not be required, in which case it would be possible to use sponsor support (either collateralised or not) to cover the remaining part of the best estimate, but there should be a set of conditions the IORP (in the broad sense) must fulfil in order to allow for it.
- 8.3.58. The risk buffer (component 2), if existent, could be covered by any of the three components (5, 6 or 7) on the asset side.
- 8.3.59. Having a risk buffer component (especially if option 1 regarding the margin for deviations is considered) would have the advantage of creating a first buffer to respond to normal fluctuations above the best estimate of liabilities. In the framework considering this option there would be a distinction between normal and unexpected (long tail events) fluctuations, the latter being given by the capital requirements (component 4) which interconnects with excess of assets over liabilities for unexpected liabilities (component 3).
- 8.3.60. For IORPs where members bear the risks, either individually or collectively, the concept of technical provisions needs to be put into the proper context as the term is not that straightforward. For instance, in case of IORPs which are treated in a similar way as UCITS, assets are evaluated mark-to-market and liabilities are divided into units in a way that the sum of all units exactly matches, at all times, the value of net assets (so-called net asset value or NAV).
- 8.3.61. Furthermore, due to their nature, the solvency framework is fully applicable to IORPs where members bear the risks but the components need to be adjusted accordingly, for example the solvency capital requirement shall only cover operational risks.

#### Holistic balance sheet and ring-fencing

- 8.3.62. EIOPA's view is that the holistic balance sheet is an important tool to identify the elements of pension security and could also be a useful management tool. As previously stated, the holistic balance sheet is a supervisory tool, and does not create or impose additional obligations on the IORP. From a supervisory viewpoint, the most important issue is whether the resources of the IORP are adequate to meet the obligations of the IORP, as defined in the balance sheet. The primary objective of the holistic balance sheet is to measure and demonstrate this.
- 8.3.63. However, within this aggregate measure, it is not always true that all resources are available to meet all obligations of the IORP, or that all liabilities rank equally for those resources. Among the reasons for this might be:
- a. ring-fencing, or more specifically patrimony protection (see CfA 3), which reserves specific assets for specific obligations.

- b. privilege rules, which give priority to certain liabilities in the allocation of assets but, subject to this prioritisation, makes any excess available for other obligations

8.3.64. Under the current IORP Directive, ring-fencing and privilege rules can arise for the following reasons:

1. Where permitted by law, these provisions may be a feature specific to an IORP and set out in its rules.
2. These obligations may be imposed by home state laws, i.e. governance law
3. Ring-fencing may occur as a consequence of cross-border operation.

Any or all of the above may arise in specific cases. The existence of these features mean that the operation of tiering and/or trigger actions may operate at a level below the aggregate balance sheet.

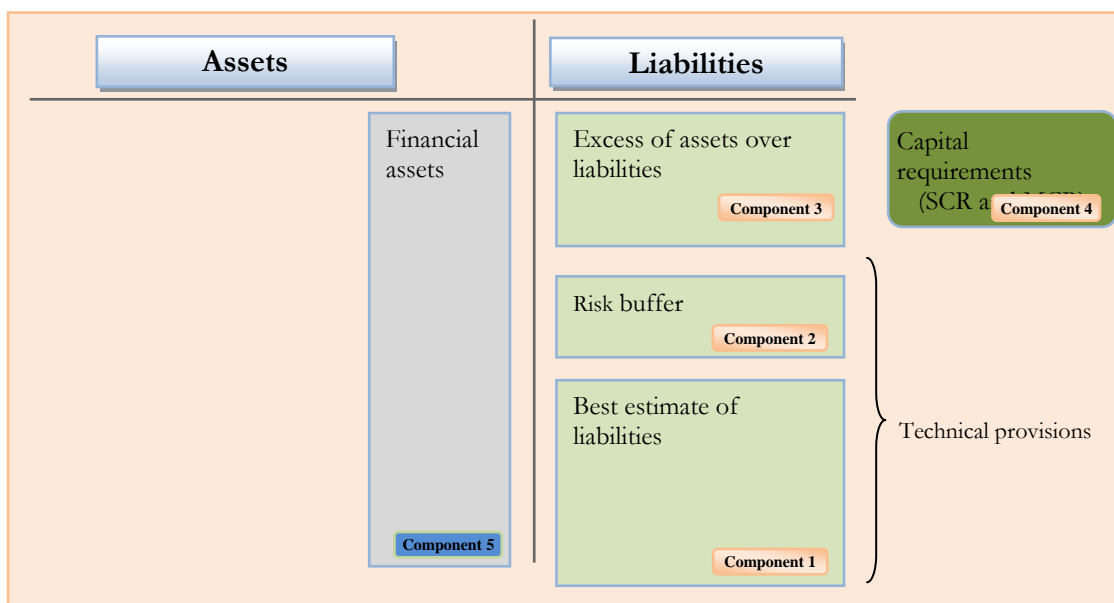
8.3.65. These mechanisms make the assessment of the solvency of an IORP more complex than it would otherwise be. Furthermore, the result of ring-fencing measures is that different benefits could enjoy different levels of security, which makes a common level of security more challenging to define. EIOPA also recognises the important effect of the recovery plan on the level of security.

8.3.66. Pension protection arrangements do not always apply to all benefits of an IORP. In a multi-employer IORP, the support of any employer does not necessarily apply to all benefits.

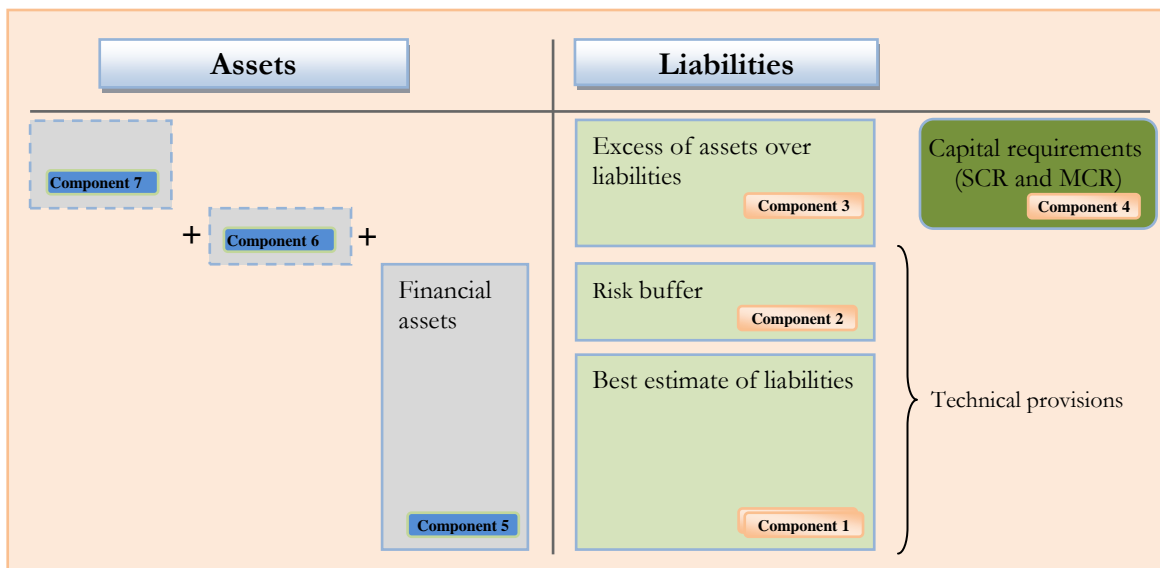
8.3.67. The holistic balance sheet is therefore best understood as a consolidated balance sheet, and does not imply or oblige that all assets and security mechanisms are equally available for all of the obligations of the IORP. It does not remove the need to look beyond the aggregate comparison of resources and obligations to issues of ring-fencing and tiering.

### Examples of holistic balance sheet

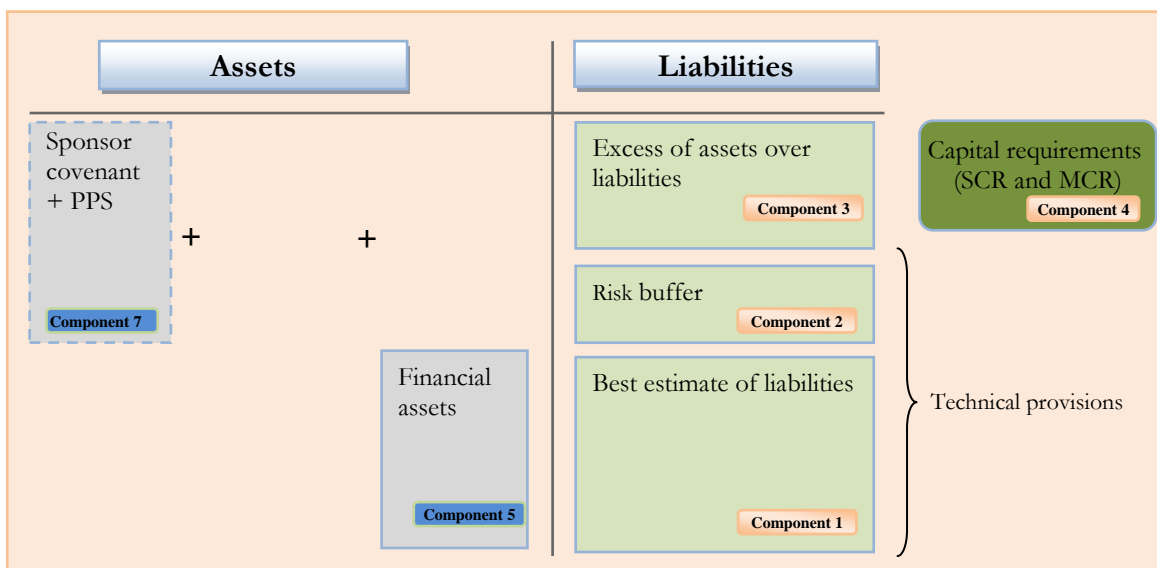
8.3.68. IORP where the IORP itself bears the risk - own fund type



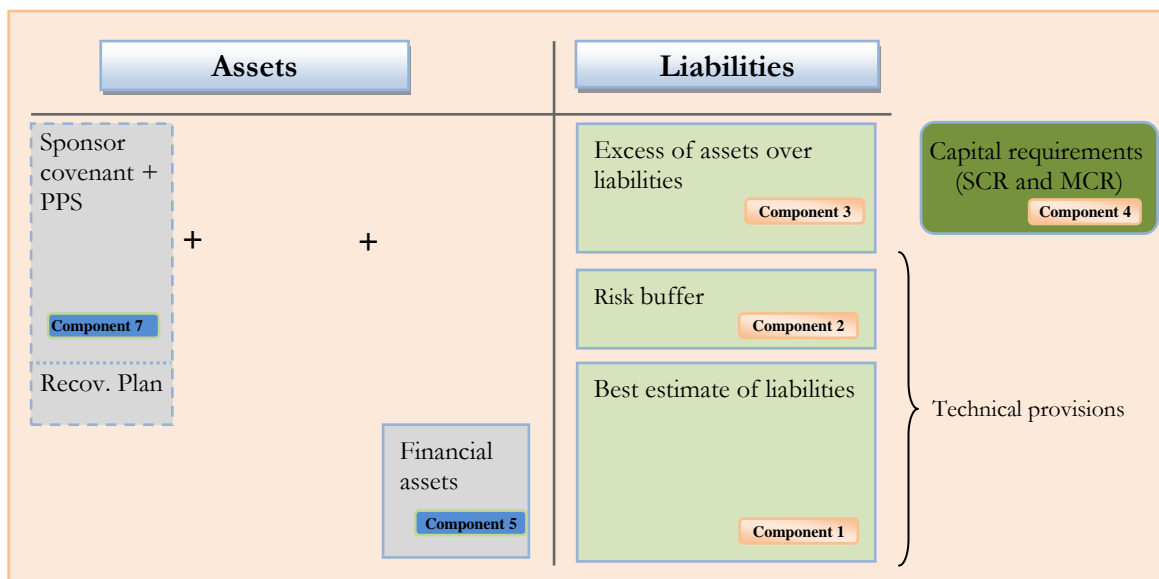
8.3.69. IORP where the sponsor undertaking bears the risks – with higher requirements in terms of the tiering of assets



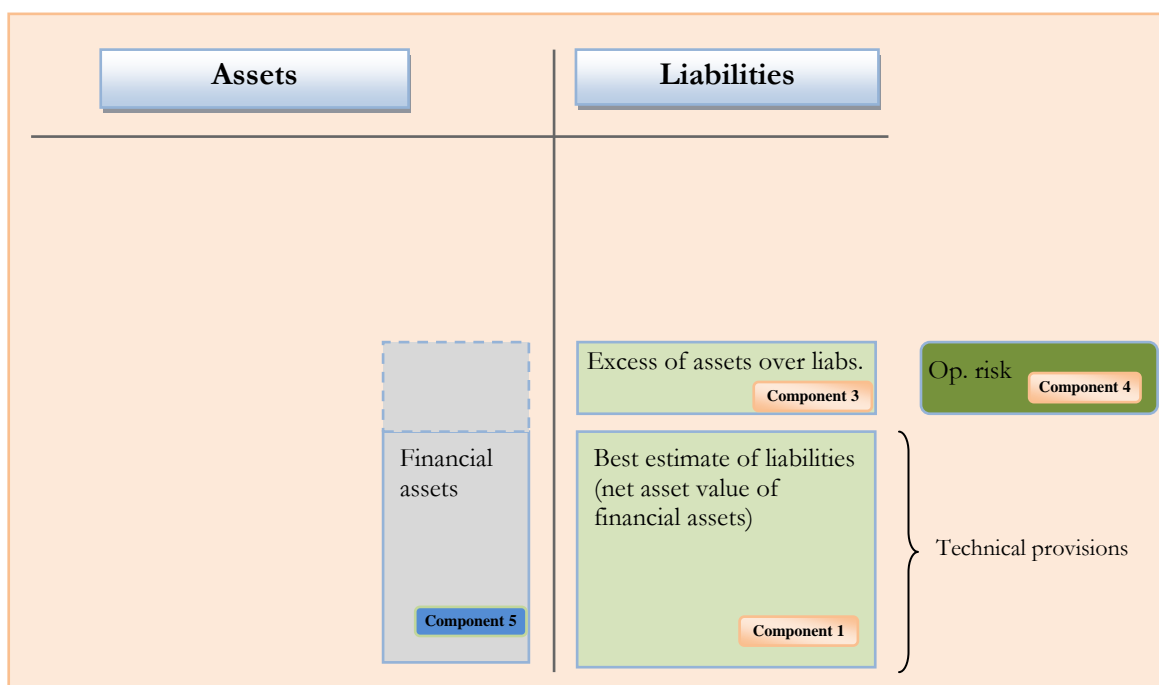
8.3.70. IORP where the sponsor undertaking bears the risks – with lower requirements in terms of the tiering of assets



8.3.71. IORP where the sponsor undertaking bears the risks – with recovery plan earmarked on the sponsor covenant



8.3.72. IORP where the member bears the risks. This can be individual DC plans or collective DC plans where the risks are shared by the members. For both types, the technical provisions in essence equal the value of the assets. In certain DC plans the IORP is required to have additional assets to cover the operational risk



## 8.4. EIOPA advice

The Commission Services would like EIOPA to advice, in close cooperation with the actuarial profession, on detailed rules by which supervisors can ensure that IORPs have proper rules to protect pension liabilities.

EIOPA proposed response is as follows:

*Where the IORP itself covers risk (in the meaning of Article 17(1) of the IORP Directive):*

[..]

*As a particular treatment of this, the extent to which a similar approach can be adopted for pension schemes where the risk is covered by the IORP and the sponsoring undertaking.*

*Where the risk (in the meaning of Article 17(1) of the IORP Directive) is covered by the sponsoring undertaking:*

*The possibility to restate the value of assets in the IORP and liabilities of the sponsoring undertakings into a single balance sheet, including the possibility to recognise sponsor covenants and claims in pension protection schemes as an asset similar to reinsurance.*

EIOPA supports the following principles for the valuation and capital requirements of IORPs:

- Transparency i.e. derivation of how a valuation was reached should be clear
- Comparability – it should therefore be possible to compare valuation of one IORP's liabilities with another, and likewise the value of the assets which support that liability
- Comprehensiveness – all potential security mechanisms and benefit adjustments should be included

EIOPA therefore recommends:

- Valuations should be market consistent
- Valuation should include the actuarial value of all enforceable pension promises of the IORP
- The holistic balance sheet as the means in principle of including all security mechanisms
- Its adoption in practice is subject to further investigation and in particular, the feasibility of the development and adoption of a methodology for the quantification of the security and benefit adjustment mechanisms, and whether that methodology is effective in terms of its costs and benefits.

EIOPA wishes to note further that some elements of its advice are conditional on the following three factors:

- The Commission's objective of a common level of security for retirement benefits. Whether this objective is accepted is a political matter which also potentially has other implications. Its rejection would necessitate a review of some of the advice.

- The results of a quantitative impact study. This will provide further information about whether a common level of security is feasible in practice and effective in terms of its costs and benefits, given the diversity of IORPs in the different member states, and EIOPA will consider whether to offer further views on these matters in light of the results.

- That the typical question in CfAs 5 and 6 on which EIOPA is asked to provide advice is whether the material elements of articles of the Solvency II directive should be amended or removed to adequately address the specificities of IORPs. EIOPA's response therefore does not consider the question of whether or not Solvency II is the correct starting point, though it is noted that many consultation respondents stated the view that Solvency II is the wrong initial framework for considering the capital requirements of IORPs.

The review of the IORP Directive should be flexible enough to allow for the full range of IORPs through the introduction of the holistic balance sheet in which all security mechanisms are valued explicitly.

## **9. CfA 5: Valuation of assets, liabilities and technical provisions**

### **9.1. Extract from the call for advice**

The Commission Services would like EIOPA to advise, in close cooperation with the actuarial profession, on detailed rules by which supervisors can ensure that IORPs have proper rules to value assets, technical provisions and other liabilities.

The EIOPA advice should address at least the following subjects:

- The material elements of Article 75 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the valuation of assets and liabilities;
- The consistency between the rules to establish prudential balance sheets of IORPs and the rules for general accounting purposes, taking into account where necessary the financial reporting rules (national or international) applicable to the sponsoring undertaking;
- The material elements of Articles 76-86 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions. This should include advice on the circumstances under which approximations in the calculation of the best estimate should be allowed;
- The need to maintain Article 15(5) of Directive 2003/41/EC;
- The application of the rules to calculate technical provisions to the calculation of the "adequate amount of liabilities" (in the meaning of Article 15(1) of the IORP Directive) to be able to pay pension benefits as and when they fall due. This should include advice on the feasibility to treat sponsor covenants like reinsurance contracts (see Article 81 of Directive 2009/138/EC) with due account for counterparty default risk;
- Other requirements for IORPs, if any.

### **9.2. Background**

#### **Current legal requirements (IORP Directive)**

- 9.2.1. The IORP Directive contains some references to valuation rules. Article 10 requires that IORPs give a "true and fair" view of their assets and liabilities in accordance with national law in annual accounts and reports as distinct from in the funding of technical provisions requirements.
- 9.2.2. The rules in the IORP Directive regarding technical provisions are more specific. Article 15 requires IORPs to establish an adequate amount of liabilities corresponding to the financial commitments arising out of the pension contracts. Where IORPs cover against risk, they are required to establish sufficient technical provisions. The minimum amount of these technical provisions is to be calculated on a forward-looking, going-concern basis, including a margin for adverse deviation. The directive does not require

a risk-free discount rate. It allows the use of asset based rates, high-quality corporate bond yields and government bond yields. Biometric tables are scheme-specific.

- 9.2.3. The home Member State may – according to Article 15 (5) make the calculation of technical provisions subject to additional and more detailed requirements.
- 9.2.4. Limited references to the transfer of assets and liabilities are made in the IORP directive. In Article 16 it is stated that in the event of termination of a pension scheme, when there are insufficient assets to cover the technical provisions, the IORP shall establish a procedure in order to transfer the assets and the corresponding liabilities to another financial institution or a similar body.
- 9.2.5. Article 14 (2) of the IORP Directive provides for supervisory powers in particular in the case of the institution having failed to establish sufficient technical provisions, but does not include the explicit supervisory power to require the IORP to increase the amount of technical provisions.
- 9.2.6. The IORP Directive specifies in Recital 30 and Article 17 that the sponsoring undertaking or the IORP itself may cover any biometric risk or guarantee certain benefits or an investment performance. The IORP is in that case required to hold regulatory own funds that serve a buffer. There are no similar requirements for sponsor backed IORPs, but Article 9(1)(e) requires Member States to ensure that the sponsor is committed to regular financing.

#### *Recital (30)*

*In many cases, it could be the sponsoring undertaking and not the institution itself that either covers any biometric risk or guarantees certain benefits or investment performance. However, in some cases, it is the institution itself which provides such cover or guarantees and the sponsor's obligations are generally exhausted by paying the necessary contributions. In these circumstances, the products offered are similar to those of life-assurance companies and the institutions concerned should hold at least the same additional own funds as life-assurance companies.*

#### *Article 9*

##### *Conditions of operation*

*1. Each Member State shall, in respect of every institution located in its territory, ensure that:*

*(e) where the sponsoring undertaking guarantees the payment of the retirement benefits, it is committed to regular financing;*

#### *Article 10*

##### *Annual accounts and annual reports*

*Each Member State shall require that every institution located in its territory draw up annual accounts and annual reports taking into account each pension scheme operated by the institution and, where applicable, annual accounts and annual reports for each pension scheme. The annual accounts and the annual reports shall*

*give a true and fair view of the institution's assets, liabilities and financial position. The annual accounts and information in the reports shall be consistent, comprehensive, fairly presented and duly approved by authorised persons, according to national law.*

#### *Article 14*

##### *Powers of intervention and duties of the competent authorities*

*2. The competent authorities shall have the power to take any measures including, where appropriate, those of an administrative or financial nature, either with regard to any institution located in their territories or against the persons running the institution, which are appropriate and necessary to prevent or remedy any irregularities prejudicial to the interests of the members and beneficiaries.*

*They may also restrict or prohibit the free disposal of the institution's assets when, in particular:*

*(a) the institution has failed to establish sufficient technical provisions in respect of the entire business or has insufficient assets to cover the technical provisions;*

#### *Article 15*

##### *Technical provisions*

*1. The home Member State shall ensure that institutions operating occupational pension schemes establish at all times in respect of the total range of their pension schemes an adequate amount of liabilities corresponding to the financial commitments which arise out of their portfolio of existing pension contracts.*

*2. The home Member State shall ensure that institutions operating occupational pension schemes, where they provide cover against biometric risks and/or guarantee either an investment performance or a given level of benefits, establish sufficient technical provisions in respect of the total range of these schemes.*

*3. The calculation of technical provisions shall take place every year. However, the home Member State may allow a calculation once every three years if the institution provides members and/or the competent authorities with a certification or a report of adjustments for the intervening years. The certification or the report shall reflect the adjusted development of the technical provisions and changes in risks covered.*

*4. The calculation of the technical provisions shall be executed and certified by an actuary or, if not by an actuary, by another specialist in this field, including an auditor, according to national legislation, on the basis of actuarial methods recognised by the competent authorities of the home Member State, according to the following principles:*

*(a) the minimum amount of the technical provisions shall be calculated by a sufficiently prudent actuarial valuation, taking account of all commitments for benefits and for contributions in accordance with the pension arrangements of the institution. It must be sufficient both for pensions and benefits already in payment to beneficiaries to continue to be paid, and to reflect the commitments which arise out of members' accrued pension rights. The economic and actuarial assumptions*

*chosen for the valuation of the liabilities shall also be chosen prudently taking account, if applicable, of an appropriate margin for adverse deviation;*

*(b) the maximum rates of interest used shall be chosen prudently and determined in accordance with any relevant rules of the home Member State. These prudent rates of interest shall be determined by taking into account:*

*- the yield on the corresponding assets held by the institution and the future investment returns and/or*

*- the market yields of high-quality or government bonds;*

*(c) the biometric tables used for the calculation of technical provisions shall be based on prudent principles, having regard to the main characteristics of the group of members and the pension schemes, in particular the expected changes in the relevant risks;*

*(d) the method and basis of calculation of technical provisions shall in general remain constant from one financial year to another. However, discontinuities may be justified by a change of legal, demographic or economic circumstances underlying the assumptions.*

*5. The home Member State may make the calculation of technical provisions subject to additional and more detailed requirements, with a view to ensuring that the interests of members and beneficiaries are adequately protected.*

*6. With a view to further harmonisation of the rules regarding the calculation of technical provisions which may be justified - in particular the interest rates and other assumptions influencing the level of technical provisions - the Commission shall, every two years or at the request of a Member State, issue a report on the situation concerning the development in cross-border activities.*

*The Commission shall propose any necessary measures to prevent possible distortions caused by different levels of interest rates and to protect the interest of beneficiaries and members of any scheme.*

## *Article 16*

### *Funding of technical provisions*

*[..]*

*2. The home Member State may allow an institution, for a limited period of time, to have insufficient assets to cover the technical provisions. In this case the competent authorities shall require the institution to adopt a concrete and realisable recovery plan in order to ensure that the requirements of paragraph 1 are met again. The plan shall be subject to the following conditions:*

*(c) in the event of termination of a pension scheme during the period referred to above in this paragraph, the institution shall inform the competent authorities of the home Member State. The institution shall establish a procedure in order to transfer the assets and the corresponding liabilities to another financial institution or a similar body. This procedure shall be disclosed to the competent authorities of the home Member State and a general outline of the procedure shall be made*

*available to members or, where applicable, to their representatives in accordance with the principle of confidentiality.*

## Article 17

### *Regulatory own funds*

*1. The home Member State shall ensure that institutions operating pension schemes, where the institution itself, and not the sponsoring undertaking, underwrites the liability to cover against biometric risk, or guarantees a given investment performance or a given level of benefits, hold on a permanent basis additional assets above the technical provisions to serve as a buffer. The amount thereof shall reflect the type of risk and asset base in respect of the total range of schemes operated. These assets shall be free of all foreseeable liabilities and serve as a safety capital to absorb discrepancies between the anticipated and the actual expenses and profits.*

### **International standards (OECD/IOPS, etc)**

9.2.7. The OECD Recommendation on the Core Principles of Occupational Pension Regulation<sup>47</sup> and the OECD Guidelines on Funding and Benefit Security in Occupational Pension Plans<sup>48</sup> contain the following guidelines on the measurement of occupational pension plan liabilities:

*1 Legal provisions should be in place requiring the determination of occupational pension plan liabilities corresponding to the financial commitments or obligations which arise out of the pension arrangement. The ongoing liability is normally defined as the accrued benefit rights of pension plan members and beneficiaries excluding future service but taking into account the projected benefits to be received under estimated retirement, mortality, and early leaver (also known as membership termination or job separation) patterns. The termination liability takes into account the pension benefits accrued if the plan were to be terminated at the time of the valuation.*

*2 Any definitions of ongoing and termination liability should reflect any benefit indexation factors prescribed by law or plan terms (unconditional indexation) that apply from membership or plan termination to the annuity starting date and, if relevant, after the annuity starting date, provided that these factors are predictable. These definitions should also reflect benefits that become vested upon plan termination.*

*3 These legal provisions should require the use of appropriate calculation methods, including actuarial techniques and amortisation rules that are consistent with generally recognised actuarial standards and methods.*

*4 The legal provisions (referencing generally recognised actuarial standards and methods) should require the use of prudent actuarial assumptions which are considered appropriate for the calculation of the pension plan's liabilities. These assumptions would include, among others, the mortality table (representing the assumed level of mortality of plan members and beneficiaries as at the date at*

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<sup>47</sup> OECD, Private Pensions and Policy Responses to the Crisis - Recommendation on Core Principles of Occupational Pension Regulation, June 2009.

<sup>48</sup> OECD, OECD Guidelines on Funding and Benefit Security in Occupational Pension Plans – Recommendation of the COuncil, May 2007

*which the plan's liabilities are calculated), future trend in mortality (representing permanent changes in mortality that are assumed to occur after the date at which the liabilities are calculated) and retirement and early leaver patterns at different ages (taking into account the actual retirement and early leaver behaviour of those covered by the plan).*

*5 The legal provisions (referencing generally recognised actuarial standards and methods) should require the use of prudent discount rates for determining liabilities that are consistent with the methodologies used in the valuation of assets and other economic assumptions. These legal provisions (or the actuarial profession) should provide guidance as to the factors that may be considered in determining the discount rate for ongoing and termination liabilities.*

*6 The calculation of pension liabilities should take place at least once every three years, while a certification or report of the adjusted development of the liabilities and changes in risks covered should be required for the intervening years. All actuarial valuations should be carried out by an actuary, or by another equivalent specialist, who has had appropriate training and experience in the field of pensions.*

*7 As part of the process of defining its funding policy, the governing body of the pension fund should seek the advice of the actuary or other relevant specialist regarding the assumptions and methods to be used in calculating pension liabilities and funding levels. This advice should be provided in a clear and timely fashion.*

- 9.2.8. The OECD discussed the issue of the volatility that is connected to certain valuation methods following the financial crisis.<sup>49</sup> It concludes that “disclosure to plan stakeholders based on current market values of pension assets and liabilities may be appropriate to increase transparency, and the use of current market values could improve risk management. However, regulators should operate flexibly when reviewing a scheme’s funding position or regulators should enable pension funds and plan sponsors to dampen somewhat the volatility of market prices when determining contributions.”

## **Solvency II Directive**

- 9.2.9. Articles 75 to 86 of the Solvency II Directive set out the rules relating to the valuation of assets and liabilities.
- 9.2.10. Articles 75 and 76 contains the principle that these should be valued at the amount to which they could be exchanged or transferred between knowledgeable willing parties (transfer value principle).
- 9.2.11. Article 77 then goes on to set out some more detailed rules for the calculation of technical provisions including valuing the best estimate as the expected present value of future cash-flows discounted at a risk-free rate. The concept of the risk margin is also introduced which together with the best estimate makes up the value of the technical provisions.
- 9.2.12. Articles 78 to 83 contain some further rules for insurance undertakings concerning the relevant elements to be considered and the processes and procedures to be in place.

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<sup>49</sup> OECD Working Paper, The impact of the financial crisis on defined benefit pension plans and the need for countercyclical funding regulations, July 2010

- 9.2.13. Articles 84 and 85 give the supervisory authority the power to require undertakings to demonstrate the appropriateness of their technical provisions and also to increase this amount if the calculations are not compliant with the relevant Articles.
- 9.2.14. Article 86 required the Commission to adopt implementing measures laying down more detailed rules regarding many of the elements in the preceding Articles.

*Recital (46)*

*Valuation standards for supervisory purposes should be compatible with international accounting developments, to the extent possible, so as to limit the administrative burden on insurance or reinsurance undertakings.*

*Article 75*

*Valuation of assets and liabilities*

*1. Member States shall ensure that, unless otherwise stated, insurance and reinsurance undertakings value assets and liabilities as follows:*

*(a) assets shall be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction;*

*(b) liabilities shall be valued at the amount for which they could be transferred, or settled, between knowledgeable willing parties in an arm's length transaction. When valuing liabilities under point (b), no adjustment to take account of the own credit standing of the insurance or reinsurance undertaking shall be made.*

*2. The Commission shall adopt implementing measures to set out the methods and assumptions to be used in the valuation of assets and liabilities as laid down in paragraph 1.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

*Article 76*

*General provisions*

*1. Member States shall ensure that insurance and reinsurance undertakings establish technical provisions with respect to all of their insurance and reinsurance obligations towards policy holders and beneficiaries of insurance or reinsurance contracts.*

*2. The value of technical provisions shall correspond to the current amount insurance and reinsurance undertakings would have to pay if they were to transfer their insurance and reinsurance obligations immediately to another insurance or reinsurance undertaking.*

*3. The calculation of technical provisions shall make use of and be consistent with information provided by the financial markets and generally available data on underwriting risks (market consistency).*

*4. Technical provisions shall be calculated in a prudent, reliable and objective manner.*

*5. Following the principles set out in paragraphs 2, 3 and 4 and taking into account the principles set out in Article 75(1), the calculation of technical provisions shall be carried out in accordance with Articles 77 to 82 and 86.*

*Article 77*

*Calculation of technical provisions*

1. The value of technical provisions shall be equal to the sum of a best estimate and a risk margin as set out in paragraphs 2 and 3.

2. The best estimate shall correspond to the probability-weighted average of future cash-flows, taking account of the time value of money (expected present value of future cash-flows), using the relevant risk-free interest rate term structure.

The calculation of the best estimate shall be based upon up-to-date and credible information and realistic assumptions and be performed using adequate, applicable and relevant actuarial and statistical methods.

The cash-flow projection used in the calculation of the best estimate shall take account of all the cash in- and out-flows required to settle the insurance and reinsurance obligations over the lifetime thereof.

The best estimate shall be calculated gross, without deduction of the amounts recoverable from reinsurance contracts and special purpose vehicles. Those amounts shall be calculated separately, in accordance with Article 81.

3. The risk margin shall be such as to ensure that the value of the technical provisions is equivalent to the amount that insurance and reinsurance undertakings would be expected to require in order to take over and meet the insurance and reinsurance obligations.

4. Insurance and reinsurance undertakings shall value the best estimate and the risk margin separately.

However, where future cash flows associated with insurance or reinsurance obligations can be replicated reliably using financial instruments for which a reliable market value is observable, the value of technical provisions associated with those future cash flows shall be determined on the basis of the market value of those financial instruments. In this case, separate calculations of the best estimate and the risk margin shall not be required.

5. Where insurance and reinsurance undertakings value the best estimate and the risk margin separately, the risk margin shall be calculated by determining the cost of providing an amount of eligible own funds equal to the Solvency Capital Requirement necessary to support the insurance and reinsurance obligations over the lifetime thereof.

The rate used in the determination of the cost of providing that amount of eligible own funds (Cost-of-Capital rate) shall be the same for all insurance and reinsurance undertakings and shall be reviewed periodically.

The Cost-of-Capital rate used shall be equal to the additional rate, above the relevant risk-free interest rate, that an insurance or reinsurance undertaking would incur holding an amount of eligible own funds, as set out in Section 3, equal to the Solvency Capital Requirement necessary to support insurance and reinsurance obligations over the lifetime of those obligations.

#### Article 78

Other elements to be taken into account in the calculation of technical provisions  
In addition to Article 77, when calculating technical provisions, insurance and reinsurance undertakings shall take account of the following:

(1) all expenses that will be incurred in servicing insurance and reinsurance obligations;

(2) inflation, including expenses and claims inflation;

(3) all payments to policy holders and beneficiaries, including future discretionary bonuses, which insurance and reinsurance undertakings expect to make, whether or not those payments are contractually guaranteed, unless those payments fall under Article 91(2).

#### *Article 79*

##### *Valuation of financial guarantees and contractual options included in insurance and reinsurance contracts*

*When calculating technical provisions, insurance and reinsurance undertakings shall take account of the value of financial guarantees and any contractual options included in insurance and reinsurance policies.*

*Any assumptions made by insurance and reinsurance undertakings with respect to the likelihood that policy holders will exercise contractual options, including lapses and surrenders, shall be realistic and based on current and credible information. The assumptions shall take account, either explicitly or implicitly, of the impact that future changes in financial and non-financial conditions may have on the exercise of those options.*

#### *Article 80*

##### *Segmentation*

*Insurance and reinsurance undertakings shall segment their insurance and reinsurance obligations into homogeneous risk groups, and as a minimum by lines of business, when calculating their technical provisions.*

#### *Article 81*

##### *Recoverables from reinsurance contracts and special purpose vehicles*

*The calculation by insurance and reinsurance undertakings of amounts recoverable from reinsurance contracts and special purpose vehicles shall comply with Articles 76 to 80.*

*When calculating amounts recoverable from reinsurance contracts and special purpose vehicles, insurance and reinsurance undertakings shall take account of the time difference between recoveries and direct payments.*

*The result from that calculation shall be adjusted to take account of expected losses due to default of the counterparty. That adjustment shall be based on an assessment of the probability of default of the counterparty and the average loss resulting therefrom (loss-given-default).*

#### *Article 82*

##### *Data quality and application of approximations, including case-by-case approaches, for technical provisions*

*Member States shall ensure that insurance and reinsurance undertakings have internal processes and procedures in place to ensure the appropriateness, completeness and accuracy of the data used in the calculation of their technical provisions.*

*Where, in specific circumstances, insurance and reinsurance undertakings have insufficient data of appropriate quality to apply a reliable actuarial method to a set or subset of their insurance and reinsurance obligations, or amounts recoverable from reinsurance contracts and special purpose vehicles, appropriate approximations, including case-by-case approaches, may be used in the calculation of the best estimate.*

#### *Article 83*

##### *Comparison against experience*

*Insurance and reinsurance undertakings shall have processes and procedures in place to ensure that best estimates, and the assumptions underlying the calculation of best estimates, are regularly compared against experience.*

*Where the comparison identifies systematic deviation between experience and the best estimate calculations of insurance or reinsurance undertakings, the undertaking concerned shall make appropriate adjustments to the actuarial methods being used and/or the assumptions being made.*

#### *Article 84*

##### *Appropriateness of the level of technical provisions*

*Upon request from the supervisory authorities, insurance and reinsurance undertakings shall demonstrate the appropriateness of the level of their technical provisions, as well as the applicability and relevance of the methods applied, and the adequacy of the underlying statistical data used.*

#### *Article 85*

##### *Increase of technical provisions*

*To the extent that the calculation of technical provisions of insurance and reinsurance undertakings does not comply with Articles 76 to 83, the supervisory authorities may require insurance and reinsurance undertakings to increase the amount of technical provisions so that they correspond to the level determined pursuant to those Articles.*

#### *Article 86*

##### *Implementing measures*

*The Commission shall adopt implementing measures laying down the following:*

- (a) actuarial and statistical methodologies to calculate the best estimate referred to in Article 77(2);*
- (b) the relevant risk-free interest rate term structure to be used to calculate the best estimate referred to in Article 77(2);*
- (c) the circumstances in which technical provisions shall be calculated as a whole, or as a sum of a best estimate and a risk margin, and the methods to be used in the case where technical provisions are calculated as a whole;*
- (d) the methods and assumptions to be used in the calculation of the risk margin including the determination of the amount of eligible own funds necessary to support the insurance and reinsurance obligations and the calibration of the Cost-of-Capital rate;*
- (e) the lines of business on the basis of which insurance and reinsurance obligations are to be segmented in order to calculate technical provisions;*
- (f) the standards to be met with respect to ensuring the appropriateness, completeness and accuracy of the data used in the calculation of technical provisions, and the specific circumstances in which it would be appropriate to use approximations, including case-by-case approaches, to calculate the best estimate;*
- (g) the methodologies to be used when calculating the counterparty default adjustment referred to in Article 81 designed to capture expected losses due to default of the counterparty;*
- (h) where necessary, simplified methods and techniques to calculate technical provisions, in order to ensure the actuarial and statistical methods referred to in points (a) and (d) are proportionate to the nature, scale and complexity of the risks supported by insurance and reinsurance undertakings including captive insurance and reinsurance undertakings.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

## OPC reports

- 9.2.15. In the CEIOPS SSC Survey on fully funded, technical provisions and security mechanisms<sup>50</sup> Member States identified four common overarching principles that should underpin a pension supervisory framework. As part of those, Member States underscore the principle of market-consistency in the valuation of an IORP's assets and liabilities for supervisory purposes. This means that market prices are used where available (mark-to-market); otherwise values may be determined by using relevant market data and a modelling approach (mark-to-model). The latter may apply to pensions and insurance liabilities since there are no (deep liquid, secondary) markets available. Supervision based on market-consistent valuation emphasises the actual financial position and allows for realistic solvency monitoring. A system based on sound market oriented valuation principles will reveal the true financial position of the IORP including a full understanding of all security mechanisms.
- 9.2.16. Transparency has been established as another important principle by the Member States. This implies that an IORP is open on how its financial position is determined and that reserves (or shortages), as well as prudence embedded in technical provisions or in any other instruments, are made explicit to the supervisor.
- 9.2.17. While the EIOPA report shows that Member States have adopted the principles set out in the IORP Directive, it also underlines that there are stark differences in the method to calculate technical provisions. Some Member States provide for the use of a market-consistent risk free discount rate and biometric tables without additional prudence (e.g. for longevity risk). In these cases risk margins are not calculated explicitly, while in other cases there are explicit risk margins in calculation bases required.
- 9.2.18. It notes that from a market oriented perspective, the applied discount rate should correspond to the security promised to the beneficiary. The reason for this is that the mark-to-market value of a pension liability equals the market price of the investment portfolio that generates congruent cash flows. Therefore, guaranteed pension liabilities should be discounted at a risk-free rate although for pension liabilities with a less than full guarantee, for example where the sponsor provides separate further security, a higher rate could be appropriate.
- 9.2.19. The survey reports that in many Member States calculations of technical provisions make allowance for some element of future expenses of the IORP (e.g. costs related to the administration, asset management and disbursement of pension rights). In other countries no allowances are made in technical provisions as these expenses are deducted from the expected returns on assets. This should have some effect on the determination of the discount rate.
- 9.2.20. The survey also contains an elaborate description of current practices regarding types of benefits and their inclusion in technical provisions. Countries have adopted different approaches to inflation protection for the preretirement and the post-retirement period. In a number of countries an allowance for inflation or salary increases must be made in the reserving method. This increases the

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<sup>50</sup> CEIOPS, Survey on fully funded, technical provisions and security mechanisms in the European occupational pension sector (CEIOPS-OPSSC-01/08 final), OPC Solvency Subcommittee, 31 March 2008.

technical provisions but does not affect the level of benefits that will be payable. Some countries provide for inflation protection or salary indexation in the technical provisions if such indexation is part of the pension promise, thus depending on the plan rules. In other countries, in general no allowance is made in the technical provisions for inflation or salary increases. Where inflation protection is part of the pension promise, in all countries this must be accounted for by reserving in the technical provisions.

### 9.3. Explanatory text

#### **Specific Call for Advice**

The material elements of Article 75 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the valuation of assets and liabilities;

#### **EIOPA view on issues in the CfA**

9.3.1. Article 75 puts forward the main principle that assets and liabilities should be valued at the amount for which they could be transferred. This implies that assets and liabilities should be valued on a market consistent basis.

#### Valuation of assets

9.3.2. EIOPA agrees with the requirement in Solvency II that assets should be valued on a market consistent basis. This means that market prices are used where available (mark-to-market). Where market prices are not available values may be determined by a modelling approach.<sup>51</sup> This may be the case for categories of illiquid assets, but also for the value of sponsor support and pension protection arrangements - if included in the holistic balance sheet.

9.3.3. The advantage of a market consistent valuation of assets – over other concepts like book value - is that it provides insight in the financial position of the IORP in an objective and transparent manner. It also enhances risk management from an ALM perspective when liabilities are valued on a market-consistent basis as well. In addition, it provides for consistency with valuation principle in Solvency II.

9.3.4. Some criticize market consistent valuation on the ground that asset prices do not always reflect their “true” value. In other words, financial markets are not necessarily efficient at all times. Moreover, volatility of capital markets may result in considerable short-term fluctuations, which may possibly result in pro-cyclical policy responses. EIOPA considers that such behaviour may be diminished by IORPs matching assets and liabilities. Supervisory authorities may take into account potential pro-cyclical effect in times of exceptional market movements by extending recovery periods, as provided for in Solvency II (see CfA 8).

#### Valuation of liabilities / transfer value

9.3.5. This part of the CfA will address the applicability of the concept of transfer value as introduced in Article 75(1)(b) of Solvency II for the valuation of liabilities. This will not be repeated in the discussion of the applicability of Article 76, which refers to the principle of transfer value as well. The related issues of the risk margin and the discount rate will be discussed in paragraphs 9.3.45-92.

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<sup>51</sup> CEIOPS, Survey on fully funded, technical provisions and security mechanisms in the European occupational pension sector (CEIOPS-OPSSC-01/08 final), OPC Solvency Subcommittee, 31 March 2008.

- 9.3.6. There are arguments for and against the applicability of the transfer value concept for valuing IORPs' liabilities.
- 9.3.7. Arguments in favour of the concept of transfer value being applicable to the valuation of technical provisions for IORPs include:
- a. The idea that technical provisions should be sufficient to face all obligations in a situation that all employees or plan members would cease their participation, because of a default of the employer or for any other reason, seems to be reasonable.
  - b. Liabilities should be calculated on similar assumptions as for insurance companies, so to make a (theoretical) transfer work. The directive must in principle anticipate future possibilities to transfer pension rights between IORPs as well as transfers to (and between) insurance companies. The existence of a (deep and liquid) market is not a necessary condition for the application of the concept of transfer value. The absence of such a market does not invalidate the application of the principle.
  - c. Some IORPs providing defined benefit schemes operate in the same market as many life insurance companies. Applying the same principles would contribute to a level playing field. There are positive experiences in some Member States of imposing the same regulations for establishing technical provisions to IORPs as life insurers. In that respect, the application of the principle of transfer value could therefore be a start background in developing harmonized solvency regulations.
- 9.3.8. Arguments against the concept of transfer value being applicable for IORPs include:
- a. IORPs do not necessarily have sufficient financial assets at all times to transfer liabilities. Technical provisions may be covered on the asset-side by future contributions or liabilities may be lowered by reducing benefits.
  - b. According to the characteristics of IORPs in some Member States there are liabilities that are not transferable, so the concept of transfer value would be inappropriate. Where IORPs in some Member States are not allowed to transfer liabilities to another entity, insurers are sometimes forced to do so.
  - c. An approach of solvency based on pure liquidation logic is too simplistic. It would be a radical evolution and not necessarily desirable in regard to the concepts of Article 15 of the existing directive.
  - d. If the aim is to ensure that the measurement of the liabilities is designed in such a way as to reflect IORPs legal nature and financing needs, then a principle based on transfer values makes little conceptual sense.
  - e. The meaning of transfer value in relation to IORPs where the sponsor bears the risk is not always clear. In some circumstances the risks will still be covered by the sponsoring undertaking and not by a third party.

- f. Where the sponsor provides (part of) the guarantee there is doubt that a principle based on transfer value has conceptual meaning given that this has little relevance to the objective of adequately pre-funding the liability from the sponsor's perspective. However, if a transfer of the full liability was to take place, a market consistent valuation would be the likely basis for measuring the cost.
- g. It is also unclear to whom liabilities are to be transferred if a similar principle was taken forward for IORPs. It would need clarification whether transfers are to be between IORPs or between an IORP and an insurer.
- h. In some Member States the basis used for calculating a transfer value from an IORP may be reflected in Social and Labour Law. In others there are prudential rules for its calculation, which may differ from those required to assess the funding position of the scheme. In essence, the notion of a transfer value for IORPs has differing meaning across Member States and different interactions with Social and Labour Law meaning the use of such a principle for valuing the liabilities would add significant complexity.

9.3.9. Regarding the concept of transfer value for insurers it was however also noted that it functions as an intellectual concept. In practice, there is no deep and liquid transfer market for insurance liabilities. Yet the concept can still be applied (transfer to an "empty shell").

9.3.10. Not applying the concept of transfer value does not preclude an approach that leads to a market consistent valuation of assets and liabilities. If the purpose of the principle for calculating liabilities is to achieve a market-consistent valuation method, then this could be achieved in a simpler way by using market-consistency as the starting principle. EIOPA is therefore of the view that this would be a better starting principle if the aim is to achieve a market-consistent valuation of technical provisions, without necessarily referring to the transfer value concept.

9.3.11. Valuing the liability using an investment portfolio with similar cash flows yields similar outcomes, but with a differing starting principle. The best estimate component could be calculated according to sound economic principles, with the liabilities cash flows being replicated in a risk-free way as far as possible using deep and liquidly traded financial instruments. For the part of the cash-flows that cannot be reliably replicated, a risk margin could be added to cover the cost-of-capital of holding those liabilities. The principle put forward by the SSC report could be used which states that from a market oriented perspective, the liability should represent the security promised to the beneficiary, i.e. that the mark-to-market value of a pension liability equals the market price of the investment portfolio that generates congruent cash flows.

9.3.12. It is also an option not to amend the IORP Directive as far as the calculation of technical provisions is concerned. The current IORP Directive has a differing starting principle for the calculation of technical provisions stating that the liabilities established should be adequate to cover the commitments of existing pension contracts, i.e. that a scheme's "technical provisions" means the amount required, on a prudent actuarial calculation, to make provision for the scheme's liabilities.

9.3.13. This principle is not as specific as that of Solvency II or one in which market consistency is directly stated as the objective. However, it does not preclude market consistency or other principles being read through into other articles which look at the calculation of technical provisions in more detail. Without further clarification and detail in other articles, it does though allow for different approaches to be adopted but with the overarching objective that technical provisions are sufficient.

#### Own credit standing

9.3.14. Article 75(1)(b) requires that no adjustment to take account of the own credit standing of the insurance or reinsurance undertaking shall be made when valuing liabilities.

9.3.15. EIOPA agrees that this principle applies equally to IORPs on the basis that it is the nature of the promise made to the plan member that it is relevant when valuing liabilities. Taking into account the financial strength of the IORP would mean that a lower credit standing would result in a lower level of liabilities.

### **Policy options**

#### Valuation of assets

Option 1: Application of article 75.1a to IORPs

#### Valuation of liabilities - transfer value

Option 1: Leave the IORP unchanged with regards to the transfer principle for technical provisions.

Option 2: Amend the current IORP Directive to state that the valuation of technical provisions should be done on a market consistent basis.

9.3.16. Market consistent basis should be read as explained in paragraph 9.3.10.

#### Comparison of policy options

9.3.17. Option 1 is not compatible with the Commission's CfA and is therefore not included in EIOPA advice.

#### Own credit standing

Option 1: Application of article 75 regarding not taking into account the own credit standing of IORPs when valuing liabilities.

### **Specific Call for Advice**

The consistency between the rules to establish prudential balance sheets of IORPs and the rules for general accounting purposes, taking into account where necessary the financial reporting rules (national or international) applicable to the sponsoring undertaking

### **EIOPA view on issues in the CfA**

- 9.3.18. The IORP Directive currently requires IORPs to prepare annual accounts giving a true and fair view of the IORPs assets and liabilities.
- 9.3.19. IAS26 sets out the international standard for how IORPs are expected to implement these requirements in IORP accounts. The international financial reporting standards are only mandatory for companies publicly listed in the EU. Member States may require or permit IORPs to apply IAS26 on a voluntary basis.
- 9.3.20. However, most IORPs are subject to national accounting standards. National GAAP tends to provide more detail than IAS26 and may be consistent with supervisory reporting rules in Member States.
- 9.3.21. For accounting purposes, sponsoring undertakings are required under EU law to prepare valuations of the assets and liabilities of DB promises made to its employees. For listed companies, IFRS applies and the relevant standard is IAS19 for employee benefits.
- 9.3.22. The aim of the IAS19 accounting standards and the current objective of the IORP Directive with regards to the valuation of the liabilities serve two differing purposes.
- 9.3.23. Under IAS19, the objective is for an employer to recognize a liability where an employee has exchanged services for a benefit to be paid in the future (including pension benefits) and to recognize an expense where the employer retains an economic benefit from this service.
- 9.3.24. Under IAS19, the discount rate used to value the liabilities is prescribed – an AA corporate bond yield structure. This aims to produce a consistent and comparable approach across all companies internationally to measuring the cost to the employer of services provided by employees. This is a very different purpose to that of the funding requirements for IORPs themselves.
- 9.3.25. IORPs are currently required to calculate a prudent assessment of their liabilities. This allows for the specific circumstances of the IORP to be taken into account including the underlying investment strategy and financial position of the sponsor. If in future IORPs were required to calculate accounts using a Solvency II framework, this would also be different from the IAS19 requirements.
- 9.3.26. In spite of these fundamental differences, where it is appropriate it would be beneficial if all assessments of the financial position of an IORP maximized the extent to which they use similar data, methods and technical analysis, as this could represent a cost saving for the IORP. However, given that the objectives of the approaches are different, it is EIOPA's view that there should not be a requirement for there to be consistency in the valuation rules.
- 9.3.27. However, EIOPA recognizes that there could be benefit in making use of the figures and commentary produced for other purposes, such as company accounting, when looking at the IORP from a supervisory perspective. For example, while the nature of the valuation for the liabilities may differ, if a market consistent view of the assets is required then those prepared for accounting could be made use of for supervisory purposes.

- 9.3.28. Although it seems unnecessary to include a preamble in a revised IORP Directive, text could be inserted that allowed for consistency “to the extent possible” or “to the extent appropriate” to include enough flexibility that the details could differ.
- 9.3.29. However, it is unlikely that to introduce such a requirement in a revised IORP Directive would add any value as regulators are already aware of the advantages of valuation standards being compatible with accounting standards, where appropriate. It may even raise confusion as to how this should be taken forward, if at all.
- 9.3.30. In particular, it would be imprudent for the rules governing funding valuation requirements for IORPs to follow the rules for general accounting purposes where the objectives are so different. Therefore, from a supervisory perspective this would add little value and could lead to the development of inappropriate standards.

### **Policy options**

Option 1: No change to the current IORP Directive.

Option 2: Insert text similar to that of recital 46 of Solvency II (with appropriate amendments) into a revised IORP Directive

- 9.3.31. Insert into the recitals of a revised IORP Directive text consistent in nature with recital 46 of Solvency II but replacing “to the extent possible” with “to extent appropriate” to ensure that rules relating to accounting standards do not inappropriately impact on solvency rules, but allow for IORPs to make use of figures and commentary provided for other purposes where it is appropriate.

### Comparison of policy options

- 9.3.32. EIOPA considers that regulators and supervisors are already advancing convergence of prudential and accounting standards, where appropriate given the different objectives. Therefore, option 1 of not changing the IORP Directive in this respect is included in the advice.

### **Specific Call for Advice**

The material elements of Article 76 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.

### **EIOPA view on issues in the CfA**

- 9.3.33. Article 76 provides further detail on the methodology for calculating technical provisions. The issue of transfer value, as prescribed by Article 76(2), is already discussed in paragraphs 9.3.5-13 and therefore this part of the CfA response deals only with paragraphs 1, 3, 4 and 5 of Article 76.
- 9.3.34. The meaning of Article 76.1 that technical provisions shall be established with regard to all obligations is already included in the IORP Directive within Article

15(1). Therefore only a change in wording is needed to make it consistent with Solvency II.

- 9.3.35. Applying Article 76(3) of Solvency II to IORPs introduces a new concept that the calculation of technical provisions should make use of and be consistent with the information provided by financial markets, i.e. be "market consistent".
- 9.3.36. It is important for IORPs to take into account information provided by the financial markets when making economic and actuarial assumptions for the valuation of liabilities. Therefore it would be appropriate to include a provision for IORPs that requires them to make use of the information provided by the financial markets.
- 9.3.37. Valuing the liabilities on a market consistent basis goes a step further than this and introduces the concept of replicating the cash flows using comparable traded assets. This concept is consistent with Option 2 regarding Article 75 on the main principle for the valuation of liabilities as discussed above. Therefore, this text is appropriate if Option 2 is seen as the preferred option and there would be no need for specific amendments, except for the replacement of "insurance and reinsurance undertakings" by "IORPs" and "policy holders" by "members and beneficiaries".
- 9.3.38. Article 76(4) requires technical provisions to be calculated in a "prudent, reliable and objective manner". The concepts of reliability and objectivity are clear, but the concept of being prudent raises issues of interpretation. The current IORP Directive requires that the economic and actuarial assumptions must be chosen prudently. As can be seen by the previous work of CEIOPS, this has been interpreted in differing ways across Member States. Some Member States have interpreted this concept as allowing for a deviation from the best estimate, for example in judging expected investment returns or mortality assumptions. This interpretation would not fit with the later articles of Solvency II specifically 77(1) where technical provisions are required to be based on the best estimate.
- 9.3.39. Therefore, it would seem that there are different interpretations and meanings for the term prudent between the IORP Directive and Solvency II and clarity over what is meant by this term would be needed if it was considered for a revised IORP Directive.
- 9.3.40. However, since the first component of calculating technical provisions is the best estimate irrespective of which principles are adopted elsewhere, EIOPA is of the view that the term prudent is not appropriate in this context. Further discussion of the risk margin as appropriate for IORPs is included in paragraphs 9.3.48-58.
- 9.3.41. Amendments to 76.5 of Solvency II should be made in accordance with the advice on articles 77 to 82 and 86.

## **Policy options**

### Article 76(1)

Option 1: Amend Article 76(1) replacing insurance and reinsurance undertakings with IORPs and replacing policy holders with members.

### Article 76(3)

Option 1: Include Article 76(3) in a revised IORP Directive but removing “be consistent with” and “(market consistency)”.

Option 2: Include Article 76(3) in a revised IORP Directive with a minor adjustment to address the specificity of IORPs.

Comparison of policy options

9.3.42. Option 2 is included in the advice because it is in line with preferred option 2 under the CfA discussion of Article 75 regarding the valuation of liabilities.

### Article 76(4)

Option 1: Include Article 76(4) in a revised IORP Directive but removing the reference to being “prudent”.

9.3.43. The concept of a risk margin is discussed under Article 76.

### Article 76(5)

Option 1: Include Article 76(5) in a revised IORP Directive with amendments focussed only on ensuring the correct references to the relevant articles are made.

9.3.44. Assuming Articles 77 to 82 are applicable with any appropriate amendments, this paragraph is applicable.

### **Specific Call for Advice**

The material elements of Article 77 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.

### **EIOPA view on issues in the CfA**

9.3.45. Article 77 of Solvency II covers several issues of particular relevance when considering a risk-based supervisory regime for IORPs. These are in particular:

- a. The existence and method of calculation of a risk margin within technical provisions, in particular the calculation based on a cost-of-capital approach (Article 77 (3) and (5));
- b. The separate valuation of the best estimate and the risk margin if cash flows can't be replicated reliably (Article 77 (4) and (in a sense) Article 77 (1));
- c. The methods of calculation of a best estimate as part of technical provisions including the use of a (risk-free) interest rate, the definition of the relevant cash-flows and the requirement to calculate the best estimate gross, without deduction of the amounts recoverable from reinsurance contracts and special purpose vehicles (Article 77 (2)).

9.3.46. There are interconnections between Article 77 and other issues, in particular parts of Articles 75-86. The concept of transfer value and the question

whether and, if so, how it can or should be used when calculating technical provisions for IORPs is of essential importance, since the effects of the approach adopted have consequences for the applicability of the concepts discussed in Article 77 also. Nevertheless, Article 77 and the issues mentioned above can be discussed here separately.

- 9.3.47. In the following there will be further analysis of the issues mentioned above. The policy options presented cover these issues separately. Depending on the possible decisions on how to design a future risk-based supervisory regime there might be the need to combine several of these options.

#### Existence and method of calculation of a risk margin

- 9.3.48. The risk margin issue cannot be tackled independently of the more general issue of the calculation of the technical provisions, of which the risk margin is an integral part, as well as the determination of the SCR.

- 9.3.49. The concept of risk margin can be considered from two different angles: from the point of view of the current IORP Directive or from the point of view of Solvency II.

- 9.3.50. According to the IORP Directive, the technical provisions shall be calculated by a sufficiently prudent actuarial valuation. The economic and actuarial assumptions chosen for the valuation of the liabilities shall be chosen prudently taking account, if applicable, of an appropriate margin for adverse deviation.

- 9.3.51. According to the IORP Directive, the maximum actuarial rates of interest shall be chosen prudently by taking into account:

a. *"the yield on the corresponding assets held by the institution and the future investment returns"* which can, from a management point of view, be seen as an ALM framework, namely because of the consistency between the requirements concerning the technical provisions and the expected yield of the covering assets;

and/or

b. *"the market yields of high-quality or government bonds"* which already approaches the Solvency II philosophy in article 77 (2) of an actuarial rate which is "independent" of the expected yield of the covering assets.

- 9.3.52. According to the IORP Directive, the biometric tables used for the calculation of technical provisions shall be based on prudent principles, having regard to, in particular, the expected changes in the relevant risks.

- 9.3.53. If the approach of the IORP Directive (Article 15 (4) (a)) is applied, the technical provisions could be regarded as consisting of the two components below. It is important to note that under the current IORP Directive it may not be possible to explicitly identify to which amount these two components contribute to the overall technical provisions due to the fact that, unlike in Solvency II, a separate valuation of these two components is not explicitly required under the IORP Directive.

- a. The first component calculated as the "basic" amount of technical provisions according to a "*best estimate*" approach. This would be calculated using realistic actuarial assumptions.
- b. The second component a "*risk margin*" which takes into account unfavourable expected fluctuations with regard to the actuarial assumptions used in the calculation of the best estimate. This "risk margin" aims to account for potential adverse development relative to the assumptions used.

9.3.54. The approach of Article 77 of Solvency II differs from this interpretation since the value of the technical provisions would be equal to the transfer value, defined as the sum of a best estimate and a risk margin:

- a. The best estimate corresponds to the present value of the probability-weighted average of future cash flows, using the risk-free interest rate curve.
- b. The risk margin does not itself cover against risk, but it ensures that the capital needed to cover against risk (deviation from the best estimate) can be obtained by the insurance undertaking. In this way, the value of technical provisions is sufficient to transfer obligations to another insurer. The risk margin is calculated using the cost-of-capital for holding own funds, and therefore linked to the calculation of the SCR (Article 77 (5) of Solvency II). The risk margin only applies to risks that cannot be hedged. Insurers do not have to hold capital for liability risks that are fully matched on the asset-side.

9.3.55. If the decision was taken to not apply a Solvency II-type transfer value approach, but to have a risk margin in the technical provisions of IORPs covering against adverse deviation, then the risk margin itself would cover against some risks. This would mean that in this case part of the risk would be taken into account in technical provisions while another part would be taken into account in calculating capital requirements.

9.3.56. A reason to do this might be that some of the risk, for example the probability of deviation from the best estimate, would be covered by technical provisions while the "unexpected" risk should be covered by capital requirements.

9.3.57. At the same time, one could argue though that there is no need to have two different mechanisms to cover against risk. In this view the "total risk" should be taken into account when calculating capital requirements. A risk margin as part of technical provisions would then not be required.

9.3.58. Note that the level of security would be the same, irrespective of having a risk margin as part of technical provisions or not, if the level of security was still determined by measuring the overall levels of risk.

Separate valuation of the best estimate and the risk margin if cash flows cannot be replicated reliably (making the risk margin explicit)

9.3.59. According to the current IORP Directive the assumptions used when calculating technical provisions have to be chosen taking into account an appropriate margin for adverse deviation. There is no explicit requirement of a

separate calculation of a best estimate and a risk margin within the technical provisions. This means that there could be an explicit or an implicit risk margin.

- 9.3.60. In Solvency II the separate calculation of best estimate and risk margin comes naturally because these two components of technical provisions have no direct interconnection. If there is a reliable market value observable for financial instruments that can be used to replicate technical provisions or the underlying cash-flows respectively a separate valuation is not necessary. In all other cases Solvency II requires an explicit risk margin.
- 9.3.61. If the decision was made to have a risk margin as part of technical provisions then there should be a separate valuation of best estimate and risk margin, irrespective of the method of calculation of the risk margin. This would mean that the risk margin would in all cases be explicit which would lead to more transparency and comparability.
- 9.3.62. If the decision was made to have no risk margin as part of technical provisions then the issue of separate valuation doesn't arise. In this case Article 77 (4) subparagraph 1 would have to be deleted.
- 9.3.63. Therefore the necessary amendments to the Solvency II-Directive as regards this issue can be derived immediately from the choice of the option regarding the existence and method of calculation of the risk margin.
- 9.3.64. Article 77 (4) subparagraph 2 of Solvency II can be adopted without amendment, again subject to the decisions taken regarding the starting principles for valuing technical provisions.

#### Definition of relevant cash-flows when calculating technical provisions

- 9.3.65. According to Article 77 (2) of Solvency II the best estimate shall correspond to the probability-weighted average of future cash-flows. The cash-flow projection used in the calculation of the best estimate shall take account of all cash in- and out-flows required to settle the obligations. Which cash-flows have to be considered is described in more detail in Article 78 of the Solvency II-Directive.
- 9.3.66. In Level 2-Measures of Solvency II contract boundaries are defined to clarify even further which cash-flows exactly have to be taken into account. The basic idea is that whenever risks can arise from future cash-flows and the undertaking has no unilateral right to reject the cash-flows and with it the corresponding risks then these cash-flows have to be taken into account.
- 9.3.67. This basic idea is also appropriate for IORPs. In practice, though, there may be a greater variety of factors influencing contract boundaries in the field of IORPs than in the field of (life) insurance, depending on the type of obligations of the pension plan and social and labour law.
- 9.3.68. There are IORPs whose payments of benefits are based on contracts or pension promises which are quite similar to a typical life insurance contract, in which the contractual commitments are based on the assumption that all future premiums are pre-defined and contractual, with no possibility of their

cessation. For these IORPs, as a general rule, all future cash in- and out-flows need to be taken into account.

- 9.3.69. There are also IORPs in which benefits are only accrued if and when contributions are paid and where future contributions are voluntary or subject to cessation. In this case, as a general rule, only the cash in- and out-flows that are related to the accrued benefits need to be taken into account. There may be exemptions to these general rules, depending on whether risks can arise to the IORP from future cash-flows.
- 9.3.70. Another issue which has to be considered is the treatment of future salary increases and/or inflation.
- 9.3.71. If the amount of the accrued pension right is not nominal, but linked to some feature which might change in the future (like the average income in the last x years before retirement) or is subject to indexation (with the exception of discretionary indexation) or inflation adjustment and there is no possibility of cessation then this should be reflected by considering accordingly adjusted future cash-flows when calculating technical provisions.
- 9.3.72. If an IORP is only obliged to pay nominal benefits then an adjustment of future expected cash-flows is not necessary or even appropriate.
- 9.3.73. If all the factors mentioned above are taken into account properly, in particular when setting the rules for the determination of contract boundaries, then the existing principle of determining the relevant cash-flows of Article 77 can also be applied to the calculation of technical provisions of IORPs.

#### Gross calculation of best estimate

- 9.3.74. According to Article 77 (2) subparagraph 4 of Solvency II the best estimate shall be calculated gross, without deduction of the amounts recoverable from reinsurance contracts and special purpose vehicles.
- 9.3.75. The principle seems to be fully acceptable for IORPs. Depending on the choices made regarding the inclusion of a risk margin the expression "best estimate" may have to be replaced by "technical provisions".
- 9.3.76. This approach is also compatible with the representation in the IORP's balance sheet of the amounts of recoverables from (re)insurance contracts as financial assets (see the introductory chapter to CfA 5 and 6).

#### Use of a risk free interest rate when calculating the best estimate

- 9.3.77. There are broadly two distinct approaches under the current IORP Directive for choosing the maximum interest rate used when valuing the liabilities of IORPs, both of which have some technical and policy reasoning behind them. These are:
- a. To use an approach that matches the estimated asset returns against the expected cash flows of the IORP (which includes in particular the possibility of maintaining Article 15(4) of the IORP Directive);

- b. To use a market-consistent approach where liabilities are measured objectively using "risk-free" interest rates consistent with information provided by financial markets, which is consistent with the current IORP Directive and with the Solvency II principles.

9.3.78. Some find that, where IORPs provide the guarantee (as opposed to the sponsors), a market consistent approach to valuing liabilities is appropriate and allows for transparency and transferability across IORPs and also between IORPs and insurance undertakings.

9.3.79. However, there are also views that, where sponsors bear the risks, the focus should be more on the financing of the liability and discounting using a prudent assessment of the expected investment returns on an IORP specific basis, i.e. an element of risk can be introduced to the technical provisions, taking a prudent view of the security offered outside of the IORP.

9.3.80. Others feel that the use of a market consistent approach for the valuation of liabilities should not related to the question whether or not the IORP or sponsor bears the risks. Instead, it is the nature of the liability (security level) that should be reflected in the valuation. Pension schemes offering similar levels of security are to be valued consistently, e.g. through the application of a similar discount rate. The application of a risk free term structure of interest rates for discounting is consistent with the unconditional character of future pension payments.

9.3.81. The main arguments supporting the approach of calculating the best estimate with a market consistent risk-free interest rate are:

- a. The valuation of liabilities reflects the character of the pension scheme (the level of security that is provided by the contract). In this respect, it should be noted that for a DC scheme a stochastic, risk-neutral valuation – i.e. the probability weighted average of future cash flows - using the risk-free interest rate is equivalent to a deterministic valuation using the expected return on assets reflecting that future pay-outs are subject to uncertainty.
- b. IORPs providing defined benefit schemes operate in the same market as many life insurance undertakings. There are positive experiences in some countries with having regulations that require IORPs to calculate technical provisions in the same way as life insurers.
- c. Market consistent valuation of both assets and liabilities allows for transparency regarding the financial position of IORPs and enhances risk management from an ALM perspective.

9.3.82. The main reasons arguing against the approach of calculating technical provisions with a market consistent risk-free interest rate are:

- a. The suggested approach does not allow consideration to be taken of the investment policy specific to the IORP, which is permitted in the existing Directive.
- b. A market-consistent valuation generally leads to a high volatility of results. This would be the case especially for IORPs with their very long-

term nature which often leads to a large mismatch between assets and liabilities. Such volatility could be addressed by appropriate risk management (e.g. hedging) or by absorbing volatility by using lengthy recovery periods or in policy responses (see e.g. the OECD paper on counter-cyclical funding rules). It has to be noted though that hedging is not always possible for very long guarantees as is the case for IORPs.

- c. There is the risk of all IORPs reacting to changes in the risk-free interest rate at the same time and in the same way in adverse situations. This would increase the risk of pro-cyclical effects. IORPs can serve as a stabilizer for markets if they are not regulated in a way that causes pro-cyclical effects. This issue is partly dealt with in Solvency II by applying a counter-cyclical premium and through policy responses.
- d. The introduction of a risk-free interest rate may result in higher allocations to risk-free bonds. This would lower expected returns and decrease expected benefits or increase contribution rates. Of course, at the same time, as there is a risk-return trade-off, it would also reduce uncertainty for sponsors and plan members. The shift away from assets such as listed equities, private equity, real estate and infrastructure could also have wider economic consequences by raising capital costs and reducing investments.

9.3.83. IORPs usually provide long-term guarantees. Therefore, if the approach of using a risk-free interest rate was followed, the same issues would have to be considered when determining the risk-free interest rate for life insurance undertakings providing long-term guarantees. Since long-term guarantees are much more common for IORPs, this specificity should be taken into account in an amended IORP Directive if the risk-free interest rate approach was taken.

9.3.84. The CEIOPS SSC Survey on fully funded, technical provisions and security mechanisms in the European occupational pension sector finds that the security provided to beneficiaries is lower when schemes make a prudent allowance for the expected returns on assets held by the IORP when setting the discount rate, unless greater emphasis is then placed on other security mechanisms. The discount rate that is applied should be consistent with the inclusion of security mechanisms in the holistic balance sheet framework.

9.3.85. Taking a holistic view of the balance sheet there may be mileage in investigating options where potential checks and balances could be found in other areas to provide an overall picture whereby all IORPs could find an appropriate solution based on the principles and presentation of the balance sheet from Solvency II and also the principles and practice from the IORP Directive.

9.3.86. The following approach tries to reconcile the two approaches described above by introducing two different levels of technical provisions within the best estimate of technical provisions:

- a. Level A technical provisions would be fully harmonized and calculated using a risk-free interest rate. This level of best estimate of technical provisions would also be the basis for the calculation of risk margin and capital requirements.

- b. Level B technical provisions could be calculated in different ways to be defined in detail on Level 2. One possibility would be to use an interest rate based on the expected return on assets.

9.3.87. The main reasoning for introducing two different levels of technical provisions would be to connect with these different levels different funding rules and different supervisory responses to deal with possible underfunding related to the respective levels of technical provisions.

9.3.88. Level A technical provisions would have to be calculated by all IORPs in all Member States in the same way. This would lead to transparency and comparability between Member States as well as different types of IORPs. Capital requirements would also have to be calculated by all IORPs in all Member States based on Level A technical provisions. This would see to a harmonized level of security across Member States and types of IORPs.

9.3.89. Different approaches are conceivable as regards Level B technical provisions:

- a. Level B technical provisions could be calculated based on the expected return on assets. Assuming that the expected return on actual assets is not risk free, the interest rate used in this case would be higher than the risk free rate and Level B technical provisions would therefore be lower than Level A technical provisions. The difference between the two levels would correspond to the risk which would have to be covered for example by sponsor support.
- b. Other possibilities are to have a fixed, but not risk-free, interest rate curve, to have more or less detailed rules how to derive an interest rate based on the financial assets of the IORP or other assets, e. g. high quality bonds, or to have an interval in which Member States could set Level B interest rates.

9.3.90. There could be different funding rules connected with the two levels of technical provisions. For example it could be stipulated that only Level B technical provisions would have to be covered with financial assets while the remaining part of technical provisions and capital requirements could in principle be covered with other assets, like sponsor support. Length and other modalities of recovery plans could also be different depending on whether there is an underfunding of the respective levels of technical provisions.

9.3.91. This approach has various advantages in terms of flexibility. Level 2 measures could allow for different methods of calculating the interest rate for Level B technical provisions which could to different degrees be Member State-specific.

9.3.92. There is also the possibility to start with Level B technical provisions which are harmonized only to a small extent, allowing to take into account the specificities of IORPs in different Member States, and then, gradually over time, converge to a higher level of harmonization.

## **Policy options**

### Existence and method of calculation of a risk margin

9.3.93. The following policy options can be identified for the calculation of the risk margin in the valuation of the technical provisions:

Option 1: Explicit risk margin in technical provisions calculated according to the IORP Directive

- 9.3.94. According to this option the risk margin is not related to the concept of transfer value/cost of capital, but to the risk of adverse deviations from assumptions. This option assumes that the best estimate part of technical provisions forms the basis for the calculation of the risk margin.
- 9.3.95. While according to the current IORP Directive the risk margin could be implicitly part of technical provisions, this option would require an explicit calculation of a risk margin for adverse deviation.
- 9.3.96. Assuming that there would also be capital requirements on top of the technical provisions, the role of the risk margin on the one hand and the role of the capital requirements on the other hand need to be clarified in order to avoid ambiguity.
- 9.3.97. The degree of security in the sense of providing a margin for adverse deviation within technical provisions relative to a realistic best estimate needs to be specified in order to separate both and to allow for consistent application of a holistic balance sheet framework and security mechanisms in different Member States. Otherwise, technical provisions in different Member States would become incomparable.
- 9.3.98. This option is only valid if the choice is made to maintain the existing approach of the IORP Directive to establishing technical provisions. This means that there is an interconnection with the options presented regarding Articles 75 and 76.
- 9.3.99. This option is quite appropriate within an "ongoing" vision of the solvency of the IORP assuming transfer of liabilities does not take place. The level of technical provisions could turn out to be insufficient to transfer the acquired pensions to another pension vehicle (IORP or insurance company) if such a transfer were to take place.

Option 2: Risk margin in technical provisions calculated according to Solvency II

- 9.3.100. According to this option, the risk margin is related to the concept of transfer of liabilities and the cost of capital. This option assumes that the best estimate part of technical provisions is also calculated according to Solvency II.
- 9.3.101. This option is only valid if the choice is made to use the option of having a Solvency II-like, market-consistent approach to the calculation of technical provisions. This means that the choice of this option is related to the options presented in connection with Articles 75 and 76.

Option 3: Best estimate calculated according to Solvency II and no risk margin in technical provisions

9.3.102. According to this option the risk of adverse deviation would be taken into account in the capital requirements only. Just like in option 1 there would be no allowance for the cost of capital.

#### Comparison of policy options

9.3.103. There is no agreed approach and no single most preferred option.

#### Use of a risk free interest rate when calculating the best estimate

##### Option 1: Maintain the current rules of the IORP Directive

9.3.104. Do not amend the IORP Directive as far as the determination of the interest rate used for the calculation of technical provisions is concerned.

##### Option 2: Risk-free interest rate

9.3.105. Use a risk-free interest rate for the calculation of the best estimate part of technical provisions taking into account the nature of the liabilities of IORPs.

##### Option 3: Approach with two discount rates/levels of technical provisions

9.3.106. Introduce two different levels of technical provisions: Level A using a fully harmonised risk-free rate and Level B based on minimum funding level such as by using the expected return on assets.

#### Comparison of policy options

9.3.107. There is no agreed approach and no single most preferred option. However, option 1 is not compatible with the Commission's objective for a harmonised approach, therefore it is not included in EIOPA advice.

#### **Specific Call for Advice**

The material elements of Article 78 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.

#### **EIOPA view on issues in the CfA**

9.3.108. Article 78 of Solvency II prescribes that technical provisions should include all expenses to be incurred in servicing the obligations (1), including an allowance for inflation (2). Sub item (3) says that all 'expected' payments to beneficiaries including any future discretionary payments whether or not guaranteed should be included within the technical provisions (unless they are considered surplus funds).

## Expenses

- 9.3.109. EIOPA agrees that expenses need to be taken into account in technical provisions to the extent that these refer to the (future servicing of) current pension promises. It is noted that, depending on the contract, the costs related to future accruals should not be considered.
- 9.3.110. Further elaboration on Level 2 is needed to determine which assets would be adequate to cover for technical provisions related to future expenses in the holistic balance sheet. Sponsor covenants covering these costs might be eligible. Where the sponsor assumes risk, the sponsor remains liable for the duration of the pension obligation, so there may be less reason to impose upfront financing of future costs with financial assets.

## All future expected payments

- 9.3.111. There is agreement within EIOPA that three tiers of benefits can be distinguished:
- a. Unconditional benefits – these are benefits that are in principle guaranteed under all circumstances (but could be reduced in very extreme circumstances that are beyond the security level associated with a “guarantee”, cf. 99,5% under Solvency II).
  - b. Conditional benefits – these benefits are granted based on certain “objective” conditions. These, for example, include benefits subject to adjustment mechanisms that are concluded beforehand, when the pension liability is transferred to or taken over by the IORP, and which are based on a contract which includes a precisely described mechanism in which circumstances and to which extent benefits will be adjusted.
  - c. Discretionary benefits – these are only granted based on a “subjective” decision making process by the IORP.
- 9.3.112. The Solvency II Directive does not distinguish between conditional benefits and (pure) discretionary benefits. (Conditional) benefits that are linked to “objective” conditions are referred to as discretionary in Solvency II. Under Article 78(3) of the Solvency II Directive all payments to policy holders and beneficiaries, including future discretionary bonuses, which insurance and reinsurance undertakings expect to make, whether or not those payments are contractually guaranteed, unless those payments fall under Article 91(2), shall be taken into account when calculating technical provisions.
- 9.3.113. A key question is how “expectation” should be interpreted and assessed in the context of IORPs. The inclusion of conditional and/or discretionary benefits on the holistic balance sheet might be considered consistent with the requirement of article 78(3) if the valuation of these benefits is to be regarded as an “expectation”. The exclusion of (pure) discretionary benefits might also be consistent with this article if there is no ex ante expectation regarding these payments. In line with the CEIOPS advice for level 2 implementing measures, a distinction between conditional discretionary benefits and pure discretionary benefits could be considered.

- 9.3.114. Other questions regarding the interpretation of “expectation” relate to the treatment of future salary increases for pension plans based on final salary and future accrual of new benefits. Whether these are to be included in technical provisions and to what extent depends on the contract and any revision of the IORP Directive should further specify the principles of the definition of discretionary benefits.
- 9.3.115. EIOPA’s view is that one part of the technical provisions should consist of the unconditional and another part of the conditional benefits.
- 9.3.116. Conditional and discretionary benefits should be distinguished from unconditional benefits. Full application of a harmonised security level should focus on the unconditional benefits. Conditional and discretionary benefits are uncertain by definition. Therefore, the latter are to be identified separately from the unconditional benefits and their character needs to be adequately reflected in the prudential framework.
- 9.3.117. However, there is no consensus regarding the classification of benefits as pure discretionary and the treatment of discretionary benefits within the holistic balance sheet approach.
- 9.3.118. On discretionary benefits that are to be decided periodically by the board/sponsor there are different views. One view follows the legal commitment perspective in which there is no obligation to provide the discretionary benefits. From this perspective these benefits are to be considered pure discretionary and should not be included in the technical provisions. Including them in the technical provisions would be irreconcilable with their discretionary character. It would demand ex ante quantification and formalisation of discretionary decisions, which given the discretionary character, would not be possible or at least be extremely difficult. Any attempt would require subjective assumptions regarding the future decision making process. Moreover, formalisation of the decision making process would change the nature of the benefits and would de facto give them a conditional character. Such formalisation and the inclusion of these benefits in the technical provisions could create unrealistic expectations with beneficiaries.
- 9.3.119. It was noted though, that a reflection of pure discretionary benefits in the prudential framework would be desirable. There are cases where these benefits reflect a soft or target promise or an ambition. Where the ambition is an important part of the pension promise it, should be subject to some form of supervisory oversight. Application of full solvency requirements on discretionary benefits could, however, discourage such ambitions. Instead, for the conditional and discretionary benefits, long-term consistency between the ambition, the financing and the realisation of indexations should be required. For example, in the Dutch supervisory framework IORPs are required to demonstrate this consistency on the basis of a stochastic long term continuity analysis. The ambition would need to be feasible under normal circumstances. Where applicable, such a “consistency test” could be part of the ORSA in pillar 2. In addition, the discretionary character of and the uncertainty regarding the benefits must be communicated to the members and beneficiaries.

- 9.3.120. In practice, depending on the legal system and case law, whether benefits classify as pure discretionary may not solely depend on the formal legal commitment where there is a recurrent practice to provide these benefits. There may be circumstances that can contribute to a situation in which a formally discretionary benefit payment is legally no longer considered discretionary, e.g.:
- a. When there is a limitative description of elements that will be taken into consideration when making discretionary decisions, the occurrence of such elements could lead to legally enforceable benefits.
  - b. When communication to members or beneficiaries is not adequately mention the discretionary character and uncertainty in relation to these benefits.
  - c. When, despite the discretionary character of benefits, a certain policy of indexation is consistently followed.
- 9.3.121. In case of legal action from members against an IORP, the discretionary character might not hold in court. As such, in order for benefits to be truly discretionary requires adequate policy, communication and supervision.
- 9.3.122. Another issue regarding the classification of discretionary benefits relates to the treatment of benefit adjustment mechanisms (ex post discretionary agreement to reduce benefits under social and labour law). Since these benefits are not unconditional, they should not be fully classified in the technical provisions as such. The question is to what extent such benefits would qualify as discretionary. It could be argued from a legal and social and labour law point of view that if the benefits can be reduced in full by a discretionary decision, they would as a whole qualify as discretionary. However, from a mathematical perspective, since there would still be a (lower) confidence level, which would be secured by the existing security mechanisms (such as capital buffers), the reduction of rights would be subject to certain boundaries. Relative to unconditional benefits, the potential reduction of benefits only sees to the part that is needed to fill the gap between the confidence level reflecting full guarantees (say 99.5%) and the lower confidence level that is specified in social and labour law. Nevertheless, this essentially splits up existing benefits in two components. While this could be possible mathematically, it might require the legal rewriting of existing contracts. Without such rewriting it would lead to supervision on a type of benefit that might not exist legally. EIOPA did not assess the legal consequences of such a proposal. Under such an approach, additional considerations regarding the eligibility of assets to cover for the SCR could also be relevant. A question was raised regarding ring fencing in the case that benefits are not fully classified in the technical provisions and, as a result, there would be excess assets over liabilities after covering the SCR. Could these excess funds be used to cover the SCR of other products?
- 9.3.123. The boundaries of what constitutes (pure) discretionary benefits would need to be further developed.
- 9.3.124. Another view is that discretionary benefits should be included in the technical provisions considering a best estimate based on probability weighted cash flows of those benefits being provided in the future. It was

argued that if, under realistic economic scenarios, it is to be expected that discretionary benefits will be paid, these should be taken into account. The technical provisions should present an overall view of all benefits that are to be expected.

- 9.3.125. It was also mentioned that discretionary benefits may be related to the concept of "surplus funds", which, under Article 91 of Solvency II and subject to authorisation in national law, shall not be considered as insurance liabilities but are included on the balance sheet as part of basic own funds. Surplus funds are profits that in future years are to be transferred to policy holders, but could be held back by the insurer. They are reflected on the balance sheet under Solvency II, though not as technical provisions, but as part of basic own funds. Although surplus funds formally may be a liability according to local GAAP, in so far as authorised under national law, they shall not be considered as insurance and reinsurance liabilities to the extent that they fulfil the criteria set out in Article 94(1) of Solvency II Directive. To this extent surplus funds are part of basic own funds. It was noted by a number of Member States that this principle of Solvency II should also be applied to IORPs.
- 9.3.126. The question was raised whether the nature of surplus funds matches with the character of discretionary benefits or would be better classified as conditional benefits since surplus funds are to be paid to the beneficiaries, albeit in later years (although there are discretionary elements). When surplus funds are to be included in the technical provisions, there should also be an offsetting allowance for risk reduction.

## **Policy options**

### Expenses

Option 1: Adapt the text of Article 78 regarding future expenses in a revised IORP directive.

- 9.3.127. EIOPA is of the view that the text of Article 78 regarding future expenses is to be adapted in a revised IORP directive.

### All future expected payments

In EIOPA's view non-discretionary benefits (unconditional as well as conditional benefits) should be included in the best estimate of technical provisions. Regarding discretionary benefits three options are distinguished:

#### Option 1: Not to include discretionary benefits in the technical provisions

- 9.3.128. Discretionary benefits would not be part of the technical provisions. Where applicable, the indexation ambition would be subject to prudential oversight, e.g. through a long term consistency test as part of ORSA.

#### Option 2: To include discretionary benefits in the technical provisions

- 9.3.129. Discretionary benefits would be part of the technical provisions. This implies these benefits will be used as a risk mitigating technique in the calculation

of the SCR. A complementary consistency test could be considered, where applicable.

Option 3: Include discretionary benefits in technical provisions with the exception of surplus funds.

9.3.130. Within discretionary benefits further distinction can be made between surplus funds and other future discretionary benefits.

- Surplus funds shall be deemed to be accumulated profits which have not been made available for distribution to policy holders and beneficiaries (Art. 91(1) of the Solvency II directive). If and when surplus funds, as defined above, fulfil the requirements of availability and loss absorbing capacity of Tier 1 own funds items, as described in Article 93 of the Solvency II Directive, they shall be excluded from the calculation of technical provisions, and will therefore become part of the excess of assets over liabilities (in the meaning of the "holistic balance sheet"). Adjustments to the definition of surplus funds should be possible to allow for the specificities of IORPs.

Comparison of options / Conclusion

9.3.131. EIOPA considers option 3 that allows for the recognition of surplus funds to be a more advanced version of option 2. Therefore option 2 is excluded from the EIOPA advice.

**Specific Call for Advice**

The material elements of Article 79 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.

**EIOPA view on issues in the CfA**

9.3.132. The text of Article 79 prescribes that, when calculating technical provisions, allowance should be made for financial guarantees and contractual options that are available to policy holders to exercise.

9.3.133. It is essential that any financial guarantees included within insurance contracts are taken into account in the valuation of the technical provisions, since they have a direct impact on the expected cash flows of the insurer. This principle is equally true for IORPs which guarantee either an investment performance or a given level of benefits and this is already dealt with by Article 15(2) of the IORP Directive. Article 15(2) also states that any cover against biometric risks should be included within the technical provisions. This could also be read as a financial guarantee, i.e. payments are guaranteed for the lifetime of the members and beneficiaries. It is therefore appropriate that such a requirement should continue and the text in Solvency II in relation to this can be seen as applicable.

9.3.134. Taking account of contractual options open to policy holders is also an important element for insurers since policy holder behaviour in this respect

can impact positively or negatively on the cash flows of the insurer. It is therefore appropriate that insurers make realistic assumptions in this regard based on current and credible information as required by the article.

- 9.3.135. Members and beneficiaries of IORPs may also have certain options available to them throughout their membership of a scheme. For example, options can include exchanging guaranteed lifetime payments for a one off lump sum payment (normally within set limits) or choosing to exchange future pension increases for a one off lump sum payment or a greater non-increased annual payment. Members may also choose to cease membership of the scheme which may trigger certain consequences such as a giving up of benefits to certain level or a change in the nature of the benefits.
- 9.3.136. To the extent that members and beneficiaries may exercise options that have an impact on the overall cash flows of an IORP, it is also necessary that IORPs make some assumptions about what options are chosen.
- 9.3.137. It may be that differing options are actuarially equivalent (or very similar) and so would have only a minor or negligible effect on the value of the technical provisions. It is also possible that the number and nature of the options available to members and beneficiaries may have a negligible effect on the overall technical provisions or be prudent not to take them into account. Therefore, it is important that proportionality is taken into account, in the level of detail that would be required in this respect (including the ability to not take them into account if it is prudent to do so) especially since this could be a complex exercise with limited overall gain.
- 9.3.138. EIOPA therefore agrees with the applicability of this Article to IORPs with only minor changes to ensure the text reflects IORPs rather than insurance.

### **Policy options**

Option 1: Include the text of Article 79 of Solvency II in a revised IORP Directive with minor changes to reflect IORPs.

### **Specific Call for Advice**

The material elements of Article 80 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.

### **EIOPA view on issues in the CfA**

- 9.3.139. The text of Article 80 in Solvency II requires insurers to ensure appropriate segmentation of risk groups when calculating their technical provisions. This can be seen as important given the variety and breadth of different types of risks that insurers may cover varying across life and non-life insurance.
- 9.3.140. For IORPs, this Article could be applicable if the IORP is covering against risks. Where the sponsoring undertaking bears the risks, the IORP is still required to ensure that it has appropriate technical provisions covering against its financial commitments and so the same situation applies.

- 9.3.141. Segmentation in risk groups is relevant where an IORP provides various occupational pension schemes to different plan members or where risks are borne to a different degree by sponsor(s) and or the institution itself. It would be necessary to ensure that proper account was taken of the differing natures of these commitments and risks in setting the technical provisions.
- 9.3.142. It may also be the case that an IORP operates schemes across borders and there are differing social and labour laws of host Member States to take account of. In this respect, it would be appropriate for IORPs to segment their business and ensure compliance across the range of schemes.
- 9.3.143. Therefore some changes to the text would be required to better reflect the nature of the risks for IORPs but the principle of Article 80 is appropriate. Implementation of the article should in any case be subject to materiality and proportionality. The nature of any relevant and required segmentation may be an issue for Level 2 to avoid any confusion over the requirements in this respect.
- 9.3.144. However, Article 15 of the IORP Directive requires IORPs to establish technical provisions in respect of the total range of schemes corresponding to the financial commitments. It could be argued that this text sufficiently covers the requirement for IORPs to take into account fully the nature of all the schemes under their operation. Therefore additional text is not required in this regard.

### **Policy options**

Option 1: Include the text of Article 80 of Solvency II in a revised IORP Directive with minor changes to reflect IORPs.

Option 2: Given that Article 15 of the IORP is sufficient for the purposes of Article 80 of Solvency II, do not include text of Article 80 into a revised IORP Directive.

### Comparison of policy options

- 9.3.145. EIOPA is of the view that option 1 can be included at little costs as it is meaningless for most IORPs and provided it is implemented in a proportional manner. Therefore option 2 is excluded from the EIOPA advice.

### **Specific Call for Advice**

The material elements of Article 81 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions

### **EIOPA view on issues in the CfA**

- 9.3.146. Article 81 of the Solvency II Directive requires that the amounts recoverable from reinsurance contracts and special purpose vehicles (SPVs) are calculated according to the following criteria:

- a. the amounts to be recovered from reinsurance contracts and SPVs shall follow the same principles as for the calculation of the technical provisions (complying with Articles 76 to 80);
- b. allowance should be made for time differences between the recoveries and the direct payments;
- c. allowance should be made for counterparty credit risk.

- 9.3.147. In Solvency II technical provisions should be calculated gross without the deduction of the amounts recoverable from reinsurance contracts and special purpose vehicles (Article 77 (2) subparagraph 4). The calculation of these amounts should follow the same principles set for the calculation of the technical provisions with specific adjustments to take into account the expected losses due to the default of the counterparty. In Solvency II recoverables have to be shown on the asset side of the balance sheet.
- 9.3.148. While recoverables from reinsurance contracts and special purpose vehicles are central issues for insurers. Many IORPs - depending on the structure of the supplementary pension system in each Member States – make use of reinsurance contracts, for instance to cover for longevity and mortality risk in providing annuities. Special purpose vehicles will have less importance for IORPs. It is not clear whether the utilization of special purpose vehicles as risk transferring mechanisms are allowed for pension schemes as they are currently subject to specific requirements by the Solvency II Directive (see Article 211).
- 9.3.149. As discussed in the response to the CfA on Article 77, EIOPA is of the view that technical provisions should be calculated gross of the amount of recoverables from reinsurance contracts. This approach is also compatible with the representation in the IORP's balance sheet of the amounts of recoverables from (re)insurance contracts as financial assets (see the introductory chapter to CfA 5 and 6).
- 9.3.150. The issue of the criteria to establish those amounts is related to the calculation of technical provisions. In case the technical provisions of IORPs are established according to the same criteria as in Solvency II then also the application of Article 81 can be considered to be acceptable.
- 9.3.151. The valuation of recoverables from insurance contract may be complex when using option valuation techniques and – if appropriate – should be able to be avoided by allowing for simplifications. The estimation of counterparty default risk may be burdensome as well. In that respect, solvency ratios instead of credit rating could be used to insurers' credit risk, which would also be beneficial in preventing systemic risks.
- 9.3.152. Some Member States point out that the level of detail of this article is not appropriate for IORPs. Therefore it could be sufficient to clarify that recoverables from (re)insurance contracts and SPVs should be calculated separately from technical provisions. The calculation of these amounts should comply with articles 76 to 80 of the Solvency II Directive. The criteria for establishing these amounts could instead be better dealt with in the Level 2 implementing measures.

## Policy options

### Option 1: Not to include art. 81 in the IORP II but incorporate its principles in the calculation of technical provisions

9.3.153. This option suggests not including Article 81 in the IORP Directive. However, it would be required to clarify that recoverables from (re)insurance contracts and SPVs should be calculated separately from technical provisions and that the calculation of these amounts should comply with articles 76 to 80 of the Solvency II Directive. Details for these calculations would be addressed in the Level 2 implementing measures.

### Option 2: Application of Article 81 of the Solvency II Directive to IORPs

9.3.154. This option considers introducing Article 81 of Solvency II into the IORP Directive with minor amendments in order to address specificities of IORPs.

### Comparison of policy options

9.3.155. EIOPA considers that the practical requirements for IORPs will not be much different in option 2 as compared to option 1 when allowing for appropriate simplifications. Therefore, and to ensure consistency with Solvency II, option 1 is not included in the advice.

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### **Specific Call for Advice**

The material elements of Article 82 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions. This should include advice on the circumstances under which approximations in the calculation of the best estimate should be allowed;

### **EIOPA view on issues in the CfA**

9.3.156. Article 82 requires insurance companies to ensure, as a general principle, that accurate data are available for calculating technical provisions. Where, in specific circumstances, insufficient data are available, appropriate approximations may be used to calculate the best estimate, including case-by-case approaches.

9.3.157. In general, there is consensus on the applicability of this article to IORPs. In particular, when the data available may not be fully appropriate, accurate and complete, due to several reasons such as the nature and the size of the liabilities, the utilization of approximations, including case-by-case approaches, allow IORPs to calculate the best estimate of the liabilities in a more sensible way. However, such approximations cannot be seen as alternatives to implementing adequate internal processes and procedures to ensure the appropriateness, completeness and accuracy of data.

9.3.158. Some amendments have to be introduced in order to stress proportional application of the article and to address specificities of IORPs, in particular regarding the calculation of technical provisions and the treatment of (re)insurance contracts. It might be necessary to identify the specific

circumstances in which these approximations can be applied in the level 2 implementing measures.

- 9.3.159. Some Member States commented that the principle of this article is already covered by the text of Article 15(4) of the IORP Directive.

### **Policy options**

#### Option 1: Introduce Article 82 of Solvency II

- 9.3.160. This option introduces Article 82 of the Solvency II Directive in the IORP Directive with minor amendments to address the specificities of IORPs. The identification of the specific circumstances in which these approximations could be applied can be addressed in the level 2 implementing measures.

### **Specific Call for Advice**

The material elements of Article 83 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.

### **EIOPA view on issues in the CfA**

- 9.3.161. Article 83 would require IORPs to have processes in place to ensure that best estimates and the assumptions underlying them are regularly compared against experience. And where the experience systematically deviates from the assumptions, appropriate adjustments are to be made.
- 9.3.162. In general, there is consensus on the applicability of this article for IORPs.
- 9.3.163. It is noted that such processes and procedures are to be proportionate to the nature, scale and complexities of the activities of IORPs, especially for small IORPs.
- 9.3.164. It is noted that the level of detail of the article may not be appropriate for application to IORPs, depending on whether prudence is to be included in the calculation of technical provisions. If so, the detail of the text may have to be amended. Comparison against experience should also take place, however. Even if technical provisions are calculated using a best estimate plus an additional safety margin (IORP Directive Article 15.4).

### **Policy options**

#### Option 1: Introduce Article 83 of Solvency II

### **Specific Call for Advice**

The material elements of Article 84 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.

### **EIOPA view on issues in the CfA**

- 9.3.165. Article 84 of Solvency II requires undertakings to demonstrate to the supervisor on request the appropriateness of the level of their technical provisions and the applicability of the methods used.
- 9.3.166. This power may be seen to already exist through Article 14 of the IORP Directive.
- 9.3.167. However, given that it is important from a supervisory perspective to be able to check these two elements this article seems to be fully applicable to IORPs as well and could be usefully explicitly stated. To avoid an unnecessary burden on IORP, it should be clarified that the article should be applied proportionally. In addition, "insurance and reinsurance undertakings" should be replaced by "IORPs".

### **Policy options**

Option 1: Introduce Article 84 of Solvency II into the IORP Directive

### **Specific Call for Advice**

The material elements of Article 85 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.

### **EIOPA view on issues in the CfA**

- 9.3.168. In the view of EIOPA supervisory authorities should have the power to require IORPs to increase the amount of technical provisions so that they correspond to the level determined by supervisory law.
- 9.3.169. Currently, the IORP Directive does not make explicit that supervisory authorities have the power to require the IORP to increase the amount of technical provisions. However, this power may be seen to already implicitly exist through Article 14 of the IORP Directive.
- 9.3.170. However, given that it is important from a supervisory perspective to be able to ensure IORPs set an appropriate level of technical provisions, this article seems to be fully applicable to IORPs as well and could be usefully explicitly stated. There is no need for specific amendments except for the replacement of "insurance and reinsurance undertakings" by "IORPs".
- 9.3.171. Of course, IOPRs should be able to apply to the courts to appeal the supervisor's decision – like any other decision in respect IORPs – to raise the level of technical provisions.

### **Specific Call for Advice**

The material elements of Article 86 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.

### **EIOPA view on issues in the CfA**

- 9.3.172. Article 86 of Solvency II calls upon the Commission to adopt implementing measures concerning several issues.
- 9.3.173. In the IORP Directive there are no provisions that require implementing measures to be adopted.
- 9.3.174. If – after a quantitative impact study and impact assessment - the decision was made to apply rules for calculating technical provisions and capital requirements for IORPs in the same or a similar way as for insurance undertakings then there would be the same need for implementing measures.
- 9.3.175. If – after a quantitative impact study and impact assessment - it was decided to have a greater level harmonisation of rules for calculation of technical provisions for IORPs, but with a different approach than that of Solvency II there would be a need for implementing measures, because greater harmonization would have to be accompanied by more detailed rules than in the current IORP Directive.
- 9.3.176. In both cases it would be of particular importance that these implementing measures provide for appropriate adjustments taking into account the concept of proportionality. It would also be advisable that implementing are established through an open process using a public consultation.
- 9.3.177. There can be no advice as to which implementing measures are needed as at this stage the future rules for the regulation of IORPs are not yet known.

### **Specific Call for Advice**

The need to maintain Article 15(5) of Directive 2003/41/EC;

### **EIOPA view on issues in the CfA**

- 9.3.178. The text of Article 15(5) allows Member States to impose additional rules in relation to the calculation of technical provisions with a view to ensuring the interests of members and beneficiaries are adequately protected.
- 9.3.179. This text allows Member States to take account of the fact that, in relation to technical provisions, the IORP Directive sets out only minimal requirements for their calculation and given the differing nature of IORPs across Member States it was necessary to allow Member States to impose additional rules reflecting these differing specificities.

- 9.3.180. At the current level of harmonization, it is necessary to continue to allow Member States to impose additional requirements. It may also be the case that given that there are significant differences in approach to IORPs across Europe, and is also in many cases enshrined in the Social and Labour Law of Member States, giving Member States freedom to impose additional rules is a useful tool to ensure adequate member protection even if the level of harmonization was significantly increased.
- 9.3.181. Allowing additional rules to be imposed prevents a maximum harmonization approach to the calculation of technical provisions and could therefore lead to differences in approach to this issue and prevent proper comparability of the technical provisions of IORPs across Member States. If the rules regarding the calculation of technical provisions follow a maximum harmonization approach and properly reflect the differing natures of IORPs across Member States, then the text of Article 15(5) is no longer required.
- 9.3.182. EIOPA is therefore of the view that if rules are developed to a sufficient degree of harmonization and reflect the nature of IORPs across Member States, this text should be deleted.

### **Policy options**

Option 1: No change to the current requirements.

Option 2: Delete Article 15(5)

### Comparison of options

There is no agreed approach and no single most preferred option. However, option 1 is not compatible with the Commission's objectives of a level of harmonisation that would not need additional requirements at the national level (as requested under 7.1 of the CfA).

### **Specific Call for Advice**

Advice on the feasibility to treat sponsor covenants like reinsurance contracts with due account for counterparty default risk.

### **EIOPA view on issues in the CfA**

- 9.3.183. In relation to the text of the CfA referring to sponsor support as similar to reinsurance, following communication with the Commission on this point, EIOPA are free to explore other methodologies for valuing the sponsor covenant i.e. EIOPA need not be restricted to valuing them as an asset similar to reinsurance.
- 9.3.184. This advice highlights the differing nature of sponsor support and provides options for how sponsor support should be taken into account in the prudential balance sheet of IORPs
- 9.3.185. The CfA also makes reference to how EIOPA should view sponsor covenants in two areas. Firstly, the possibility that having recourse to additional

contributions from members and/or sponsors acts as a risk mitigation mechanism, and implies that the covenant can then impact on the liability side. Secondly, in the same paragraph, recourse to a sponsor covenant is mentioned as an asset, although some aspects are noted as possibly being outside of the IORP balance sheet.

- 9.3.186. The ability for IORPs to call upon further support from sponsoring undertakings is one of the main and significant differences between the operation of insurance undertakings and IORPs. In practice, many MSs have allowed for this support within their legislation and supervisory frameworks. This is the case both in terms of impacting on the valuation of the liabilities but also in being able to rely on sponsors to provide support in the event of unmitigated risks materialising.
- 9.3.187. The CfA to EIOPA covers a wide range of issues and asks EIOPA to provide advice on how the support of a sponsor should be factored into a risk based supervisory framework for IORPs including the possibility for it to play a role on the liability and asset side of an IORPs balance sheet.
- 9.3.188. EIOPA is of the view that sponsor support can take many different forms. It is therefore appropriate to understand the nature of these different forms and types of sponsor support and ensure that they are appropriately taken into account in the development of a risk based supervisory framework.
- 9.3.189. EIOPA is also of the view that sponsor support should be considered for all types of IORPs and not only for those where the sponsor bears the risks completely. Sponsor support can also occur in IORPs that themselves provide guarantees to a certain degree.
- 9.3.190. Finally, EIOPA is of the view that it does not matter whether pension commitments are supported by contributions made by the employer or employees for their treatment in the prudential regime. The term sponsor support in this response may refer to contributions paid by the employer as well as active members.
- 9.3.191. In general, sponsor support is the ability of the sponsor or sponsors of the scheme to provide financial support to the scheme or the members when necessary. There are in effect four main forms of sponsor support.
- 9.3.192. Forms of sponsor support:
- A. Increases in contributions (on-going basis) – Providing ex-post security through sponsor support if the developments surrounding the pension benefits lead to situations of underfunding. This is usually made through an immediate injection of funds; increase in future contributions or the establishment of a specific recovery plan to eliminate the shortfall, usually with the agreement/approval of the supervisor, or through the change in the overall contribution level paid by employers and/or employees. There might be conditions and limits to the increases in contributions.
  - B. Subsidiary liability of the sponsor (on-going basis) – Support from the sponsor may come in the form of assuming directly the responsibility to

fulfil all or some of the pension commitments meaning that if the IORP is not able to fulfil the promise the employer can pay directly to the members and beneficiaries.

- C. Contingent assets of the sponsor (on-going and discontinuance basis) – In this instance, the IORP has a hold on assets of the employer for use by the IORP. These assets may be in the form of funds, possibly held in an escrow account or can be a call on other assets of the sponsor. They are not necessarily transferred into the IORP but can be appropriately identified from other assets of the sponsor and may flow to the IORP under a defined set of circumstances.
- D. Claims on the sponsor (discontinuance basis) – In the case of the scheme being discontinued or if the employer changes its legal form, requirements for sponsors to recover deficits in the IORP or if a new sponsor is present, the new sponsor to take on the obligations of the IORP.

- 9.3.193. Forms A & B differ in their approach in that in A, contributions from the sponsor flow to the IORP to repair any underfunding and allow the benefits to be paid as they fall due by the IORP whereas in B, if the IORP is unable to pay the benefits the sponsor assumes this responsibility directly. In practice it may not be necessary for forms A & B to be crystallised in all circumstances but the ability of the IORP to call on this support should still be recognised.
- 9.3.194. From the members' perspective there is little (no) difference between these two forms of sponsor support since they both rely on the sponsor to provide the security that members benefits will be paid. There may be some differences though in the interaction with other security mechanisms or if other security mechanisms operate before one of the types of sponsor support.
- 9.3.195. These forms of sponsor support could be included on the balance sheet of the IORP as an asset and act as a risk mitigation mechanism having a direct impact on the calculation of the risk based capital requirements.
- 9.3.196. If included as an asset, it would need to be valued in an appropriate way. This could be through arriving at a market value or using a model if there is not a suitable market by which to assess the expected support from the sponsor. One methodology for this could be achieved through looking at the expected cash flows of the sponsor and applying probability weighted amounts to what could be expected to flow into the scheme under normal (average) circumstances. This would be in line with the valuation principles of Solvency II.
- 9.3.197. This methodology for many IORPs would be a complex task and it may not be possible to arrive at a robust and accurate valuation of what support could be expected to flow to the IORP under various scenarios. It would therefore be important that the principle of proportionality is allowed for in these assessments and that approximations and more qualitative assessments to an appropriate degree of precision should be possible.

- 9.3.198. In addition, this type of support could be taken into account in calculating the risk based capital requirements, potentially reducing them to zero. This may be a more appropriate way to take account of the role the sponsor plays if a purely quantitative methodology for valuing the sponsor is not possible or not proportionate to the desired outcome.
- 9.3.199. The risk of default of the sponsor could be valued in an approximate way, perhaps by reference to yield spread (versus an equivalent risk-free instrument) available on bonds issued by the sponsor that have the same priority (on sponsor default) as the IORP has via the commitments that form the sponsor support. Another approach could be through the pricing of credit default swaps (CDS) that provide protection against the sponsor defaulting. Perhaps the most realistic and readily available will be through credit ratings supplied by relevant rating agencies.
- 9.3.200. In some Member States a government-mandated industry-wide protection arrangement exists that charges IORPs/sponsors premiums that depend on the deemed creditworthiness of the IORP sponsor. To provide comprehensive industry-wide coverage, these arrangements will necessarily have had to identify ways of assessing the creditworthiness of essentially all sponsors within their jurisdiction, even if in some cases a fall-back default assumption may be being relied upon. One way of accommodating sponsors where no other information is available would then be to revert in such circumstances to the creditworthiness implied by the premium rates payable to these industry-wide protection mechanisms
- 9.3.201. However, in jurisdictions without such industry-wide protection arrangements it may be necessary to require IORPs to carry out their own assessment of the creditworthiness of their sponsor, if the sponsor covenant would otherwise be material. Suitable safeguards may be needed to ensure that the IORP does not form an overly rosy picture of the financial strength of its sponsor. This is an example where issues around proportionality and simplifications may become particularly important.
- 9.3.202. Following the methodology of Solvency II, treating sponsor support as an asset in the IORP's balance sheet would automatically lead to its consideration in the SCR for IORPs that are required to hold assets against a SCR. By applying the risk-modules used for the calculation of the SCR one would assess the amount of further sponsor support exceeding the amount of the asset which was computed under average circumstances. These additional amounts could reduce the net SCR.
- 9.3.203. Form C operates in a different way to A & B. Depending on the type and nature of the contingent asset, it in theory operates in the same way as other assets held directly by the IORP although it may only take effect under prescribed circumstances. From the perspective of the IORP it has the same value and provides the same security as other assets and so it would seem appropriate to view it on the balance sheet and treat it in the same risk based manner.
- 9.3.204. It would though be appropriate to take into account the individual nature of each type of such contingent assets. For example to take into account the circumstances under which the scheme can acquire the asset and any restrictions to this as well as the quality of the asset itself. The level of

security or value of the contingent asset would need to be taken into account on case by case basis.

- 9.3.205. For example, these types of assets may only be available on default of the sponsor itself and so it would be appropriate for the IORP to take into account the impact of sponsor insolvency on the value of the asset provided.
- 9.3.206. Form D refers to the assets that would be available to the IORP on the event that the link between the IORP and the sponsor is broken. For example on discontinuance of the sponsor and/or IORP, or a change in the legal form of the sponsor. This element is key in understanding the level of security and support the sponsor could provide in the event that the link is broken and no future contributions would be payable.
- 9.3.207. This form of support is different in nature to A & B as it represents one-off payments which would flow to the IORP under prescribed scenarios, but in general likely to be situations of stress at that time for the sponsor. Forms A and B are more likely to be periodic payments from the sponsor when the IORP is underfunded, at times when the sponsor may or may not be stressed. Form D would place emphasis on the value of the sponsor on a break-up situation, whereas for Forms A and B the ongoing position of the sponsor is more important.
- 9.3.208. Taking into account all forms of sponsor support on the balance sheet of the IORP raises a question over whether and how much it should be allowed to be used by the IORP as an asset to cover its liabilities. For very strong sponsors, the value attached to it could be significant and if it was allowed to be fully recognised on the balance sheet of the IORP, it could result in the IORP requiring no further assets to be held. It is also important to ensure there is no double counting between the different forms of sponsor support (i.e. A to D).
- 9.3.209. It is therefore necessary to ensure that an appropriate methodology for classifying assets is in place taking into account the nature of the liabilities of the IORP and ensuring that reliance on certain assets is appropriate diversified. This may be achieved through Pillar 2 aspects of a revised supervisory framework for IORPs but it would be appropriate that the Level 1 text allows for this to be developed within Level 2 or Level 3.

#### Accessibility of sponsor support:

- 9.3.210. The “accessibility” of the sponsor support should be defined by reference to the type of legal/contractual/statutory obligation, in the sense that the IORP/members/ supervisory authority can/may force the sponsor to put in place one or more of the forms of sponsor support. The following classification will then be used to classify the accessibility of the protection.
- a. Unlimited support – the legal/contractual/statutory obligation corresponds to a full and automatic recourse to the sponsor support which usually is embedded in law, or be based on a contract, a declaration of commitment or a statute.

- b. Limited support – the legal/contractual/statutory obligation corresponds to an automatic recourse to the sponsor support but subject to certain contingencies usually stipulated as part of the contract between the IORP and the sponsor.
- c. No automatic recourse – The legal/contractual/statutory obligation does not correspond to an automatic recourse. IORPs have very limited or no automatic means to call on additional sponsor financing.

9.3.211. In valuing the availability of sponsor support as described above, it is necessary to take into account these 3 situations.

9.3.212. The “Default risk” should then be considered here in a wider sense, including the risk that the sponsor is able, but not willing to pay as required by any legal obligations. In essence, in valuing the sponsor support, account should be taken of both the ability of the sponsor to make any such payments (financial constraints) and also the ability of the IORP/supervisor to demand them (level of obligation).

9.3.213. If there is no legal or contractual obligation and therefore sponsor support is purely voluntary, then it would not be appropriate to assume that the sponsors’ available cash flows will be available to the IORP. In this case the IORP would need to make an assessment of the likelihood that sponsor support will be available. This could be achieved by putting in place an agreement between the IORP and the sponsor and, depending on the nature of this agreement, it could significantly increase the value that can be attached to the support.

## **Policy options**

### Option 1: Maintain the treatment of sponsor support of the current IORP Directive

9.3.214. This option would allow each Member State to take into account the value and risk-mitigating properties of sponsor support in their own way.

### Option 2: Value all forms of sponsor support as an asset on the balance sheet of the IORP and impacting on the calculation of the solvency capital requirements where these are required

9.3.215. This option allows for the support from the sponsor to be valued as an asset on the balance sheet of the IORP. Following the principles of Solvency II the change of the value of the asset when applying the risk modules would be considered in the calculation of the SCR.

### Option 3: Take account of sponsor support as impacting on the calculation of the technical provision and the capital requirements of the IORP where these are required

9.3.216. In this option the sponsor covenant plays a role in (i) the calculation of the technical provisions and (ii) acts as security mechanism in the case of adverse scenarios

9.3.217. In (i), the level of sponsor support could impact on the level of prudence that should be adopted when setting the actuarial assumptions for the

calculation of the technical provisions. Under this methodology, it would only be appropriate if technical provisions were calculated based on a prudent assessment of the expected return on assets, i.e. the level of prudence that should be adopted in the assumptions should correlate to the level of support that can be expected from the sponsor, therefore covering against the risk that the returns on the assets do not match the assumptions used.

- 9.3.218. In (ii), under stress scenarios the sponsor can provide support to the IORP. This would then act as a risk mitigation mechanism reducing the amount of any upfront capital that the IORP would be required to hold to cover against adverse scenario risks.

Option 4: Value all forms of sponsor support as an asset on the balance sheet of the IORP and impacting on the calculation of the technical provision and the capital requirements of the IORP where these are required

- 9.3.219. This option combines the two previous options to allow for appropriate forms of sponsor support to be recognised in the balance sheet of the IORP.

Option 5: Recognition of sponsor support as Ancillary Own Funds

- 9.3.220. One of the rationales for considering also the "ancillary own funds" option is that sponsor support meets the definition of Ancillary Own Funds as in Article 89 of the Solvency II Directive; indeed:

- 9.3.221. Sponsor support is not held by the IORP, but can be called up to meet funding requirements

- a. It constitutes a commitment received by the IORP
- b. As soon as the sponsor has paid its support contribution to the IORP, this contribution materialises in the IORP's balance sheet as an asset, and consequently increases the "excess of assets over liabilities" (basic own funds) of the IORP

- 9.3.222. With this option, sponsor support will not appear on the balance sheet (item 7 of the "holistic balance sheet" would disappear) nor on the SCR calculation. On the other hand, sponsor support would be recognised as an ancillary own funds item, potentially eligible for covering capital requirements (depending on the rules on tiering and eligibility of own funds). This option will result in a separate valuation for balance sheet items and SCR on the one hand, sponsor support on the other hand (while in other options all valuations are combined in a single calculation).

Comparison of policy options

- 9.3.223. EIOPA considers that option 2 is appropriate since it allows for full recognition of sponsor support both as an asset and as a risk mitigation mechanism. Option 1 is not consistent with the objective of the Commission's CfA to increase the level of harmonisation.

## **9.4. Impact assessment**

9.4.1. This section describes the potential impacts of the various options presented in the explanatory text regarding the valuation of assets, liabilities and technical provisions, such as the:

- Principles for the valuation of assets and liabilities
- Inclusion of a risk margin in technical provisions
- Discount rate used to establish the present value of future cash flows
- Treatment of conditional and discretionary benefits
- Inclusion of sponsor support in the holistic balance sheet

9.4.2. It should be emphasized that these are qualitative assessments, which are partial in nature. In practice the impacts of the various options will be very much related to other choices made within the holistic balance sheet framework. For example:

- The impact of a rise in technical provisions will - for some types of IORPs - depend on whether the value of future contributions (CfA 5) or even pension protection arrangements (CfA 6) may be included on the asset side of the balance sheet.
- A required level of technical provisions is meaningless without specifying funding rules. As is discussed in CfA 6, the required funding level depends on whether a risk-based solvency capital requirement is imposed and the confidence level that is applied.
- The options with extended recovery periods in CfA 6 may help to cushion the negative impacts of some other options or prevent a pro-cyclical impact of market valuation.

9.4.3. To arrive at a comprehensive impact assessment of the holistic balance sheet approach, it is essential to quantify the various elements to make them comparable. EIOPA will undertake such a quantitative impact study (QIS) of its advice in the coming months.

9.4.4. It should also be emphasised that the impact of the different elements of the holistic balance sheet proposal may vary substantially between Member States due to differences in existing occupational pension systems:

- The existing IORP Directive takes a minimum harmonisation approach and allows Member States to impose additional prudential regulation upon IORPs. This means that the impact of a revised IORP Directive will depend on national prudential regimes rather than the IORP Directive.
- Pension schemes typically provided by IORPs differ widely as well. The impact of a new solvency regime will depend crucially whether the risks are borne by plan members, the sponsor or the IORP itself.

## Principles for the valuation of assets and liabilities (Article 75)

### Valuation of assets

Option 1: Application of Article 75.1a to IORPs that assets should be valued on a market consistent basis

### Positive impacts

#### ➤ Members/beneficiaries

- Facilitates transparency regarding the current position of the IORP.

#### ➤ IORPs/sponsoring employers

- Idem.

#### ➤ Supervisory authorities

- Consistency with Solvency II framework
- Supervision based on market-consistent valuation emphasises the actual financial position and allows for realistic solvency monitoring. A system based on sound market-oriented valuation principles will reveal the true financial position of the IORP including a full understanding of all security mechanisms.

### Negative impacts

➤ Members/beneficiaries

- Not foreseen.

➤ IORPs/sponsoring employers

- Possibly high volatility in asset values. Such volatility could be (partially) addressed by appropriate risk management (e.g. hedging) or by absorbing volatility by using lengthy recovery periods or in policy responses (see e.g. the OECD paper on counter-cyclical funding rules).

➤ Supervisory authorities

- Not foreseen.

Valuation of liabilities

Option 1: Leave the IORP directive unchanged with regards to the transfer principle for technical provisions.

Option 2: Amend the current IORP Directive to state that the valuation of technical provisions should be done on a market consistent basis.

Positive impacts

Option 1: No impact

Option 2:

➤ Members/beneficiaries

- Facilitates transparency regarding the current position of the IORP.
- This would allow for a “fair” treatment of the remaining participants in the IORP if a part of the liabilities is transferred.

➤ IORPs/sponsoring employers

- Consistent valuation of assets and liabilities, which facilitates adequate risk management and ALM analysis.
- In case of the need to transfer (a part of) the acquired pensions to another pension vehicle (IORP or insurance company) there would be no problem because the technical provisions equal the market consistent value. Note that in practice the transfer of pension liabilities occurs regularly in some Member States. This approach is consistent with a "liquidation" vision of the solvency of the IORP.

➤ Supervisory authorities

- Increased consistency with the Solvency II framework.

Negative impacts

Option 1:

No impact

Option 2:

➤ Members/beneficiaries

- Not foreseen.

➤ IORPs/sponsoring employers

- This approach would lead to an increase in the level of technical provisions when compared to option 1. This could lead to a greater upfront cost to sponsors on a basis not designed to reflect the ability of the IORP to meet its commitments without transfer.
- This approach does not aim to fully reflect the "ongoing" vision of the solvency of the IORP, but rather focuses on the market consistent value of the liabilities. IORPs do not necessarily have sufficient financial assets to transfer liabilities due to intergenerational risk-sharing.

➤ Supervisory authorities

- Not foreseen.

Own credit standing

Option 1: Application of article 75 regarding not taking into account the own credit standing of IORPs when valuing liabilities.

Positive impacts

➤ Members/beneficiaries

- Value of pension promise is not dependent on the financial position of the IORP.

➤ IORPs/sponsoring employers

- In line with the "ongoing" vision of the solvency of the IORP.

➤ Supervisory authorities

- Consistency with Solvency II.

Negative impacts

- Members/beneficiaries
  - Not foreseen.
- IORPs/sponsoring employers
  - Not foreseen.
- Supervisory authorities
  - Not foreseen.

### Consistency with accounting standards

Option 1: No change to the current IORP

Option 2: Insert text similar to that of recital 46 of Solvency II (with appropriate amendments) into a revised IORP Directive

### Positive impacts

Option 1:

No impact foreseen since there would be no change to existing requirements.

Option 2:

- Members/beneficiaries
  - Not foreseen.
- IORPs/sponsoring employers
  - May result in a reduced cost for IORPs if the requirements are consistent.
- Supervisory authorities
  - Not foreseen.

### Negative impacts

Option 1:

No impact foreseen since there would be no change to existing requirements.

## Option 2:

### ➤ Members/beneficiaries

- Not foreseen.

### ➤ IORPs/sponsoring employers

- Could create confusion as to how to make the standards consistent 'to the extent possible' without further explanation.

### ➤ Supervisory authorities

- Adds little value from a supervisory perspective to have this requirement.
- The objectives of the two bases are too different to be consistent and could cause difficulties if supervisory standards were based on accounting standards.

## Existence and method of calculation of a risk margin (Article 77)

Option 1: Explicit risk margin in technical provisions calculated according to the current IORP Directive.

Option 2: Explicit risk margin in technical provisions calculated according to Solvency II.

Option 3: Best estimate calculated according to Solvency II and no risk margin in technical provisions.

## Positive impacts

### Option 1:

#### ➤ Members/beneficiaries

- Including explicitly a risk margin leads to more transparency because according to the current IORP Directive risk margins do not have to be made explicit.

#### ➤ IORPs/sponsoring employers

- Including explicitly a risk margin leads to more transparency because according to the current IORP Directive risk margins do not have to be made explicit.

#### ➤ Supervisors

- Including explicitly a risk margin leads to more transparency because according to the current IORP Directive risk margins do not have to be made explicit.

### Option 2:

- Members/beneficiaries
  - Including explicitly a risk margin leads to more transparency because according to the current IORP Directive risk margins do not have to be made explicit.
  - This option ensures a better comparability of technical provisions between IORPs, as well as between IORPs and insurance undertakings.
  - This option is quite appropriate within a "liquidation" vision of the solvency of the IORP. It allows for the transfer of acquired pensions to another pension institution provided that financial assets are sufficient to cover technical provisions. It might therefore make transfers between IORPs as well as from IORPs to insurance companies easier.
- IORPs/sponsoring employers
  - Including explicitly a risk margin leads to more transparency because according to the current IORP Directive risk margins do not have to be made explicit.
  - This option ensures a better comparability of technical provisions between IORPs, as well as between IORPs and insurance undertakings.
- Supervisors
  - Including explicitly a risk margin leads to more transparency because according to the current IORP Directive risk margins do not have to be made explicit.
  - This option ensures a better comparability of technical provisions between IORPs, as well as between IORPs and insurance undertakings.

#### Option 3:

- Supervisors
  - In case of this option all adverse deviations would be considered in the calculation of capital requirements. There would be a clear distinction that technical provisions are there to allow for "expected" cash-flows while the capital requirements are there to deal with risks and adverse deviations. This would improve transparency.
  - This option takes more of a going-concern perspective of IORPs' liabilities, while still allowing for a harmonized approach to establishing technical provisions.

#### Negative impacts

#### Option 1:

- Members/beneficiaries
  - Depending on the required level of the risk margin which is at this stage unknown this option could also lead to a higher level of technical provisions and therefore higher up-front financing costs for sponsors which might possibly lead to employers/sponsors being less willing to provide occupational pensions to members and beneficiaries.
  - If the value of technical provisions, including the margin for adverse deviation, does not reflect market fluctuations, adequate risk management may be hampered due to lack of transparency and inconsistency between the valuation of assets and liabilities.
- IORPs/sponsoring employers
  - If the value of technical provisions, including the margin for adverse deviation, does not reflect market fluctuations, adequate risk management may be hampered due to lack of transparency and inconsistency between the valuation of assets and liabilities.
- Supervisors
  - If the value of technical provisions, including the margin for adverse deviation, does not reflect market fluctuations, adequate risk management may be hampered due to lack of transparency and inconsistency between the valuation of assets and liabilities.

Option 2:

Not foreseen.

Option 3:

- Supervisors
  - Technical provisions are lower if they do not include a risk margin. If the coverage of the total of technical provisions is a trigger for certain supervisory actions than this trigger will be pulled later if technical provisions are lower. If this is considered a problem this could be tackled by introducing threshold(s) above technical provisions as a trigger for supervisory action.

Use of a risk free interest rate when calculating the best estimate (Article 77)

Option 2: Risk-free interest rate.

Option 3: Approach with two discount rates/levels of technical provisions.

Positive impacts

Option 2:

- Members/beneficiaries
  - There would be better transparency regarding the financial position and consistency with the valuation of assets. This would allow for adequate risk management from an ALM perspective.
- IORPs/sponsoring employers
  - There would be better transparency regarding the financial position and consistency with the valuation of assets. This would allow for adequate risk management from an ALM perspective.
- Supervisors
  - The level of technical provisions would be better comparable between IORPs, and also between IORPs and insurance undertakings, than in a situation where the interest rate used for the calculation of technical provisions differs between IORPs due to differences in the assets of the IORPs.
  - There would be better transparency regarding the financial position and consistency with the valuation of assets. This would allow for adequate risk management from an ALM perspective.

#### Option 3:

- IORPs/sponsoring employers
  - A rise in up-front costs for sponsoring undertakings could be prevented if level B of technical provisions were used as a minimum funding requirement for IORPs. That would be consistent with the aim of the EU-Commission not to undermine the spread of occupational pension provision in the EU.
- Supervisors
  - This option would allow mitigating the negative effects described regarding Option 2 by providing a flexible framework which could be adjusted to the specificities of IORPs, also in different Member States, as well as over time to achieve a higher level of harmonization.
  - There would be a harmonised overall level of security and consistency in the methodology for calculating technical provisions.
  - The specification of Level B technical provisions on Level 2 would allow for a very flexible framework, taking into account in particular the specificities of IORPs in different Member States.
  - This option could ease pro-cyclical effects with regard to the need to upfront funding requirements of sponsors.

#### Negative impacts

#### Option 2:

- Members/beneficiaries
  - There could be high volatility of results when calculating technical provisions and capital requirements due to changes in the risk free interest rate. In particular all the problems linked to long term guarantees in Solvency II are of particular relevance for IORPs because they provide far more and longer lasting

guarantees than life insurance companies do on average. This option could therefore cause problems for IORPs to comply with quantitative requirements.

- It could cause reluctance of employers to further provide occupational pensions to their employees because of higher up-front costs.

➤ IORPs/sponsoring employers

- The use of a risk free interest rate and, connected with this, the transfer of all quantitative requirements of Solvency II to IORPs, would probably lead to a material rise in technical provisions in many Member States and therefore to higher up-front financing costs for IORPs, unless security mechanisms could be used to cover technical provisions to the same extent they are implicitly considered in the calculation of technical provisions.
- There could be high volatility of results when calculating technical provisions and capital requirements due to changes in the risk free interest rate. In particular all the problems linked to long term guarantees in Solvency II are of particular relevance for IORPs because they provide far more and longer lasting guarantees than life insurance companies do on average. This option could therefore cause problems for IORPs to comply with quantitative requirements.
- It could cause reluctance of employers to further provide occupational pensions to their employees because of higher up-front costs.

➤ Supervisors

- There could be high volatility of results when calculating technical provisions and capital requirements due to changes in the risk free interest rate. In particular all the problems linked to long term guarantees in Solvency II are of particular relevance for IORPs because they provide far more and longer lasting guarantees than life insurance companies do on average. This option could therefore cause problems for IORPs to comply with quantitative requirements.
- It could cause reluctance of employers to further provide occupational pensions to their employees because of higher up-front costs.
- There is the risk of pro-cyclical effects if all IORPs reacted to changes in the risk free interest rate in the same way at the same time introducing systemic risk. This risk could be reduced by policy responses and adequate risk management.
- It may be less clear what “risk-free” means in the current market environment.

Option 3:

Not foreseen.

Expenses (Article 78)

Option 1: Adapt the text of Article 78 regarding future expenses in a revised IORP directive.

#### Positive impacts

- Members/beneficiaries
  - Adequate technical provisions in light of (future) expenses related to servicing benefit payments. Expenses would be distributed fairly over members and beneficiaries according to their benefits.
- IORPs/sponsoring employers
  - Idem.
  - Expenses would become more transparent. In most of the countries that do not explicitly account for expenses, allowances are made though in the technical provisions because these expenses are deducted from the expected returns on assets.
- Supervisory authorities
  - Consistency with Solvency II.

#### Negative impacts

➤ Members/beneficiaries

- No negative impact foreseen.

➤ IORPs/sponsoring employers

- Could lead to an increase in upfront costs for sponsors where IORPs are not currently required to include expenses in the technical provisions. It is noted that the issue of expenses is not of great materiality as it is not a major source of difference in the current levels of technical provision.
- The inclusion of expenses would impact those IORPs that currently do not account for those. The SSC Survey on fully funded, technical provisions and security mechanisms in the European occupational pension sector indicates that 11 out of 18 participants in the Survey cover the expenses in their technical provisions. The amount of future expenses that is incorporated in the technical provisions varies from very small (0.18%) to 5% of the size of technical provisions.
- Depending on the quality of assets that are required to cover for (this part of) the technical provisions, there may be an additional impact for the IORP or sponsoring undertaking.

➤ Supervisory authorities

- No negative impact foreseen.

All future expected payments – conditional benefits (Article 78)

EIOPA advises that all (non-discretionary) unconditional as well as conditional benefits are included in the best estimate of technical provisions.

Positive impacts

➤ Members/beneficiaries

- Ensures that all explicit commitments to plan members are adequately reserved for in technical provisions.

➤ IORPs/sponsoring employers

- Idem.

➤ Supervisory authorities

- Idem.

Negative impacts

➤ Members/beneficiaries

- Higher funding requirements due to the inclusion of conditional benefits in technical provisions may discourage occupational pension provision by employers.

➤ IORPs/sponsoring employers

- Including conditional benefits may potentially result in future wage increases in final pay plans to be included in technical provisions.

➤ Supervisory authorities

- None foreseen.

All future expected payments – discretionary benefits (Article 78)

Option 1: Not to include discretionary benefits in the technical provisions

Option 2: To include discretionary benefits in the technical provisions

Option 3: Include discretionary benefits in technical provisions with the exception of surplus funds.

Positive impacts

Option 1:

➤ Members/beneficiaries

- Objectivity, harmonisation and comparability: the balance sheet only reflects those items that are unconditional or related to objective conditions (i.e. conditional benefits).

➤ IORPs/sponsoring employers

- Technical provisions to be in line with existing calculation of benefits to the extent that these do not include discretionary benefits.
- No additional subjective assumptions need to be made regarding the allowance of discretionary benefits.
- No additional calculations for supervisory purposes needed as regards this issue.
- There would not be a disincentive to incorporate ambitions within pension plans.

➤ Supervisory authorities

- The added value of adding discretionary benefits in the technical provisions from a prudential perspective might be limited, as the additional technical provisions will likely be offset by security mechanisms on the holistic balance sheet. Also, an increase in technical provisions would reflect a probability weighted best estimate, which would not necessarily reflect full indexation.
- Soft promises / ambitions, where applicable, would be reflected in the prudential framework in a way that better fits their character.
- Might be considered consistent with Solvency II depending on the interpretation of "expectation".

Option 2:

➤ Members/beneficiaries

- Different varieties of promises are clarified on the balance sheet so that all elements of the benefits are transparent and, to some extent, comparable among member states.

➤ IORPs/sponsoring employers

- Not foreseen.

➤ Supervisory authorities

- Might be considered more consistent with Solvency II (than option 1) under which future discretionary bonuses are to be included in the technical provisions.

Option 3:

➤ Members/beneficiaries

- As option 2.

➤ IORPs/sponsoring employers

- As option 2.

➤ Supervisory authorities

- As option 2.
- The inclusion of the Member State option to treat discretionary benefits as surplus fund would be consistent with Solvency II.

Negative impacts

Option 1:

➤ Members/beneficiaries

- No full picture of possible future payouts on the holistic balance sheet as discretionary benefits are not taken into account.

➤ IORPs/sponsoring employers

- The classification of discretionary benefits might sometimes be ambiguous.

➤ Supervisory authorities

- When a reduction in accrued rights is possible on a discretionary basis, and to the extent the corresponding benefits are classified as 'discretionary', they would be excluded from the balance sheet. The balance sheet may therefore appear to have a large surplus, ignoring future discretionary payments. Regulators would not get information about discretionary benefits from the balance sheet. The discretionary benefits however can be analysed in a long term (stochastic) continuity analysis.

Option 2:

➤ Members/beneficiaries

- Increased complexity of and room for discretion in calculations. Calculations require subjective assumptions, which may hamper transparency.
- Including discretionary benefits in technical provisions might raise expectations of members regarding to payments unreasonably.
- Employers may be discouraged to provide discretionary benefits to members if inclusion in the best estimate results in legal enforceable payments.

➤ IORPs/sponsoring employers

- At present it is not clear to what extent benefits would qualify as discretionary and whether they are, or are not, to be included in technical provisions of member states. Moreover, assumptions about inflation are crucial in the estimation of the potential impact. Therefore it is not possible to make an adequate impact assessment at this point.
- Including discretionary benefits in the technical provisions would violate their discretionary character. A formalisation of the discretionary process would have to be made. As a consequence, such an approach might potentially render discretionary benefits into legally enforceable payments.
- Potentially major increase on the technical provisions and the size of the balance sheet. An increase in technical provisions would reflect a probability weighted best estimate, which would not necessarily reflect full indexation.
- As discretionary benefits are currently not part of the technical provisions, additional and potentially costly calculations have to be made. The SSC survey shows that about half of the countries do not reserve for inflation or salary indexation. Where inflation protection or salary indexation (in the reserving method) is mandatory in law or guaranteed through a promise by the IORP, it adds significantly to the size of technical provisions.
- Including inflation for the technical provisions related to the accumulation phase would automatically lead to a PBO approach of the best estimate, which could go beyond the actual liability of the sponsor / IORP.
- The impact on the SCR of including discretionary benefits may be limited, since a deteriorating solvency position under stress could (partly) be compensated by a reduction of discretionary benefits.

➤ Supervisory authorities

- The validity of assumptions may be difficult to assess for supervisors. Moreover, there will be increased complexity when offsetting security mechanisms are to be applied in the calculation of the capital requirement.

Option 3:

- Members/beneficiaries
  - As option 2.
  - Earmarking surplus funds on the IORPs balance sheet might result in false expectations of members regarding future discretionary benefits.
- IORPs/sponsoring employers
  - As option 2.
- Supervisory authorities
  - As option 2.
  - Lowers comparability of pension promises across Europe as Member States will be allowed to choose whether or not to include discretionary benefits in technical provisions.

#### Financial guarantees and contractual options (Article 79)

Option 1: Include the text of Article 79 of Solvency II in a revised IORP Directive with minor changes to reflect IORPs

#### Positive impacts

- Members/beneficiaries
  - Not foreseen.
- IORPs/sponsoring employers
  - Helps ensure technical provisions better reflect the nature of the liabilities
- Supervisory authorities
  - Helps ensure technical provisions better reflect the nature of the liabilities

#### Negative impacts

- Members/beneficiaries
  - Not foreseen.
- IORPs/sponsoring employers
  - May be a complex process with little gain for some IORPs. Therefore proportionality is important in its implementation
- Supervisory authorities
  - May create an additional burden if supervisor is required to ensure and/or check that the IORP has undertaken this process.

### Segmentation of risk groups (Article 80)

Option 1: Include the text of Article 80 of Solvency II in a revised IORP Directive with minor changes to reflect IORPs.

Option 2: Given that Article 15 of the IORP is sufficient for the purposes of Article 80 of Solvency II, do not include text of Article 80 into a revised IORP Directive.

### Positive impacts

#### Option 1 :

- Members/beneficiaries
  - Not foreseen.
- IORPs/sponsoring employers
  - Helps ensure technical provisions reflect the nature of the liabilities
- Supervisory authorities
  - Helps ensure technical provisions reflect the nature of the liabilities

Option 2:

No impact foreseen since there would be no change to existing requirements.

### Negative impacts

#### Option 1 :

➤ Members/beneficiaries

- Not foreseen.

➤ IORPs/sponsoring employers

- May be seen to overly burdensome – especially for cross-border IORPs providing different schemes - with little or no additional gain

➤ Supervisory authorities

- May be seen to overly burdensome – especially for cross-border IORPs providing different schemes - with little or no additional gain

Option 2:

No impact foreseen since there would be no change to existing requirements.

Criteria for the calculation of recoverables from reinsurance contracts and special purpose vehicles (Article 81)

Option 1: Not to include Article 81 in the IORP Directive but incorporate its principles in the calculation of technical provisions

Option 2: Application of Article 81 of the Solvency II Directive to IORPs

Positive impacts

Option 1:

➤ IORPs/sponsoring employers

- Minor changes of the current Directive reflecting the lesser importance of recoverable from (re) insurance contracts and SPV for IORPs compared with insurance companies.

Option2:

➤ Supervisory authority

- Consistency with Solvency II Directive, taking explicitly into account the counterparty credit risk from reinsurance contracts that can be a material factor.

Negative impacts

Option 1:

- Supervisory authority
  - Not consistent with Solvency II Directive.

Option2:

- IORPs/sponsoring employers
  - Excessive level of detail with regard to principles already set out in Article 75 of Solvency II.
  - Estimating counterparty default risk may be burdensome.
- Supervisory authority
  - Excessive level of detail with regard to principles already set out in Article 75 of Solvency II.

#### Availability of accurate data and circumstances in which approximations are allowed (Article 82)

EIOPA advises to include Article 82 of the Solvency II Directive in the IORP Directive with minor amendments to stress proportionality and address the specificities of IORPs

#### Estimated impact

Clear recognition of the use of approximations, including a case-by-case approach, in the calculation of the best estimate of technical provisions at minimal costs.

#### Processes to ensure that best estimates are regularly compared against experience (Article 83)

EIOPA is of the view that article 83 of Solvency II is applicable for IORPs with the clarification that application is subject to proportionality.

#### Positive impacts

➤ Members/beneficiaries

- Allows for assumptions to be regularly checked for their accuracy against experience leading to a more reliable outcome.

➤ IORPs/sponsoring employers

- Minor. An assessment of the assumptions underlying the calculation of technical provisions is already implicit in Article 15.4 of the IORP directive.

➤ Supervisory authorities

- Consistency with Solvency II Directive.

Negative impacts

➤ Members/beneficiaries

- No negative impact foreseen.

➤ IORPs/sponsoring employers

- Would be an additional burden and would require proportionate application.

➤ Supervisory authorities

- No negative impact foreseen.

Demonstration of appropriateness of level of technical provisions to supervisor (Article 84)

EIOPA is of the view that Article 84 of the Solvency II Directive is applicable to IORPs, with the modifications that the words 'insurance and reinsurance undertakings' must be replaced by 'IORPs' and it should be applied proportionally and upon reasonable request.

Positive impacts

- Members/beneficiaries
  - Wouldn't affect benefits of the members/beneficiaries by additional costs for the employer since it is a demonstration only "on request".
- IORPs/sponsoring employers
  - Since it is assumed that IORP's themselves verify the appropriateness of the level of their technical provisions and the applicability of their used methods, a demonstration only "on request" wouldn't make additional administrative burden for the IORP's nor additional costs for the employer.
- Supervisory authorities
  - Creates more appropriate ways to check the level of technical provisions and the applicability of the methods used.
  - A demonstration only 'on request' wouldn't make additional administrative burden for the supervisory authority.
  - Consistency with the Solvency II Directive.

#### Negative impacts

- Members/beneficiaries
  - No negative impact foreseen.
- IORPs/sponsoring employers
  - The more explicitly stated possibility of a demonstration \on request\ could move IORP's to insert less detailed descriptions in the financing plan.
  - Poses a burden for IORPs if used excessively.
- Supervisory authorities
  - The more explicitly stated possibility of a demonstration "on request" could require the supervisor to request additional information on each occasion

#### Estimated impact

Minor. Demonstration by the IORP, on request of the supervisor, of elements already available in the IORP Directive.

#### Power of supervisor to increase amount of technical provisions (Article 85)

##### Estimated impact

In general the impact on all groups of stakeholders would be minor, although this would represent an additional supervisory power in some Member States.

#### Implementing measures (Article 86)

##### Estimated impact

Having detailed implementing measures to be applied by all IORPs in all Member States would lead to greater harmonisation, which may not fit the current national

approaches. If implementing measures contained too many and too complex detailed rules there might be problems for some IORPs to comply with these rules as well as high costs for compliance for all IORPs.

This could also cause reluctance of employers/sponsors to further provide occupational pensions to their employees because of higher costs, which would have negative impact on (potential) members and beneficiaries.

#### The need to maintain Article 15(5) of Directive 2003/41/EC

Option 1: No change to the current requirements.

Option 2: Delete Article 15(5)

The impacts following directly from these options are dependent on the decisions made from other Articles regarding the calculation of Technical Provisions.

#### Advice on the feasibility to treat sponsor covenants like reinsurance contracts with due account for counterparty default risk

Option 1: Maintain the treatment of sponsor support of the current IORP Directive

Option 2: Value all forms of sponsor support as an asset on the balance sheet of the IORP and impacting on the calculation of the solvency capital requirements where these are required

Option 3: Take account of sponsor support as impacting on the calculation of the technical provision and the capital requirements of the IORP where these are required

Option 4: Value all forms of sponsor support as an asset on the balance sheet of the IORP and impacting on the calculation of the technical provision and the capital requirements of the IORP where these are required

Option 5: Recognition of sponsor support as ancillary own funds

#### Positive impacts

Option 1:

No impact because no change from current IORP Directive.

Option 2:

➤ Members/beneficiaries

- If coupled with appropriate disclosure requirements, provides for an increased transparency of the security of benefits.

➤ IORPs/sponsoring employers

- Enables full transparency of the support that is provided by the sponsor by placing on the balance sheet of the IORP.
- Supports a harmonized approach across IORPs in valuing sponsor support
- Provides for a more crystallised view of the level of support the sponsor can be expected to provide the IORP

➤ Supervisory authorities

- Explicit valuations increase objectivity and transparency as supervisors are currently putting an implicit value on sponsor support.

Option 3:

➤ Members/beneficiaries

- No impact foreseen.

➤ IORPs/sponsoring employers

- May allow for a more proportionate and qualitative assessment of the support of the sponsor to be made

➤ Supervisory authorities

- As per IORPs/sponsoring employers.

Option 4:

➤ Members/beneficiaries

- No impact foreseen.

➤ IORPs/sponsoring employers

- Allows for sponsor support to be recognized in all circumstances

➤ Supervisory authorities

- As per IORPs/sponsoring employers.

Option 5:

➤ Members/beneficiaries

- This option implies an obligation of full funding, as technical provisions could be covered only by hard financial assets. From this prospective it's the most protective option for the members and beneficiaries.

➤ IORPs/sponsoring employers

- Improved transparency in the solvency position of the IORP, as there is no upfront netting of the risks with the security mechanisms which help facing it.
- Reduced complexity in the calculations, as asset items and SCR on the one hand, sponsor support on the other hand, will be calculated separately.

➤ Supervisory authorities

- Increased involvement of the supervisory authority in the assessment of the financial situation of the sponsor, provided that ancillary own funds are subject to an approval process, as they are in Solvency II.
- From a prudential prospective, this option is the only one consistent with the fact that the sponsor doesn't materialise its commitment as a liability in its own balance sheet.
- This option is the most consistent with the current Solvency II framework.

Negative impacts

Option 1:

No impact because no change from current IORP Directive.

Option 2:

➤ Members/beneficiaries

- Considering sponsor support on the asset side of the IORP will create a counter-incentive for the sponsor to keep the IORP fully funded, as a “virtual” support could take the place of hard assets. This may eventually jeopardize the rights of the members and beneficiaries. This impact could however be mitigated if sponsor support were excluded from the coverage of technical provisions, by tiering rules on assets.

➤ IORPs/sponsoring employers

- The explicit valuation of sponsor support on the prudential balance sheet may eventually result in companies having to report the same figure in their financial statements, which might reduce the willingness of employers to provide occupational schemes to their workers.
- A potentially complex and costly exercise for IORPs to undertake, which would practically imply the development of an internal model for a proper assessment. As most undertakings will not be in a position to develop such a model, this option will require substantial simplifications, which could significantly undermine the prudential quality of the framework.
- May not be proportionate to the individual circumstances of some IORPs.
- May be too complex to determine an accurate and objective assessment.

➤ Supervisory authorities

- May be too complex to determine an accurate assessment
- This option could lead to considering the solvency position of an underfunded IORP as satisfactory as the solvency position of a fully funded IORP.
- This option is equivalent to considering sponsor support as a reinsurance arrangement. However, there are two major intrinsic differences between “sponsor support” and “reinsurance”, which in the case of sponsor support lead to a prudential inconsistency:
  - The sponsor doesn’t necessarily account for a liability in its own balance sheet, the value of which would reflect its commitment towards the IORP; this absence of adequate liability leads to a double accounting of wealth between the IORP and its sponsor.
- The sponsor is not subject to prudential supervision (with respect to this point it should be noted that under Solvency II, a reinsurance arrangement will be recognised as a risk-mitigation technique only if the reinsurer is itself compliant with Solvency II or with a supervisory regime recognised as equivalent)

Option 3:

- Members/beneficiaries
  - Same as Option 2
- IORPs/sponsoring employers
  - Same as Option 2
- Supervisory authorities
  - Would not provide for full transparency of the level of sponsor support
  - + same as Option 2

Option 4:

- Members/beneficiaries
  - Same as Option 2
- IORPs/sponsoring employers
  - Same as Option 2
- Supervisory authorities
  - Same as Option 2

Option 5:

➤ Members/beneficiaries

- No impact foreseen.

➤ IORPs/sponsoring employers

- It implies component 7 of the holistic balance sheet would not exist and would make it impossible for IORPs to cover any part of the technical provisions with sponsor support. Hence, it would result in an increase in upfront capital for IORPs which rely on sponsor support
- Unless changes were made to the eligibility of ancillary own funds (compared to the current Solvency II approach), this option would not allow for sponsor support to cover all capital requirements (where required) and would result in an increase in upfront capital for IORPs which rely on sponsor support

➤ Supervisory authorities

- Potential additional burden for the supervisory authorities, due to the ancillary own funds approval process.

## 9.5. EIOPA advice

The Commission Services would like EIOPA to advise, in close cooperation with the actuarial profession, on detailed rules by which supervisors can ensure that IORPs have proper rules to value assets, technical provisions and other liabilities.

### EIOPA's general position

EIOPA supports the following principles for the valuation and capital requirements of IORPs:

- Transparency i.e. derivation of how a valuation was reached should be clear
- Comparability – it should therefore be possible to compare valuation of one IORP's liabilities with another, and likewise the value of the assets which support that liability
- Comprehensiveness – all potential security mechanisms and benefit adjustments should be included

EIOPA therefore recommends:

- Valuations should be market consistent
- Valuation should include the actuarial value of all enforceable pension promises of the IORP
- The holistic balance sheet as the means in principle of including all security mechanisms
- Its adoption in practice is subject to further investigation and in particular, the feasibility of the development and adoption of a methodology for the quantification of the security and benefit adjustment mechanisms, and whether that methodology is effective in terms of its costs and benefits.

EIOPA wishes to note further that some elements of its advice are conditional on the following three factors:

- The Commission's objective of a common level of security for retirement benefits. Whether this objective is accepted is a political matter which also potentially has other implications. Its rejection would necessitate a review of some of the advice.
- The results of a quantitative impact study. This will provide further information about whether a common level of security is feasible in practice and effective in terms of its costs and benefits, given the diversity of IORPs in the different member states, and EIOPA will consider whether to offer further views on this matter in light of the results.
- That the typical question in CfAs 5 and 6 on which EIOPA is asked to provide advice is whether the material elements of articles of the Solvency II directive should be amended or removed to adequately address the specificities of IORPs. EIOPA's response therefore does not consider the question of whether or not Solvency II is the correct starting point, though it is noted that many consultation

respondents stated the view that Solvency II is the wrong initial framework for considering the capital requirements of IORPs.

EIOPA's advice in this section is consistent with the Call for Advice's objective to increase the level of harmonisation and the holistic balance sheet proposal, and with the Commission's objective of achieving a common level of security for all IORPs. EIOPA would like to stress that this not necessarily implies that these options are preferred over the other options presented in the explanatory text, which are more in line with the existing IORP Directive. It would therefore be preferable to achieve agreement about the question of a common level of security before making decisions about other matters considered in this section. In addition, although the various options in the advice on CfA 5 and CfA 6 may be in line with the holistic balance sheet approach, they may not always be consistent with each other.

The advice in this section has been considered in principle only, and without the results of any quantitative impact studies or detailed cost/benefit analysis.

EIOPA proposed response is as follows:

*The material elements of Article 75 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the valuation of assets and liabilities;*

#### Valuation of assets

EIOPA agrees with the requirement of Solvency II that assets should be valued on a market consistent basis by specifying in the IORP Directive that:

*"Member States shall ensure that IORPs value their assets on a market consistent basis"*

#### Valuation of liabilities – transfer value

EIOPA advises that the current IORP Directive is amended to state that the valuation of technical provisions should be done on a market-consistent basis.

Article 15 of the IORP Directive should be amended to require IORPs to value their liabilities on a market consistent basis, without necessarily referring to the concept of transfer value.

*"Member States shall ensure that IORPs value their liabilities on a market consistent basis"*

#### Own credit standing

EIOPA agrees with the requirement of Solvency II that no adjustment should be made to take account of the own credit standing of the IORP when valuing liabilities. The text of Article 75 can be used in a revised IORP Directive, changing references to insurers to IORPs as appropriate.

*"When valuing liabilities, no adjustment to take account of the own credit standing of the IORP shall be made."*

*The consistency between the rules to establish prudential balance sheets of IORPs*

*and the rules for general accounting purposes, taking into account where necessary the financial reporting rules (national or international) applicable to the sponsoring undertaking;*

It is considered that regulators and supervisors are already advancing convergence of prudential and accounting standards, where appropriate given their different objectives. Therefore, EIOPA advises not to adjust the IORP Directive with regard to consistency with accounting standards.

*The material elements of Article 76 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions. This should include advice on the circumstances under which approximations in the calculation of the best estimate should be allowed;*

#### Article 76(1)

Amend Article 76(1) which requires insurers to calculate technical provisions with respect to all their obligations replacing insurance and reinsurance undertakings with IORPs and replacing policy holders with members.

New text to be added to a revised IORP Directive as follows:

*"Member States shall ensure that IORPs establish technical provisions with respect to all of their occupational pension scheme obligations towards members and beneficiaries of pension contracts."*

#### Article 76(3)

Include Article 76(3) in a revised IORP Directive requiring IORPs to calculate their technical provisions on a market consistent basis with a small change to address the specificities of IORPs.

*"The calculation of technical provisions shall make use of and be consistent with information provided by the financial markets and generally available data on biometric risks (market consistency)."*

#### Article 76(4)

Include Article 76(4) in a revised IORP Directive but removing the reference to being "prudent".

Insert the below text as an Article into the revised IORP Directive:

*"Technical provisions shall be calculated in a reliable and objective manner."*

#### Article 76(5)

Assuming Articles 77 to 82 are applicable with any appropriate amendments, this paragraph is applicable.

Include Article 76(5) in a revised IORP Directive with amendments focussed only on ensuring the correct references to the relevant Articles are made. The appropriate text can only be drafted following decisions made elsewhere and so is not shown here.

*The material elements of Article 77 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.*

#### Existence and method of calculation of a risk margin

The following policy options are proposed:

**Option 1:** Explicit risk margin in technical provisions calculated according to the current IORP Directive

According to this option the risk margin is not related to the concept of transfer value/cost of capital, but to the risk of adverse deviations from assumptions. This option assumes that the best estimate part of technical provisions is also calculated as the starting basis for the calculation of the risk margin. While according to the current IORP Directive the risk margin could be implicitly part of technical provisions this option would require an explicit calculation of a risk margin for adverse deviation.

**Option 2:** Explicit risk margin in technical provisions calculated according to Solvency II

According to this option the risk margin is related to the concept of transfer of liabilities and the cost of capital. This option assumes that the best estimate part of technical provisions is also calculated according to Solvency II. This option is only valid if the choice is made to use the option of having a Solvency II-like, market consistent approach to calculation of technical provisions. This means that there is an interconnection with the options presented regarding Articles 75 and 76.

The text of Article 77 can then be added to a revised IORP Directive with appropriate amendments.

*"The risk margin shall be such as to ensure that the value of the technical provisions is equivalent to the amount that IORPs would be expected to require in order to take over and meet the IORPs obligations.*

*Where IORPs value the best estimate and the risk margin separately, the risk margin shall be calculated by determining the cost of providing an amount of eligible own funds equal to the Solvency Capital Requirement necessary to support the IORPs obligations over the lifetime thereof.*

*The rate used in the determination of the cost of providing that amount of eligible own funds (Cost-of-Capital rate) shall be the same for IORPs and shall be reviewed periodically.*

*The Cost-of-Capital rate used shall be equal to the additional rate, above the relevant risk-free interest rate, that an IORP would incur holding an amount of eligible own funds, [as set out in Section 3], equal to the Solvency Capital Requirement necessary to support the IORP obligations over the lifetime of those obligations."*

**Option 3:** Best estimate calculated according to Solvency II and no risk margin in technical provisions

According to this option the risk of adverse deviation would be taken into account in the capital requirements only. Just like in option 1 there would be no allowance for cost of capital. No explicit text would need to be inserted into a revised IORP Directive.

Separate valuation of the best estimate and the risk margin if cash flows cannot be replicated reliably (making the risk margin explicit)

If the decision was made to have a risk margin as part of technical provisions then there should be a separate valuation of best estimate and risk margin, irrespective of the method of calculation of the risk margin. This would mean that the risk margin would in all cases be explicit which would lead to more transparency and comparability.

If the decision was made to have no risk margin as part of technical provisions then the issue of separate valuation does not arise. In this case Article 77 (4) subparagraph 1 would have to be deleted.

Therefore the necessary amendments to the Solvency II-Directive as regards this issue can be derived immediately from the choice of the option regarding the existence and method of calculation of the risk margin.

Article 77 (4) subparagraph 2 of Solvency II should remain unchanged.

Appropriate text would need to be drafted for insertion into a revised IORP Directive consistent with the decisions made based on the principles described above.

Definition of cash-flows relevant when calculating technical provisions

EIOPA considers that the contract boundaries of occupational pension schemes depend on the nature of the plan as well as social and labour law. Future accruals should only be taken into account if there is a commitment which is other than voluntary. Similarly, future indexation of accrued pension rights should only be included if there is no possibility of cessation. If these considerations with regard to contract boundaries are taken into account no amendments to Article 77 of the Solvency II Directive are necessary as far as the determination of the relevant cash-flows is concerned.

Gross calculation of best estimate

No amendments to Article 77 (2) subparagraph 4 of the Solvency II Directive are necessary and the text can be inserted into a revised IORP Directive.

*"The best estimate shall be calculated gross, without deduction of the amounts recoverable from reinsurance contracts and special purpose vehicles. Those amounts shall be calculated separately, in accordance with Article 81."*

Use of a risk free interest rate when calculating the best estimate part of technical provisions

The following policy options are proposed:

**Option 2:** Risk-free interest rate

Use a risk-free interest rate for the calculation of the best estimate part of technical provisions that takes into account the nature of the liabilities of IORPs.

**Option 3:** Approach with two discount rates/levels of technical provisions

Introduce two different levels of technical provisions within best estimate of technical provisions: Level A would be calculated with a risk free interest rate, which would be chosen as described in option 2. Level B – that is part of Level A - would be calculated on the expected return of assets or on a fixed, but not risk-free, interest rate curve, on a basis further defined by level 2 implementing measures.

*The material elements of Article 78 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.*

Clarification is needed on how article 78(3) is to be interpreted and assessed in the specific context of IORPs. Any revision of the IORP Directive should further specify the principles of the definition of discretionary benefits.

In EIOPA's view non-discretionary benefits (conditional as well as unconditional benefits) should be included in the best estimate of technical provisions.

Regarding discretionary benefits two options are distinguished in the advice to exclude or include discretionary benefits in the best estimate of technical provisions. The impact of both options on IORPs for which discretionary benefits play an important role has to be further clarified during the quantitative impact study (QIS).

**Option 1:** Not to include discretionary benefits and surplus funds in the technical provisions

For option 1, the text of article 78 needs to be amended:

In addition to Article 77, when calculating technical provisions, ~~insurance and reinsurance undertakings~~ IORPs shall take account of the following:

(1) all expenses that will be incurred in servicing ~~insurance and reinsurance~~ pension obligations;

(2) inflation, including expenses and claims inflation to the extent pension promises are subject to unconditional or conditional indexation;

(3) all payments to ~~policy holders~~ members and beneficiaries, ~~including future discretionary bonuses, which insurance and reinsurance undertakings~~ IORPs expect to make, whether or not those payments are unconditional ~~contractually guaranteed, unless those payments~~ with the exception of future discretionary bonuses and payments which fall under Article 91(2).

Further Level 2 implementing measures would be needed to specify the boundaries of what constitutes (pure) discretionary benefits.

**Option 3:** Include discretionary benefits in technical provisions with the exception of surplus funds.

The text of article 78 needs to be amended:

In addition to Article 77, when calculating technical provisions, ~~insurance and reinsurance undertakings~~ IORPs shall take account of the following:

(1) all expenses that will be incurred in servicing ~~insurance and reinsurance~~ pension obligations;

(2) inflation, including expenses and claims inflation to the extent pension promises are subject to indexation;

(3) all payments to ~~policy holders~~ members and beneficiaries, including future discretionary benefits ~~bonuses~~, which ~~insurance and reinsurance undertakings~~ IORPs expect to make, whether or not those payments are unconditional, unless those payments ~~fall under~~ stem from Article 91(2).

Level 2 implementing measures would be needed to specify the boundaries of discretionary benefits and how discretionary benefits are to be quantified in the technical provisions, in particular on the way the uncertainty is to be taken into account.

*The material elements of Article 79 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.*

Include the text of Article 79 of Solvency II in a revised IORP Directive with minor changes to reflect IORPs.

The following text to be added to a revised IORP Directive regarding the need to take account of financial guarantees and contractual option in the calculation of technical provisions noting that the principle of proportionality will apply.

*"When calculating technical provisions, where applicable IORPs shall take account of the value of financial guarantees and contractual options included in occupational pension schemes.*

*Any assumptions made by IORPs with respect to the likelihood that members and beneficiaries will exercise contractual options shall be realistic and based on current and credible information. The assumptions shall take account, either explicitly or implicitly, of the impact that future changes in financial and non-financial conditions may have on the exercise of those options.*

*Where the impact of such options is not significant, IORPs should be able to apply the principle of proportionality in their estimations."*

*The material elements of Article 80 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.*

Include the text of Article 80 of Solvency II in a revised IORP Directive with minor changes to reflect IORPs and to stress the importance of a proportional implementation.

The following text to be added to a revised IORP Directive requiring the

segregation of risk groups:

*"IORPs shall segment their occupational pension obligations into homogeneous risk groups, and as a minimum by DB and DC, when calculating their technical provisions subject to materiality and proportionality."*

*The material elements of Article 81 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.*

Introduce Article 81 of Solvency II regarding recoverables from reinsurance contracts and special purpose vehicles in a revised IORP Directive with minor amendments in order to address specificities of IORPs.

*"The calculation by IORPs of amounts recoverable from reinsurance contracts and special purpose vehicles shall comply with Articles [76 to 80]."*

*When calculating amounts recoverable from reinsurance contracts and special purpose vehicles, IORPs shall take account of the time difference between recoveries and direct payments.*

*The result from that calculation shall be adjusted to take account of expected losses due to default of the counterparty. That adjustment shall be based on an assessment of the probability of default of the counterparty and the average loss resulting therefrom (loss-given-default)."*

Appropriate simplifications to avoid – where appropriate – complex option valuation techniques should be laid down in level 2 implementing measures.

*The material elements of Article 82 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions. This should include advice on the circumstances under which approximations in the calculation of the best estimate should be allowed.*

Introduce Article 82 of Solvency II in the IORP Directive, with minor amendments to stress the importance of materiality and proportionality and to address the specificities of IORPs. The identification of the specific circumstances in which these approximations could be applied can be addressed in the level 2 implementing measures.

*"Member States shall ensure that IORPs have internal processes and procedures in place to ensure the appropriateness, completeness and accuracy of the data used in the calculation of their technical provisions subject to proportionality."*

*Where, in specific circumstances, IORPs have insufficient data of appropriate quality to apply a reliable actuarial method to a set or subset of their insurance and reinsurance obligations, or amounts recoverable from reinsurance contracts and special purpose vehicles, appropriate approximations, including case-by-case approaches, may be used in the calculation of the best estimate."*

*The material elements of Article 83 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.*

Article 83 regarding comparison of assumptions against experience can be applied included in a revised IORP Directive by emphasising proportionality and changing references to insurance to IORPs.

*"IORPs shall have processes and procedures in place to ensure that best estimates, and the assumptions underlying the calculation of best estimates, are regularly compared against experience subject to proportionality.*

*Where the comparison identifies systematic deviation between experience and the best estimate calculations of IORPs, the IORP concerned shall make appropriate adjustments to the actuarial methods being used and/or the assumptions being made."*

*The material elements of Article 84 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.*

Article 84 regarding the ability of supervisory authorities to request insurers to demonstrate the appropriateness of the level of technical provisions can be included in a revised IORP Directive by changing references to insurance to IORPs and stressing that application should be proportional.

*Upon request from the supervisory authorities, ~~insurance and reinsurance undertakings~~ IORPs shall demonstrate subject to proportionality the appropriateness of the level of their technical provisions, as well as the applicability and relevance of the methods applied, and the adequacy of the underlying statistical data used.*

*The material elements of Article 85 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.*

Article 85 regarding the ability of supervisory authorities to increase the amount of technical provisions if the calculation does not comply with the relevant articles can be included in a revised IORP Directive by changing references to insurance to IORPs only.

*"To the extent that the calculation of technical provisions IORPs does not comply with Articles [76 to 83], the supervisory authorities may require IORPs to increase the amount of technical provisions so that they correspond to the level determined pursuant to those Articles."*

IORPs evidently have the right to appeal in court – like any other decision taken in respect of IORPs – the decision taken to raise the amount of technical provisions.

*The material elements of Article 86 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the technical provisions.*

If the decision was made after a quantitative impact study and impact assessment to apply rules for calculating technical provisions and capital requirements for IORPs in the same or a similar way as for insurance undertakings then there would be the same need for implementing measures.

Therefore in this case an article similar to Article 86 should exist in a revised IORP Directive. At this stage the future rules for the regulation of IORPs are not clear, so there can be no advice which implementing measures are needed. It is clear however that the level 2 implementing measures should be established through an open process including a public consultation and be subject to materiality and proportionality.

*The need to maintain Article 15(5) of Directive 2003/41/EC.*

Delete Article 15(5) from the IORP Directive that allows Member States to lay down more detailed rules for the calculation of technical provisions.

*Advice on the feasibility to treat sponsor covenants like reinsurance contracts with due account for counterparty default risk.*

**Option 2:** Value all forms of sponsor support as an asset on the balance sheet of the IORP and impacting on the calculation of the solvency capital requirements where these are required.

EIOPA's position is that sponsor support should be valued as an asset and so have a value on the asset side of the holistic balance sheet of the IORP and can also act as a risk mitigation mechanism reducing capital requirements.

Sponsor support should be legally enforceable in order to be included in the balance sheet and the way it should be valued needs further elaboration. This should include analysis of the feasibility of introducing tiering requirements on the assets (analogous to the approach taken for the classification of own funds into 3 tiers) ensuring that an appropriate amount of reliance is placed on all the types of assets eligible to cover IORPs' liabilities.

## 10. CfA 6: Security mechanisms

### 10.1. Extract from the call for advice

The Commission Services would like EIOPA to advise, in close cooperation with the actuarial profession, on detailed rules by which supervisors can ensure that IORPs have proper rules to protect pension liabilities.

The EIOPA advice should address at least the following subjects:

- Where the IORP itself covers risk (in the meaning of Article 17(1) of the IORP Directive):
  - The material elements of Article 87-99 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to own funds; the advice should include an assessment as to whether there is an advantage to keep a three-tier system;
  - The adequacy of using subordinated debt as own funds in the light of the borrowing restriction for IORPs contained in Article 18(2) of the IORP Directive;
  - The material elements of Articles 100-127 and 304 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the SCR (including the duration approach for the equity risk sub-module). Particular attention should be paid to the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes to take into account the specificities of pension schemes;
  - The material elements of Article 128-131 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the MCR.
  - As a particular treatment of this, the extent to which a similar approach can be adopted for pension schemes where the risk is covered by the IORP and the sponsoring undertaking.
- Where the risk (in the meaning of Article 17(1) of the IORP Directive) is covered by the sponsoring undertaking:
  - The possibility to restate the value of assets in the IORP and liabilities of the sponsoring undertakings into a single balance sheet, including the possibility to recognise sponsor covenants and claims in pension protection schemes as an asset similar to reinsurance.
  - The level of protection of the scheme members and beneficiaries provided by the security mechanisms in the various systems.
  - The treatment of operational risk where the investment risk is borne by the scheme member or beneficiary;

• The material elements of Articles 136-142 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the recovery plan and, where necessary, the finance scheme; particular attention should be paid to (i) the length of the recovery period allowed and (ii) the need to maintain a specific wording for cross-border activity.

- Other requirements for IORPs, if any,
- Proportionality: e.g. simplifications in the standard SCR formula.

## 10.2. Background

### Current legal requirements (IORP Directive)

- 10.2.1. The current IORP Directive makes a clear distinction between IORPs that themselves cover biometric risks or guarantee certain benefits or investment performance and IORPs where the sponsoring undertaking provides these guarantees
- 10.2.2. Recital 30 refers to situations where the IORP - instead of the employer - provides guarantees to cover against certain risks. In these instances, the IORP is said to offer products similar to those of life insurance companies and should hold at least the same amount of additional own funds as required of life insurance companies. Article 17 provides for these additional requirements, notably the need to hold assets above technical provisions to serve as a buffer.
- 10.2.3. Where the sponsoring undertaking bears these risks, there are no similar requirements. However, Article 9(1)(e) requires Member States to ensure that the sponsor is committed to regular financing.
- 10.2.4. The case in which both the sponsoring undertaking and the IORP bear the risk is not mentioned in the IORP Directive. One could argue that for these IORPs Article 17(3) applies which gives Member States the right to decide about the need to hold regulatory own funds.
- 10.2.5. According to the IORP Directive, own funds are assets held by the IORP exceeding the liabilities. They serve as a buffer against risks the IORP is exposed to, such as the absorption of deviations from anticipated investment returns. After the amendment of the IORP Directive through Article 303 of Solvency II the own funds of an IORP can consist of various items exhaustively listed in Article 17a, distinguishing between own funds not subject and subject to an agreement of the competent authorities.
- 10.2.6. The IORP Directive does not specify a quantitative confidence level for determining the capital requirements nor a pre-defined time horizon. However, the frequency of calculation of technical provisions is addressed in Article 15(3) of the current IORP Directive.
- 10.2.7. In the IORP Directive, the minimum amount of own funds is determined as a percentage of the technical reserves and risk capital (see Article 17(2) and Article 17b).
- 10.2.8. In the current IORP Directive, the capital requirement ("regulatory own funds") is not split in two components, as it is in the Solvency II framework.

Therefore, there is no concept of the IORP Directive which could be directly compared to the Minimum Capital Requirement as introduced in the Solvency II Directive.

- 10.2.9. Article 16 of the IORP Directive specifies the current requirements for adequate funding of technical provisions as well as recovery plan requirements if an IORP has insufficient assets to cover technical provisions. Recital 29 of the IORP Directive states that Member States should be able to permit underfunding if the institution does not work on a cross-border basis and provided that a proper plan is established to restore full funding. According to Recital 28, the technical provisions of cross-border IORPs should be fully funded at all times.

*Recital (28)*

*Sufficient and appropriate assets to cover the technical provisions protect the interests of members and beneficiaries of the pension scheme if the sponsoring undertaking becomes insolvent. In particular in cases of cross-border activity, the mutual recognition of supervisory principles applied in Member States requires that the technical provisions be fully funded at all times.*

*Recital (29)*

*If the institution does not work on a cross-border basis, Member States should be able to permit underfunding provided that a proper plan is established to restore full funding and without prejudice to the requirements of Council Directive 80/987/EEC of 20 October 1980 on the approximation of the laws of the Member States relating to the protection of employees in the event of the insolvency of their employer.*

*Recital (30)*

*In many cases, it could be the sponsoring undertaking and not the institution itself that either covers any biometric risk or guarantees certain benefits or investment performance. However, in some cases, it is the institution itself which provides such cover or guarantees and the sponsor's obligations are generally exhausted by paying the necessary contributions. In these circumstances, the products offered are similar to those of life-assurance companies and the institutions concerned should hold at least the same additional own funds as life-assurance companies.*

*Article 9*

*Conditions of operation*

*1. Each Member State shall, in respect of every institution located in its territory, ensure that:*

*(e) where the sponsoring undertaking guarantees the payment of the retirement benefits, it is committed to regular financing;*

*Article 16*

*Funding of technical provisions*

*1. The home Member State shall require every institution to have at all times sufficient and appropriate assets to cover the technical provisions in respect of the total range of pension schemes operated.*

*2. The home Member State may allow an institution, for a limited period of time, to have insufficient assets to cover the technical provisions. In this case the competent authorities shall require the institution to adopt a concrete and realisable recovery plan in order to ensure that the requirements of paragraph 1 are met again. The plan shall be subject to the following conditions:*

*(a) the institution shall set up a concrete and realisable plan to re-establish the required amount of assets to cover fully the technical provisions in due time. The plan shall be made available to members or, where applicable, to their representatives and/or shall be subject to approval by the competent authorities of the home Member State;*

*(b) in drawing up the plan, account shall be taken of the specific situation of the institution, in particular the asset/liability structure, risk profile, liquidity plan, the age profile of the members entitled to receive retirement benefits, start-up schemes and schemes changing from non-funding or partial funding to full funding;*

*(c) in the event of termination of a pension scheme during the period referred to above in this paragraph, the institution shall inform the competent authorities of the home Member State. The institution shall establish a procedure in order to transfer the assets and the corresponding liabilities to another financial institution or a similar body. This procedure shall be disclosed to the competent authorities of the home Member State and a general outline of the procedure shall be made available to members or, where applicable, to their representatives in accordance with the principle of confidentiality.*

*3. In the event of cross-border activity as referred to in Article 20, the technical provisions shall at all times be fully funded in respect of the total range of pension schemes operated. If these conditions are not met, the competent authorities of the home Member State shall intervene in accordance with Article 14. To comply with this requirement the home Member State may require ring-fencing of the assets and liabilities.*

## *Article 17*

### *Regulatory own funds*

*1. The home Member State shall ensure that institutions operating pension schemes, where the institution itself, and not the sponsoring undertaking, underwrites the liability to cover against biometric risk, or guarantees a given investment performance or a given level of benefits, hold on a permanent basis additional assets above the technical provisions to serve as a buffer. The amount thereof shall reflect the type of risk and asset base in respect of the total range of schemes operated. These assets shall be free of all foreseeable liabilities and serve as a safety capital to absorb discrepancies between the anticipated and the actual expenses and profits.*

*2. For the purposes of calculating the minimum amount of the additional assets, the rules laid down in Articles 27 and 28 of Directive 2002/83/EC shall apply.*

*3. Paragraph 1 shall, however, not prevent Member States from requiring institutions located in their territory to hold regulatory own funds or from laying down more detailed rules provided that they are prudentially justified.*

#### *Article 303*

#### *Amendments to Directive 2003/41/EC*

*Directive 2003/41/EC shall be amended as follows:*

*1. Article 17(2) is replaced by the following:*

*"2. For the purposes of calculating the minimum amount of additional assets, the rules laid down in Articles 17a to 17d shall apply."*

*2. The following articles are inserted:*

*"Article 17a*

#### *Available solvency margin*

*1. Each Member State shall require of every institution referred to in Article 17(1) which is located in its territory an adequate available solvency margin in respect of its entire business at all times which is at least equal to the requirements in this Directive.*

*2. The available solvency margin shall consist of the assets of the institution free of any foreseeable liabilities, less any intangible items, including:*

*(a) the paid-up share capital or, in the case of an institution taking the form of a mutual undertaking, the effective initial fund plus any accounts of the members of the mutual undertaking which fulfil the following criteria:*

*(i) the memorandum and articles of association must stipulate that payments may be made from those accounts to members of the mutual undertaking only in so far as this does not cause the available solvency margin to fall below the required level or, after the dissolution of the undertaking, where all the undertaking's other debts have been settled;*

*(ii) the memorandum and articles of association must stipulate, with respect to any payments referred to in point (i) for reasons other than the individual termination of membership in the mutual undertaking, that the competent authorities must be notified at least one month in advance and can prohibit the payment within that period; and*

*(iii) the relevant provisions of the memorandum and articles of association may be amended only after the competent authorities have declared that they have no objection to the amendment, without prejudice to the criteria stated in points (i) and (ii);*

*(b) reserves (statutory and free) not corresponding to underwriting liabilities;*

*(c) the profit or loss brought forward after deduction of dividends to be paid; and*

*(d) in so far as authorised under national law, profit reserves appearing in the balance sheet where they may be used to cover any losses which may arise and where they have not been made available for distribution to members and beneficiaries.*

*The available solvency margin shall be reduced by the amount of own shares directly held by the institution.*

*3. Member States may provide that the available solvency margin may also comprise:*

*(a) cumulative preferential share capital and subordinated loan capital up to 50 % of the lesser of the available solvency margin and the required solvency margin, no more than 25 % of which shall consist of subordinated loans with a fixed maturity, or fixed-term cumulative preferential share capital, provided that binding agreements exist under which, in the event of the bankruptcy or liquidation of the institution, the subordinated loan capital or preferential share capital ranks after the claims of all other creditors and is not to be repaid until all other debts outstanding at the time have been settled;*

*(b) securities with no specified maturity date and other instruments, including cumulative preferential shares other than those referred to in point (a), to a maximum of 50 % of the available solvency margin, or the required solvency margin, whichever the lesser, for the total of such securities, and the subordinated loan capital referred to in point (a) provided they fulfil the following conditions:*

*(i) they must not be repaid on the initiative of the bearer or without the prior consent of the competent authority;*

*(ii) the contract of issue must enable the institution to defer the payment of interest on the loan;*

*(iii) the lender's claims on the institution must rank entirely after those of all non-subordinated creditors;*

*(iv) the documents governing the issue of the securities must provide for the loss-absorption capacity of the debt and unpaid interest, while enabling the institution to continue its business; and*

*(v) only fully paid-up amounts must be taken into account.*

*For the purposes of point (a), subordinated loan capital shall also fulfil the following conditions:*

*(i) only fully paid-up funds shall be taken into account;*

*(ii) for loans with a fixed maturity, the original maturity shall be at least five years. No later than one year before the repayment date, the institution shall submit to the competent authorities for their approval a plan showing how the available solvency margin will be kept at or brought to the required level at maturity, unless the extent to which the loan may rank as a component of the available solvency margin is gradually reduced during at least the five years before the repayment date. The competent authorities may authorise the early repayment of such loans*

*provided application is made by the issuing institution and its available solvency margin will not fall below the required level;*

*(iii) loans the maturity of which is not fixed shall be repayable only subject to five years' notice unless the loans are no longer considered as a component of the available solvency margin or unless the prior consent of the competent authorities is specifically required for early repayment. In the latter event the institution shall notify the competent authorities at least six months before the date of the proposed repayment, specifying the available solvency margin and the required solvency margin both before and after that repayment. The competent authorities shall authorise repayment only where the institution's available solvency margin will not fall below the required level;*

*(iv) the loan agreement shall not include any clause providing that in specified circumstances, other than the winding-up of the institution, the debt will become repayable before the agreed repayment dates; and*

*(v) the loan agreement may be amended only after the competent authorities have declared that they have no objection to the amendment.*

*4. Upon application, with supporting evidence, by the institution to the competent authority of the home Member State and with the agreement of that competent authority, the available solvency margin may also comprise:*

*(a) where Zillmerising is not practised or where, if practised, it is less than the loading for acquisition costs included in the premium, the difference between a non-Zillmerised or partially Zillmerised mathematical provision and a mathematical provision Zillmerised at a rate equal to the loading for acquisition costs included in the premium;*

*(b) any hidden net reserves arising out of the valuation of assets, in so far as such hidden net reserves are not of an exceptional nature;*

*(c) one half of the unpaid share capital or initial fund, once the paid-up part amounts to 25 % of that share capital or fund, up to 50 % of the available or required solvency margin, whichever is the lesser.*

*The figure referred to in point (a) shall not exceed 3,5 % of the sum of the differences between the relevant capital sums of life assurance and occupational retirement provision activities and the mathematical provisions for all policies for which Zillmerising is possible. The difference shall be reduced by the amount of any undepreciated acquisition costs entered as an asset.*

*5. The Commission may adopt implementing measures relating to paragraphs 2 to 4 in order to take account of developments that justify a technical adjustment of the elements eligible for the available solvency margin.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 21b.*

## *Article 17b*

### *Required solvency margin*

1. Subject to Article 17c, the required solvency margin shall be determined as laid down in paragraphs 2 to 6 according to the liabilities underwritten.

2. The required solvency margin shall be equal to the sum of the following results:

(a) the first result:

a 4 % fraction of the mathematical provisions relating to direct business and reinsurance acceptances gross of reinsurance cessions shall be multiplied by the ratio, which shall not be less than 85 %, for the previous financial year, of the mathematical provisions net of reinsurance cessions to the gross total mathematical provisions;

(b) the second result:

for policies on which the capital at risk is not a negative figure, a 0,3 % fraction of such capital underwritten by the institution shall be multiplied by the ratio, which shall not be less than 50 %, for the previous financial year, of the total capital at risk retained as the institution's liability after reinsurance cessions and retrocessions to the total capital at risk gross of reinsurance.

For temporary assurances on death of a maximum term of three years, that fraction shall be 0,1 %. For such assurance of a term of more than three years but not more than five years, that fraction shall be 0,15 %.

3. For supplementary insurances referred to in Article 2(3)(a)(iii) of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) [] the required solvency margin shall be equal to the required solvency margin for institutions as laid down in Article 17d.

4. For capital redemption operations referred to in Article 2(3)(b)(ii) of Directive 2009/138/EC, the required solvency margin shall be equal to a 4 % fraction of the mathematical provisions calculated in compliance with paragraph 2(a).

5. For operations referred to in Article 2(3)(b)(i) of Directive 2009/138/EC, the required solvency margin shall be equal to 1 % of their assets.

6. For assurances covered by Article 2(3)(a)(i) and (ii) of Directive 2009/138/EC linked to investment funds and for the operations referred to in Article 2(3)(b)(iii), (iv) and (v) of Directive 2009/138/EC, the required solvency margin shall be equal to the sum of the following:

(a) in so far as the institution bears an investment risk, a 4 % fraction of the technical provisions, calculated in compliance with paragraph 2(a);

(b) in so far as the institution bears no investment risk but the allocation to cover management expenses is fixed for a period exceeding five years, a 1 % fraction of the technical provisions, calculated in compliance with paragraph 2(a);

(c) in so far as the institution bears no investment risk and the allocation to cover management expenses is not fixed for a period exceeding five years, an amount equivalent to 25 % of the net administrative expenses of the previous financial year pertaining to such business;

*(d) in so far as the institution covers a death risk, a 0,3 % fraction of the capital at risk calculated in compliance with paragraph 2(b).*

#### *Article 17c*

##### *Guarantee fund*

*1. Member States may provide that one third of the required solvency margin as specified in Article 17b shall constitute the guarantee fund. That fund shall comprise the items listed in Article 17a(2) and (3) and, subject to the agreement of the competent authority of the home Member State, in Article 17a(4)(b).*

*2. The guarantee fund shall not be less than EUR 3 million. Any Member State may provide for a 25 % reduction of the minimum guarantee fund in the case of mutual and mutual-type undertakings.*

#### *Article 17d*

##### *Required solvency margin for the purpose of Article 17b(3)*

*1. The required solvency margin shall be determined on the basis either of the annual amount of premiums or contributions, or of the average burden of claims for the past three financial years.*

*2. The amount of the required solvency margin shall be equal to the higher of the two results as set out in paragraphs 3 and 4.*

*3. The premium basis shall be calculated using the higher of gross written premiums or contributions as calculated below, and gross earned premiums or contributions.*

*The premiums or contributions (inclusive of charges ancillary to premiums or contributions) due in respect of direct business in the previous financial year shall be aggregated.*

*To that sum there shall be added the amount of premiums accepted for all reinsurance in the previous financial year.*

*From that sum there shall then be deducted the total amount of premiums or contributions cancelled in the previous financial year, as well as the total amount of taxes and levies pertaining to the premiums or contributions entering into the aggregate.*

*The amount so obtained shall be divided into two portions, the first extending up to EUR 50 million, the second comprising the excess; 18 % of the first portion and 16 % of the second shall be added together.*

*The sum so obtained shall be multiplied by the ratio existing in respect of the sum of the previous three financial years between the amount of claims remaining to be borne by the institution after deduction of amounts recoverable under reinsurance and the gross amount of claims. That ratio shall be no less than 50 %.*

*4. The claims basis shall be calculated, as follows:*

*The amounts of claims paid in respect of direct business (without any deduction of claims borne by reinsurers and retrocessionaires) in the periods specified in paragraph 1 shall be aggregated.*

*To that sum there shall be added the amount of claims paid in respect of reinsurances or retrocessions accepted during the same periods and the amount of provisions for claims outstanding established at the end of the previous financial year both for direct business and for reinsurance acceptances.*

*From that sum there shall be deducted the amount of recoveries effected during the periods specified in paragraph 1.*

*From the sum then remaining, there shall be deducted the amount of provisions for claims outstanding established at the commencement of the second financial year preceding the last financial year for which there are accounts, both for direct business and for reinsurance acceptances.*

*One third of the amount so obtained shall be divided into two portions, the first extending up to EUR 35 million and the second comprising the excess; 26 % of the first portion and 23 % of the second, shall be added together.*

*The sum so obtained shall be multiplied by the ratio existing in respect of the sum of the previous three financial years between the amount of claims remaining to be borne by the institution after deduction of amounts recoverable under reinsurance and the gross amount of claims. That ratio shall be no less than 50 %.*

*5. Where the required solvency margin as calculated in paragraphs 2 to 4 is lower than the required solvency margin of the preceding year, the required solvency margin shall be at least equal to the required solvency margin of the preceding year, multiplied by the ratio of the amount of the technical provisions for claims outstanding at the end of the previous financial year and the amount of the technical provisions for claims outstanding at the beginning of the previous financial year. In those calculations technical provisions shall be calculated net of reinsurance but the ratio may be no higher than 1.*

## **Article 18**

### **Investment rules**

*2. The home Member State shall prohibit the institution from borrowing or acting as a guarantor on behalf of third parties. However, Member States may authorise institutions to carry out some borrowing only for liquidity purposes and on a temporary basis.*

## **International standards (OECD/IOPS, etc...)**

10.2.10. The OECD Recommendation on the Core Principles of Occupational Pension Regulation<sup>52</sup> and the OECD Guidelines on Funding and Benefit Security in

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<sup>52</sup> OECD, Private Pensions and Policy Responses to the Crisis - Recommendation on the Core Principles of Occupational Pension Regulation, June 2009.

Occupational Pension Plans<sup>53</sup> contain the following guidelines on the funding rules for occupational pension plans/funds:

- 1. The legal provisions require the identification and maintenance of a level of assets that would be at least sufficient to meet accrued benefit payments. The targeted funding level may be based on the termination or the ongoing liability. It should also take account of the plan sponsor's ability and commitment to increase contributions to the pension plan in situations of underfunding, the possibility of benefit adjustments or changes in retirement ages, as well as the link between the pension fund's assets and its liabilities.*
- 2. Approved funding methods (also known as actuarial cost methods) for the ongoing liability should attempt to prevent sharply rising cost curves over time by spreading the actuarial (or accrued) liability over the expected career path of plan members. In order to ensure adequate funding levels over time, ongoing funding methods should take into account factors such as future salary growth, mortality, disability, early leaver (separation) and other relevant events.*
- 3. In addition to normal costs (the present value of benefits that have accrued on behalf of the members during the valuation period), contributions should reflect other factors, including, to the extent appropriate to the accrual of benefits under the plan, work before a plan's inception, plan amendments that increase liability attributable to past service, deviations of actual results from assumptions (experience gains and losses), and the effects of changes in assumptions (actuarial gains and losses). These supplemental costs should be amortised as even currency units or at a minimum as even percentages of payroll. Amortisation periods should in general not be longer than the expected future period of service of active plan participants.*
- 4. The legal provisions should not prevent funding methods that seek to dampen the short term volatility in firms' funding contributions. Prudent amortisation of supplemental costs over time might help achieve a smoother contribution schedule and more stable funding levels.*
- 5. These legal provisions set out the different mechanisms and the recovery period for correcting a situation of underfunding, taking into account the sources of underfunding and the type of underfunding (ongoing or termination basis). Funding rules may grant some reprieve on contribution obligations only under restricted circumstances and to defined limits. Temporary reductions of contribution obligations may be considered with a clear waiver procedure managed by the pension regulator.*
- 6. Funding rules should aim to be countercyclical, providing incentives to build reserves against market downturns. They should also take market volatility into account when limiting contributions (or their tax deductibility) as a certain funding level is reached. Tax regulations should not discourage the build-up of sufficient reserves to withstand adverse market conditions and should avoid restricting the full funding of the ongoing or termination liability. Temporary suspension of contribution obligations may be appropriate in circumstances of significant overfunding (calculated on an on-going basis).*

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<sup>53</sup> OECD, OECD Guidelines on Funding and Benefit Security in Occupational Pension Plans – Recommendation of the Council, May 2007.

*7. Funding rules should take into account the extent to which the autonomous pension fund itself as opposed to the plan sponsor or the plan members is directly responsible partly or wholly for the commitments represented by the pension liabilities. Where the pension fund itself underwrites the pension liability without any guarantee from the plan sponsor or members, it should be required to hold additional assets over and above those necessary to fully fund the pension liabilities on a plan termination basis. This capital requirement or solvency margin should be determined taking into account the nature and size of assets held and liabilities due that are the responsibility of the pension fund and the extent to which benefits may be reduced.*

## **Solvency II Directive**

- 10.2.11. The Solvency II Directive distinguishes between basic and ancillary own funds. Basic own funds consist of i) the excess of assets over liabilities and ii) subordinated liabilities. Ancillary own funds consist of items other than basic own funds which can be called up to absorb losses. They are subject to prior supervisory approval.
- 10.2.12. In addition to this distinction, the Solvency II directive provides a classification of own funds into 3 Tiers, depending on the capacity and availability of the different own funds items to absorb losses. This classification into tiers then leads to the definition of eligible own funds.
- 10.2.13. The Solvency II Directive does not contain a provision regarding the prohibition of borrowing or acting as a guarantor on behalf of third parties.
- 10.2.14. The Solvency Capital Requirement (SCR) is calculated by taking into account the actual risk profile of the undertaking and corresponds to the amount of own funds to be held in order to ensure the solvency of the undertaking over a certain time horizon with a given confidence level. Article 101 and 102 specify the value-at-risk (99.5% at a 1 year horizon), the risks covered and the frequency of calculations.
- 10.2.15. Articles 103-111 describe the working of the standard model for calculating the SCR. According to Article 304, insurers may – subject to strict conditions – use the duration-based equity risk sub-model for their domestic (occupational) retirement business. Insurance undertakings may employ a full or partial internal model, which is subject to the conditions laid down in Articles 112-127.
- 10.2.16. The Articles 128–131 of Solvency II contain both qualitative and quantitative provisions on the main characteristics and calculation of the Minimum Capital Requirement (MCR).
- 10.2.17. Solvency II contains no distinction – as there is in the IORP Directive – between the institution and the sponsoring undertaking bearing the risks.
- 10.2.18. Solvency II sets a specific capital requirement for operational risk as part of the SCR. In the case of the unit-linked business, the capital requirement for operational risk is set taking into account only the annual expenses incurred in respect of these insurance operations.

10.2.19. Articles 136-142 contain the provisions on recovery plans when insurance undertakings do not comply with the capital requirements. They aim to ensure that either the financial position of the company is corrected over a short period - so that it has adequate capital to operate in that market - or that the insurer is closed for new business and transfers its business to another similar entity.

#### *Article 87*

##### *Own funds*

*Own funds shall comprise the sum of basic own funds, referred to in Article 88 and ancillary own funds referred to in Article 89.*

#### *Article 88*

##### *Basic own funds*

*Basic own funds shall consist of the following items:*

*(1) the excess of assets over liabilities, valued in accordance with Article 75 and Section 2;*

*(2) subordinated liabilities.*

*The excess amount referred to in point (1) shall be reduced by the amount of own shares held by the insurance or reinsurance undertaking.*

#### *Article 89*

##### *Ancillary own funds*

*1. Ancillary own funds shall consist of items other than basic own funds which can be called up to absorb losses.*

*Ancillary own funds may comprise the following items to the extent that they are not basic own-fund items:*

*(a) unpaid share capital or initial fund that has not been called up;*

*(b) letters of credit and guarantees;*

*(c) any other legally binding commitments received by insurance and reinsurance undertakings.*

*In the case of a mutual or mutual-type association with variable contributions, ancillary own funds may also comprise any future claims which that association may have against its members by way of a call for supplementary contribution, within the following 12 months.*

*2. Where an ancillary own-fund item has been paid in or called up, it shall be treated as an asset and cease to form part of ancillary own-fund items.*

#### *Article 90*

### *Supervisory approval of ancillary own funds*

- 1. The amounts of ancillary own-fund items to be taken into account when determining own funds shall be subject to prior supervisory approval.*
- 2. The amount ascribed to each ancillary own-fund item shall reflect the loss-absorbency of the item and shall be based upon prudent and realistic assumptions. Where an ancillary own-fund item has a fixed nominal value, the amount of that item shall be equal to its nominal value, where it appropriately reflects its loss-absorbency.*
- 3. Supervisory authorities shall approve either of the following:*
  - (a) a monetary amount for each ancillary own-fund item;*
  - (b) a method by which to determine the amount of each ancillary own-fund item, in which case supervisory approval of the amount determined in accordance with that method shall be granted for a specified period of time.*
- 4. For each ancillary own-fund item, supervisory authorities shall base their approval on an assessment of the following:*
  - (a) the status of the counterparties concerned, in relation to their ability and willingness to pay;*
  - (b) the recoverability of the funds, taking account of the legal form of the item, as well as any conditions which would prevent the item from being successfully paid in or called up;*
  - (c) any information on the outcome of past calls which insurance and reinsurance undertakings have made for such ancillary own funds, to the extent that information can be reliably used to assess the expected outcome of future calls.*

### *Article 91*

#### *Surplus funds*

- 1. Surplus funds shall be deemed to be accumulated profits which have not been made available for distribution to policy holders and beneficiaries.*
- 2. In so far as authorised under national law, surplus funds shall not be considered as insurance and reinsurance liabilities to the extent that they fulfil the criteria set out in Article 94(1).*

### *Article 92*

#### *Implementing measures*

- 1. The Commission shall adopt implementing measures specifying the following:*
  - (a) the criteria for granting supervisory approval in accordance with Article 90;*
  - (b) the treatment of participations, within the meaning of the third subparagraph of Article 212(2), in financial and credit institutions with respect to the determination of own funds.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

*2. Participations in financial and credit institutions as referred to in paragraph 1(b) shall comprise the following:*

*(a) participations which insurance and reinsurance undertakings hold in:*

*(i) credit institutions and financial institutions within the meaning of Article 4(1) and (5) of Directive 2006/48/EC,*

*(ii) investment firms within the meaning of point 1 of Article 4(1) of Directive 2004/39/EC;*

*(b) subordinated claims and instruments referred to in Article 63 and Article 64(3) of Directive 2006/48/EC which insurance and reinsurance undertakings hold in respect of the entities defined in point (a) of this paragraph in which they hold a participation.*

## *Article 93*

*Characteristics and features used to classify own funds into tiers*

*1. Own-fund items shall be classified into three tiers. The classification of those items shall depend upon whether they are basic own fund or ancillary own-fund items and the extent to which they possess the following characteristics:*

*(a) the item is available, or can be called up on demand, to fully absorb losses on a going-concern basis, as well as in the case of winding-up (permanent availability);*

*(b) in the case of winding-up, the total amount of the item is available to absorb losses and the repayment of the item is refused to its holder until all other obligations, including insurance and reinsurance obligations towards policy holders and beneficiaries of insurance and reinsurance contracts, have been met (subordination).*

*2. When assessing the extent to which own-fund items possess the characteristics set out in points (a) and (b) of paragraph 1, currently and in the future, due consideration shall be given to the duration of the item, in particular whether the item is dated or not. Where an own-fund item is dated, the relative duration of the item as compared to the duration of the insurance and reinsurance obligations of the undertaking shall be considered (sufficient duration).*

*In addition, the following features shall be considered:*

*(a) whether the item is free from requirements or incentives to redeem the nominal sum (absence of incentives to redeem);*

*(b) whether the item is free from mandatory fixed charges (absence of mandatory servicing costs);*

*(c) whether the item is clear of encumbrances (absence of encumbrances).*

## *Article 94*

*Main criteria for the classification into tiers*

*1. Basic own-fund items shall be classified in Tier 1 where they substantially possess the characteristics set out in Article 93(1)(a) and (b), taking into consideration the features set out in Article 93(2).*

*2. Basic own-fund items shall be classified in Tier 2 where they substantially possess the characteristic set out in Article 93(1)(b), taking into consideration the features set out in Article 93(2).*

*Ancillary own-fund items shall be classified in Tier 2 where they substantially possess the characteristics set out in Article 93(1)(a) and (b), taking into consideration the features set out in Article 93(2).*

*3. Any basic and ancillary own-fund items which do not fall under paragraphs 1 and 2 shall be classified in Tier 3.*

## *Article 95*

### *Classification of own funds into tiers*

*Member States shall ensure that insurance and reinsurance undertakings classify their own-fund items on the basis of the criteria laid down in Article 94.*

*For that purpose, insurance and reinsurance undertakings shall refer to the list of own-fund items referred to in Article 97(1)(a), where applicable.*

*Where an own-fund item is not covered by that list, it shall be assessed and classified by insurance and reinsurance undertakings, in accordance with the first paragraph. That classification shall be subject to approval by the supervisory authority.*

## *Article 96*

### *Classification of specific insurance own-fund items*

*Without prejudice to Article 95 and Article 97(1)(a) for the purposes of this Directive the following classifications shall be applied:*

*(1) surplus funds falling under Article 91(2) shall be classified in Tier 1;*

*(2) letters of credit and guarantees which are held in trust for the benefit of insurance creditors by an independent trustee and provided by credit institutions authorised in accordance with Directive 2006/48/EC shall be classified in Tier 2;*

*(3) any future claims which mutual or mutual-type associations of shipowners with variable contributions solely insuring risks listed in classes 6, 12 and 17 in Part A of Annex I may have against their members by way of a call for supplementary contributions, within the following 12 months, shall be classified in Tier 2.*

*In accordance with the second subparagraph of Article 94(2), any future claims which mutual or mutual-type associations with variable contributions may have against their members by way of a call for supplementary contributions, within the following 12 months, not falling under point (3) of the first subparagraph shall be classified in Tier 2 where they substantially possess the characteristics set out in Article 93(1)(a) and (b), taking into consideration the features set out in Article 93(2).*

## *Article 97*

## *Implementing measures*

*1. The Commission shall adopt implementing measures laying down the following:*

*(a) a list of own-fund items, including those referred to in Article 96, deemed to fulfil the criteria, set out in Article 94, which contains for each own-fund item a precise description of the features which determined its classification;*

*(b) the methods to be used by supervisory authorities, when approving the assessment and classification of own-fund items which are not covered by the list referred to in point (a).*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

*2. The Commission shall regularly review and, where appropriate, update the list referred to in paragraph 1(a) in the light of market developments.*

## *Article 98*

### *Eligibility and limits applicable to Tiers 1, 2 and 3*

*1. As far as the compliance with the Solvency Capital Requirement is concerned, the eligible amounts of Tier 2 and Tier 3 items shall be subject to quantitative limits. Those limits shall be such as to ensure that at least the following conditions are met:*

*(a) the proportion of Tier 1 items in the eligible own funds is higher than one third of the total amount of eligible own funds;*

*(b) the eligible amount of Tier 3 items is less than one third of the total amount of eligible own funds.*

*2. As far as compliance with the Minimum Capital Requirement is concerned, the amount of basic own-fund items eligible to cover the Minimum Capital Requirement which are classified in Tier 2 shall be subject to quantitative limits. Those limits shall be such as to ensure, as a minimum, that the proportion of Tier 1 items in the eligible basic own funds is higher than one half of the total amount of eligible basic own funds.*

*3. The eligible amount of own funds to cover the Solvency Capital Requirement set out in Article 100 shall be equal to the sum of the amount of Tier 1, the eligible amount of Tier 2 and the eligible amount of Tier 3.*

*4. The eligible amount of basic own funds to cover the Minimum Capital Requirement set out in Article 128 shall be equal to the sum of the amount of Tier 1 and the eligible amount of basic own-fund items classified in Tier 2.*

## *Article 99*

### *Implementing measures*

*The Commission shall adopt implementing measures laying down:*

*(a) the quantitative limits referred to in Article 98(1) and (2);*

*(b) the adjustments that should be made to reflect the lack of transferability of those own-fund items that can only be used to cover losses arising from a particular segment of liabilities or from particular risks (ring-fenced funds).*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

## *Article 100*

### *General provisions*

*Member States shall require that insurance and reinsurance undertakings hold eligible own funds covering the Solvency Capital Requirement.*

*The Solvency Capital Requirement shall be calculated, either in accordance with the standard formula in Subsection 2 or using an internal model, as set out in Subsection 3.*

## *Article 101*

### *Calculation of the Solvency Capital Requirement*

*1. The Solvency Capital Requirement shall be calculated in accordance with paragraphs 2 to 5.*

*2. The Solvency Capital Requirement shall be calculated on the presumption that the undertaking will pursue its business as a going concern.*

*3. The Solvency Capital Requirement shall be calibrated so as to ensure that all quantifiable risks to which an insurance or reinsurance undertaking is exposed are taken into account. It shall cover existing business, as well as the new business expected to be written over the following 12 months. With respect to existing business, it shall cover only unexpected losses.*

*It shall correspond to the Value-at-Risk of the basic own funds of an insurance or reinsurance undertaking subject to a confidence level of 99,5 % over a one-year period.*

*4. The Solvency Capital Requirement shall cover at least the following risks:*

*(a) non-life underwriting risk;*

*(b) life underwriting risk;*

*(c) health underwriting risk;*

*(d) market risk;*

*(e) credit risk;*

*(f) operational risk.*

*Operational risk as referred to in point (f) of the first subparagraph shall include legal risks, and exclude risks arising from strategic decisions, as well as reputation risks.*

*5. When calculating the Solvency Capital Requirement, insurance and reinsurance undertakings shall take account of the effect of risk-mitigation techniques, provided that credit risk and other risks arising from the use of such techniques are properly reflected in the Solvency Capital Requirement.*

#### *Article 102*

##### *Frequency of calculation*

*1. Insurance and reinsurance undertakings shall calculate the Solvency Capital Requirement at least once a year and report the result of that calculation to the supervisory authorities.*

*Insurance and reinsurance undertakings shall hold eligible own funds which cover the last reported Solvency Capital Requirement.*

*Insurance and reinsurance undertakings shall monitor the amount of eligible own funds and the Solvency Capital Requirement on an ongoing basis.*

*If the risk profile of an insurance or reinsurance undertaking deviates significantly from the assumptions underlying the last reported Solvency Capital Requirement, the undertaking concerned shall recalculate the Solvency Capital Requirement without delay and report it to the supervisory authorities.*

*2. Where there is evidence to suggest that the risk profile of the insurance or reinsurance undertaking has altered significantly since the date on which the Solvency Capital Requirement was last reported, the supervisory authorities may require the undertaking concerned to recalculate the Solvency Capital Requirement.*

#### *Article 103*

##### *Structure of the standard formula*

*The Solvency Capital Requirement calculated on the basis of the standard formula shall be the sum of the following items:*

*(a) the Basic Solvency Capital Requirement, as laid down in Article 104;*

*(b) the capital requirement for operational risk, as laid down in Article 107;*

*(c) the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes, as laid down in Article 108.*

#### *Article 104*

##### *Design of the Basic Solvency Capital Requirement*

*1. The Basic Solvency Capital Requirement shall comprise individual risk modules, which are aggregated in accordance with point (1) of Annex IV.*

*It shall consist of at least the following risk modules:*

*(a) non-life underwriting risk;*

*(b) life underwriting risk;*

- (c) health underwriting risk;*
- (d) market risk;*
- (e) counterparty default risk.*

*2. For the purposes of points (a), (b) and (c) of paragraph 1, insurance or reinsurance operations shall be allocated to the underwriting risk module that best reflects the technical nature of the underlying risks.*

*3. The correlation coefficients for the aggregation of the risk modules referred to in paragraph 1, as well as the calibration of the capital requirements for each risk module, shall result in an overall Solvency Capital Requirement which complies with the principles set out in Article 101.*

*4. Each of the risk modules referred to in paragraph 1 shall be calibrated using a Value-at-Risk measure, with a 99,5 % confidence level, over a one-year period.*

*Where appropriate, diversification effects shall be taken into account in the design of each risk module.*

*5. The same design and specifications for the risk modules shall be used for all insurance and reinsurance undertakings, both with respect to the Basic Solvency Capital Requirement and to any simplified calculations as laid down in Article 109.*

*6. With regard to risks arising from catastrophes, geographical specifications may, where appropriate, be used for the calculation of the life, non-life and health underwriting risk modules.*

*7. Subject to approval by the supervisory authorities, insurance and reinsurance undertakings may, within the design of the standard formula, replace a subset of its parameters by parameters specific to the undertaking concerned when calculating the life, non-life and health underwriting risk modules.*

*Such parameters shall be calibrated on the basis of the internal data of the undertaking concerned, or of data which is directly relevant for the operations of that undertaking using standardised methods.*

*When granting supervisory approval, supervisory authorities shall verify the completeness, accuracy and appropriateness of the data used.*

## *Article 105*

### *Calculation of the Basic Solvency Capital Requirement*

*1. The Basic Solvency Capital Requirement shall be calculated in accordance with paragraphs 2 to 6.*

*2. The non-life underwriting risk module shall reflect the risk arising from non-life insurance obligations, in relation to the perils covered and the processes used in the conduct of business.*

*It shall take account of the uncertainty in the results of insurance and reinsurance undertakings related to the existing insurance and reinsurance obligations as well as to the new business expected to be written over the following 12 months.*

*It shall be calculated, in accordance with point (2) of Annex IV, as a combination of the capital requirements for at least the following sub-modules:*

*(a) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from fluctuations in the timing, frequency and severity of insured events, and in the timing and amount of claim settlements (non-life premium and reserve risk);*

*(b) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from significant uncertainty of pricing and provisioning assumptions related to extreme or exceptional events (non-life catastrophe risk).*

*3. The life underwriting risk module shall reflect the risk arising from life insurance obligations, in relation to the perils covered and the processes used in the conduct of business.*

*It shall be calculated, in accordance with point (3) of Annex IV, as a combination of the capital requirements for at least the following sub-modules:*

*(a) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend, or volatility of mortality rates, where an increase in the mortality rate leads to an increase in the value of insurance liabilities (mortality risk);*

*(b) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend, or volatility of mortality rates, where a decrease in the mortality rate leads to an increase in the value of insurance liabilities (longevity risk);*

*(c) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend or volatility of disability, sickness and morbidity rates (disability – morbidity risk);*

*(d) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend, or volatility of the expenses incurred in servicing insurance or reinsurance contracts (life-expense risk);*

*(e) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from fluctuations in the level, trend, or volatility of the revision rates applied to annuities, due to changes in the legal environment or in the state of health of the person insured (revision risk);*

*(f) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level or volatility of the rates of policy lapses, terminations, renewals and surrenders (lapse risk);*

*(g) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from the significant uncertainty of pricing and provisioning assumptions related to extreme or irregular events (life-catastrophe risk).*

*4. The health underwriting risk module shall reflect the risk arising from the underwriting of health insurance obligations, whether it is pursued on a similar technical basis to that of life insurance or not, following from both the perils covered and the processes used in the conduct of business.*

*It shall cover at least the following risks:*

- (a) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend, or volatility of the expenses incurred in servicing insurance or reinsurance contracts;*
- (b) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from fluctuations in the timing, frequency and severity of insured events, and in the timing and amount of claim settlements at the time of provisioning;*
- (c) the risk of loss, or of adverse change in the value of insurance liabilities, resulting from the significant uncertainty of pricing and provisioning assumptions related to outbreaks of major epidemics, as well as the unusual accumulation of risks under such extreme circumstances.*

*5. The market risk module shall reflect the risk arising from the level or volatility of market prices of financial instruments which have an impact upon the value of the assets and liabilities of the undertaking. It shall properly reflect the structural mismatch between assets and liabilities, in particular with respect to the duration thereof.*

*It shall be calculated, in accordance with point (4) of Annex IV, as a combination of the capital requirements for at least the following sub-modules:*

- (a) the sensitivity of the values of assets, liabilities and financial instruments to changes in the term structure of interest rates, or in the volatility of interest rates (interest rate risk);*
- (b) the sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of market prices of equities (equity risk);*
- (c) the sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of market prices of real estate (property risk);*
- (d) the sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of credit spreads over the risk-free interest rate term structure (spread risk);*
- (e) the sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of currency exchange rates (currency risk);*
- (f) additional risks to an insurance or reinsurance undertaking stemming either from lack of diversification in the asset portfolio or from large exposure to default risk by a single issuer of securities or a group of related issuers (market risk concentrations).*

*6. The counterparty default risk module shall reflect possible losses due to unexpected default, or deterioration in the credit standing, of the counterparties and debtors of insurance and reinsurance undertakings over the following 12 months. The counterparty default risk module shall cover risk-mitigating contracts, such as reinsurance arrangements, securitisations and derivatives, and receivables from intermediaries, as well as any other credit exposures which are not covered in the spread risk sub-module. It shall take appropriate account of collateral or other security held by or for the account of the insurance or reinsurance undertaking and the risks associated therewith.*

*For each counterparty, the counterparty default risk module shall take account of the overall counterparty risk exposure of the insurance or reinsurance undertaking concerned to that counterparty, irrespective of the legal form of its contractual obligations to that undertaking.*

#### *Article 106*

##### *Calculation of the equity risk sub-module: symmetric adjustment mechanism*

- 1. The equity risk sub-module calculated in accordance with the standard formula shall include a symmetric adjustment to the equity capital charge applied to cover the risk arising from changes in the level of equity prices.*
- 2. The symmetric adjustment made to the standard equity capital charge, calibrated in accordance with Article 104(4), covering the risk arising from changes in the level of equity prices shall be based on a function of the current level of an appropriate equity index and a weighted average level of that index. The weighted average shall be calculated over an appropriate period of time which shall be the same for all insurance and reinsurance undertakings.*
- 3. The symmetric adjustment made to the standard equity capital charge covering the risk arising from changes in the level of equity prices shall not result in an equity capital charge being applied that is more than 10 percentage points lower or 10 percentage points higher than the standard equity capital charge.*

#### *Article 107*

##### *Capital requirement for operational risk*

- 1. The capital requirement for operational risk shall reflect operational risks to the extent they are not already reflected in the risk modules referred to in Article 104. That requirement shall be calibrated in accordance with Article 101(3).*
- 2. With respect to life insurance contracts where the investment risk is borne by the policy holders, the calculation of the capital requirement for operational risk shall take account of the amount of annual expenses incurred in respect of those insurance obligations.*
- 3. With respect to insurance and reinsurance operations other than those referred to in paragraph 2, the calculation of the capital requirement for operational risk shall take account of the volume of those operations, in terms of earned premiums and technical provisions which are held in respect of those insurance and reinsurance obligations. In this case, the capital requirement for operational risks shall not exceed 30 % of the Basic Solvency Capital Requirement relating to those insurance and reinsurance operations.*

#### *Article 108*

##### *Adjustment for the loss-absorbing capacity of technical provisions and deferred taxes*

*The adjustment referred to in Article 103(c) for the loss-absorbing capacity of technical provisions and deferred taxes shall reflect potential compensation of unexpected losses through a simultaneous decrease in technical provisions or deferred taxes or a combination of the two.*

*That adjustment shall take account of the risk mitigating effect provided by future discretionary benefits of insurance contracts, to the extent insurance and reinsurance undertakings can establish that a reduction in such benefits may be used to cover unexpected losses when they arise. The risk mitigating effect provided by future discretionary benefits shall be no higher than the sum of technical provisions and deferred taxes relating to those future discretionary benefits.*

*For the purpose of the second paragraph, the value of future discretionary benefits under adverse circumstances shall be compared to the value of such benefits under the underlying assumptions of the best-estimate calculation.*

#### *Article 109*

##### *Simplifications in the standard formula*

*Insurance and reinsurance undertakings may use a simplified calculation for a specific sub-module or risk module where the nature, scale and complexity of the risks they face justifies it and where it would be disproportionate to require all insurance and reinsurance undertakings to apply the standardised calculation.*

*Simplified calculations shall be calibrated in accordance with Article 101(3).*

#### *Article 110*

##### *Significant deviations from the assumptions underlying the standard formula calculation*

*Where it is inappropriate to calculate the Solvency Capital Requirement in accordance with the standard formula, as set out in Subsection 2, because the risk profile of the insurance or reinsurance undertaking concerned deviates significantly from the assumptions underlying the standard formula calculation, the supervisory authorities may, by means of a decision stating the reasons, require the undertaking concerned to replace a subset of the parameters used in the standard formula calculation by parameters specific to that undertaking when calculating the life, non-life and health underwriting risk modules, as set out in Article 104(7). Those specific parameters shall be calculated in such a way to ensure that the undertaking complies with Article 101(3).*

#### *Article 111*

##### *Implementing measures*

*1. In order to ensure that the same treatment is applied to all insurance and reinsurance undertakings calculating the Solvency Capital Requirement on the basis of the standard formula, or to take account of market developments, the Commission shall adopt implementing measures providing for the following:*

*(a) a standard formula in accordance with the provisions of Articles 101 and 103 to 109;*

*(b) any sub-modules necessary or covering more precisely the risks which fall under the respective risk modules referred to in Article 104 as well as any subsequent updates;*

*(c) the methods, assumptions and standard parameters to be used when calculating each of the risk modules or sub-modules of the Basic Solvency Capital Requirement laid down in Articles 104, 105 and 304, the symmetric adjustment mechanism and the appropriate period of time, expressed in the number of months, as referred to in Article 106, and the appropriate approach for integrating the method referred to in Article 304 in the Solvency Capital Requirement as calculated in accordance with the standard formula;*

*(d) the correlation parameters, including, if necessary, those set out in Annex IV, and the procedures for the updating of those parameters;*

*(e) where insurance and reinsurance undertakings use risk-mitigation techniques, the methods and assumptions to be used to assess the changes in the risk profile of the undertaking concerned and to adjust the calculation of the Solvency Capital Requirement;*

*(f) the qualitative criteria that the risk-mitigation techniques referred to in point (e) must fulfil in order to ensure that the risk has been effectively transferred to a third party;*

*(g) the methods and parameters to be used when assessing the capital requirement for operational risk set out in Article 107, including the percentage referred to in paragraph 3 of Article 107;*

*(h) the methods and adjustments to be used to reflect the reduced scope for risk diversification of insurance and reinsurance undertakings related to ring-fenced funds;*

*(i) the method to be used when calculating the adjustment for the loss-absorbing capacity of technical provisions or deferred taxes, as laid down in Article 108;*

*(j) the subset of standard parameters in the life, non-life and health underwriting risk modules that may be replaced by undertaking-specific parameters as set out in Article 104(7);*

*(k) the standardised methods to be used by the insurance or reinsurance undertaking to calculate the undertaking-specific parameters referred to in point (j), and any criteria with respect to the completeness, accuracy, and appropriateness of the data used that must be met before supervisory approval is given;*

*(l) the simplified calculations provided for specific sub-modules and risk modules, as well as the criteria that insurance and reinsurance undertakings, including captive insurance and reinsurance undertakings, shall be required to fulfil in order to be entitled to use each of those simplifications, as set out in Article 109;*

*(m) the approach to be used with respect to related undertakings within the meaning of Article 212 in the calculation of the Solvency Capital Requirement, in particular the calculation of the equity risk sub-module referred to in Article 105(5), taking into account the likely reduction in the volatility of the value of those related undertakings arising from the strategic nature of those investments and the influence exercised by the participating undertaking on those related undertakings.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

*2. The Commission may adopt implementing measures laying down quantitative limits and asset eligibility criteria in order to address risks which are not adequately covered by a sub-module. Such implementing measures shall apply to assets covering technical provisions, excluding assets held in respect of life insurance contracts where the investment risk is borne by the policy holders. Those measures shall be reviewed by the Commission in the light of developments in the standard formula and financial markets.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

## *Article 112*

### *General provisions for the approval of full and partial internal models*

*1. Member States shall ensure that insurance or reinsurance undertakings may calculate the Solvency Capital Requirement using a full or partial internal model as approved by the supervisory authorities.*

*2. Insurance and reinsurance undertakings may use partial internal models for the calculation of one or more of the following:*

*(a) one or more risk modules, or sub-modules, of the Basic Solvency Capital Requirement, as set out in Articles 104 and 105;*

*(b) the capital requirement for operational risk as set out in Article 107;*

*(c) the adjustment referred to in Article 108.*

*In addition, partial modelling may be applied to the whole business of insurance and reinsurance undertakings, or only to one or more major business units.*

*3. In any application for approval, insurance and reinsurance undertakings shall submit, as a minimum, documentary evidence that the internal model fulfils the requirements set out in Articles 120 to 125.*

*Where the application for that approval relates to a partial internal model, the requirements set out in Articles 120 to 125 shall be adapted to take account of the limited scope of the application of the model.*

*4. The supervisory authorities shall decide on the application within six months from the receipt of the complete application.*

*5. Supervisory authorities shall give approval to the application only if they are satisfied that the systems of the insurance or reinsurance undertaking for identifying, measuring, monitoring, managing and reporting risk are adequate and in particular, that the internal model fulfils the requirements referred to in paragraph 3.*

*6. A decision by the supervisory authorities to reject the application for the use of an internal model shall state the reasons on which it is based.*

*7. After having received approval from supervisory authorities to use an internal model, insurance and reinsurance undertakings may, by means of a decision stating the reasons, be required to provide supervisory authorities with an estimate of the*

*Solvency Capital Requirement determined in accordance with the standard formula, as set out in Subsection 2.*

#### *Article 113*

##### *Specific provisions for the approval of partial internal models*

*1. In the case of a partial internal model, supervisory approval shall be given only where that model fulfils the requirements set out in Article 112 and the following additional conditions:*

*(a) the reason for the limited scope of application of the model is properly justified by the undertaking;*

*(b) the resulting Solvency Capital Requirement reflects more appropriately the risk profile of the undertaking and in particular complies with the principles set out in Subsection 1;*

*(c) its design is consistent with the principles set out in Subsection 1 so as to allow the partial internal model to be fully integrated into the Solvency Capital Requirement standard formula.*

*2. When assessing an application for the use of a partial internal model which only covers certain sub-modules of a specific risk module, or some of the business units of an insurance or reinsurance undertaking with respect to a specific risk module, or parts of both, supervisory authorities may require the insurance and reinsurance undertakings concerned to submit a realistic transitional plan to extend the scope of the model.*

*The transitional plan shall set out the manner in which insurance and reinsurance undertakings plan to extend the scope of the model to other sub-modules or business units, in order to ensure that the model covers a predominant part of their insurance operations with respect to that specific risk module.*

#### *Article 114*

##### *Implementing measures*

*The Commission shall adopt implementing measures setting out the following:*

*(1) the procedure to be followed for the approval of an internal model;*

*(2) the adaptations to be made to the standards set out in Articles 120 to 125 in order to take account of the limited scope of the application of the partial internal model.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

#### *Article 115*

##### *Policy for changing the full and partial internal models*

*As part of the initial approval process of an internal model, the supervisory authorities shall approve the policy for changing the model of the insurance or reinsurance*

*undertaking. Insurance and reinsurance undertakings may change their internal model in accordance with that policy.*

*The policy shall include a specification of minor and major changes to the internal model.*

*Major changes to the internal model, as well as changes to that policy, shall always be subject to prior supervisory approval, as laid down in Article 112.*

*Minor changes to the internal model shall not be subject to prior supervisory approval, insofar as they are developed in accordance with that policy.*

#### *Article 116*

##### *Responsibilities of the administrative, management or supervisory bodies*

*The administrative, management or supervisory bodies of the insurance and reinsurance undertakings shall approve the application to the supervisory authorities for approval of the internal model referred to in Article 112, as well as the application for approval of any subsequent major changes made to that model.*

*The administrative, management or supervisory body shall have responsibility for putting in place systems which ensure that the internal model operates properly on a continuous basis.*

#### *Article 117*

##### *Reversion to the standard formula*

*After having received approval in accordance with Article 112, insurance and reinsurance undertakings shall not revert to calculating the whole or any part of the Solvency Capital Requirement in accordance with the standard formula, as set out in Subsection 2, except in duly justified circumstances and subject to the approval of the supervisory authorities.*

#### *Article 118*

##### *Non-compliance of the internal model*

*1. If, after having received approval from the supervisory authorities to use an internal model, insurance and reinsurance undertakings cease to comply with the requirements set out in Articles 120 to 125, they shall, without delay, either present to the supervisory authorities a plan to restore compliance within a reasonable period of time, or demonstrate that the effect of non-compliance is immaterial.*

*2. In the event that insurance and reinsurance undertakings fail to implement the plan referred to in paragraph 1, the supervisory authorities may require insurance and reinsurance undertakings to revert to calculating the Solvency Capital Requirement in accordance with the standard formula, as set out in Subsection 2.*

#### *Article 119*

##### *Significant deviations from the assumptions underlying the standard formula calculation*

*Where it is inappropriate to calculate the Solvency Capital Requirement in accordance with the standard formula, as set out in Subsection 2, because the risk profile of the insurance or reinsurance undertaking concerned deviates significantly from the assumptions underlying the standard formula calculation, the supervisory authorities may, by means of a decision stating the reasons, require the undertaking concerned to use an internal model to calculate the Solvency Capital Requirement, or the relevant risk modules thereof.*

## *Article 120*

### *Use test*

*Insurance and reinsurance undertakings shall demonstrate that the internal model is widely used in and plays an important role in their system of governance, referred to in Articles 41 to 50, in particular:*

*(a) their risk-management system as laid down in Article 44 and their decision-making processes;*

*(b) their economic and solvency capital assessment and allocation processes, including the assessment referred to in Article 45.*

*In addition, insurance and reinsurance undertakings shall demonstrate that the frequency of calculation of the Solvency Capital Requirement using the internal model is consistent with the frequency with which they use their internal model for the other purposes covered by the first paragraph.*

*The administrative, management or supervisory body shall be responsible for ensuring the ongoing appropriateness of the design and operations of the internal model, and that the internal model continues to appropriately reflect the risk profile of the insurance and reinsurance undertakings concerned.*

## *Article 121*

### *Statistical quality standards*

*1. The internal model, and in particular the calculation of the probability distribution forecast underlying it, shall comply with the criteria set out in paragraphs 2 to 9.*

*2. The methods used to calculate the probability distribution forecast shall be based on adequate, applicable and relevant actuarial and statistical techniques and shall be consistent with the methods used to calculate technical provisions.*

*The methods used to calculate the probability distribution forecast shall be based upon current and credible information and realistic assumptions.*

*Insurance and reinsurance undertakings shall be able to justify the assumptions underlying their internal model to the supervisory authorities.*

*3. Data used for the internal model shall be accurate, complete and appropriate.*

*Insurance and reinsurance undertakings shall update the data sets used in the calculation of the probability distribution forecast at least annually.*

4. No particular method for the calculation of the probability distribution forecast shall be prescribed.

Regardless of the calculation method chosen, the ability of the internal model to rank risk shall be sufficient to ensure that it is widely used in and plays an important role in the system of governance of insurance and reinsurance undertakings, in particular their risk-management system and decision-making processes, and capital allocation in accordance with Article 120.

The internal model shall cover all of the material risks to which insurance and reinsurance undertakings are exposed. Internal models shall cover at least the risks set out in Article 101(4).

5. As regards diversification effects, insurance and reinsurance undertakings may take account in their internal model of dependencies within and across risk categories, provided that supervisory authorities are satisfied that the system used for measuring those diversification effects is adequate.

6. Insurance and reinsurance undertakings may take full account of the effect of risk-mitigation techniques in their internal model, as long as credit risk and other risks arising from the use of risk-mitigation techniques are properly reflected in the internal model.

7. Insurance and reinsurance undertakings shall accurately assess the particular risks associated with financial guarantees and any contractual options in their internal model, where material. They shall also assess the risks associated with both policy holder options and contractual options for insurance and reinsurance undertakings. For that purpose, they shall take account of the impact that future changes in financial and non-financial conditions may have on the exercise of those options.

8. In their internal model, insurance and reinsurance undertakings may take account of future management actions that they would reasonably expect to carry out in specific circumstances.

In the case set out in the first subparagraph, the undertaking concerned shall make allowance for the time necessary to implement such actions.

9. In their internal model, insurance and reinsurance undertakings shall take account of all payments to policy holders and beneficiaries which they expect to make, whether or not those payments are contractually guaranteed.

## Article 122

### Calibration standards

1. Insurance and reinsurance undertakings may use a different time period or risk measure than that set out in Article 101(3) for internal modelling purposes as long as the outputs of the internal model can be used by those undertakings to calculate the Solvency Capital Requirement in a manner that provides policy holders and beneficiaries with a level of protection equivalent to that set out in Article 101.

2. Where practicable, insurance and reinsurance undertakings shall derive the Solvency Capital Requirement directly from the probability distribution forecast

*generated by the internal model of those undertakings, using the Value-at-Risk measure set out in Article 101(3).*

*3. Where insurance and reinsurance undertakings cannot derive the Solvency Capital Requirement directly from the probability distribution forecast generated by the internal model, the supervisory authorities may allow approximations to be used in the process to calculate the Solvency Capital Requirement, as long as those undertakings can demonstrate to the supervisory authorities that policy holders are provided with a level of protection equivalent to that provided for in Article 101.*

*4. Supervisory authorities may require insurance and reinsurance undertakings to run their internal model on relevant benchmark portfolios and using assumptions based on external rather than internal data in order to verify the calibration of the internal model and to check that its specification is in line with generally accepted market practice.*

#### *Article 123*

##### *Profit and loss attribution*

*Insurance and reinsurance undertakings shall review, at least annually, the causes and sources of profits and losses for each major business unit.*

*They shall demonstrate how the categorisation of risk chosen in the internal model explains the causes and sources of profits and losses. The categorisation of risk and attribution of profits and losses shall reflect the risk profile of the insurance and reinsurance undertakings.*

#### *Article 124*

##### *Validation standards*

*Insurance and reinsurance undertakings shall have a regular cycle of model validation which includes monitoring the performance of the internal model, reviewing the ongoing appropriateness of its specification, and testing its results against experience.*

*The model validation process shall include an effective statistical process for validating the internal model which enables the insurance and reinsurance undertakings to demonstrate to their supervisory authorities that the resulting capital requirements are appropriate.*

*The statistical methods applied shall test the appropriateness of the probability distribution forecast compared not only to loss experience but also to all material new data and information relating thereto.*

*The model validation process shall include an analysis of the stability of the internal model and in particular the testing of the sensitivity of the results of the internal model to changes in key underlying assumptions. It shall also include an assessment of the accuracy, completeness and appropriateness of the data used by the internal model.*

#### *Article 125*

##### *Documentation standards*

*Insurance and reinsurance undertakings shall document the design and operational details of their internal model.*

*The documentation shall demonstrate compliance with Articles 120 to 124.*

*The documentation shall provide a detailed outline of the theory, assumptions, and mathematical and empirical bases underlying the internal model.*

*The documentation shall indicate any circumstances under which the internal model does not work effectively.*

*Insurance and reinsurance undertakings shall document all major changes to their internal model, as set out in Article 115.*

## *Article 126*

### *External models and data*

*The use of a model or data obtained from a third party shall not be considered to be a justification for exemption from any of the requirements for the internal model set out in Articles 120 to 125.*

## *Article 127*

### *Implementing measures*

*The Commission shall, in order to ensure a harmonised approach to the use of internal models throughout the Community and to enhance the better assessment of the risk profile and management of the business of insurance and reinsurance undertakings, adopt implementing measures with respect to Articles 120 to 126.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

## *Article 128*

### *General provisions*

*Member States shall require that insurance and reinsurance undertakings hold eligible basic own funds, to cover the Minimum Capital Requirement.*

## *Article 129*

### *Calculation of the Minimum Capital Requirement*

*1. The Minimum Capital Requirement shall be calculated in accordance with the following principles:*

*(a) it shall be calculated in a clear and simple manner, and in such a way as to ensure that the calculation can be audited;*

*(b) it shall correspond to an amount of eligible basic own funds below which policy holders and beneficiaries are exposed to an unacceptable level of risk were insurance and reinsurance undertakings allowed to continue their operations;*

*(c) the linear function referred to in paragraph 2 used to calculate the Minimum Capital Requirement shall be calibrated to the Value-at-Risk of the basic own funds of an insurance or reinsurance undertaking subject to a confidence level of 85 % over a one-year period;*

*(d) it shall have an absolute floor of:*

*(i) EUR 2 200 000 for non-life insurance undertakings, including captive insurance undertakings, save in the case where all or some of the risks included in one of the classes 10 to 15 listed in Part A of Annex 1 are covered, in which case it shall be no less than EUR 3 200 000,*

*(ii) EUR 3 200 000 for life insurance undertakings, including captive insurance undertakings,*

*(iii) EUR 3 200 000 for reinsurance undertakings, except in the case of captive reinsurance undertakings, in which case the Minimum Capital Requirement shall be no less than EUR 1 000 000,*

*(iv) the sum of the amounts set out in points (i) and (ii) for insurance undertakings as referred to in Article 73(5).*

*2. Subject to paragraph 3, the Minimum Capital Requirement shall be calculated as a linear function of a set or sub-set of the following variables: the undertaking's technical provisions, written premiums, capital-at-risk, deferred tax and administrative expenses. The variables used shall be measured net of reinsurance.*

*3. Without prejudice to paragraph 1(d), the Minimum Capital Requirement shall neither fall below 25 % nor exceed 45 % of the undertaking's Solvency Capital Requirement, calculated in accordance with Chapter VI, Section 4, Subsections 2 or 3, and including any capital add-on imposed in accordance with Article 37.*

*Member States shall allow their supervisory authorities, for a period ending no later than 31 October 2014, to require an insurance or reinsurance undertaking to apply the percentages referred to in the first subparagraph exclusively to the undertaking's Solvency Capital Requirement calculated in accordance with Chapter VI, Section 4, Subsection 2.*

*4. Insurance and reinsurance undertakings shall calculate the Minimum Capital Requirement at least quarterly and report the results of that calculation to supervisory authorities.*

*Where either of the limits referred to in paragraph 3 determines an undertaking's Minimum Capital Requirement, the undertaking shall provide to the supervisory authority information allowing a proper understanding of the reasons therefor.*

*5. The Commission shall submit to the European Parliament and the European Insurance and Occupational Pensions Committee established by Commission Decision 2004/9/EC [35], by 31 October 2017, a report on Member States' rules and supervisory authorities' practices adopted pursuant to paragraphs 1 to 4.*

*That report shall address, in particular, the use and level of the cap and the floor set out in paragraph 3 as well as any problems faced by supervisory authorities and by undertakings in the application of this Article.*

## *Article 130*

### *Implementing measures*

*The Commission shall adopt implementing measures specifying the calculation of the Minimum Capital Requirement, referred to in Articles 128 and 129.*

*Those measures, designed to amend non-essential elements of this Directive, by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

## *Article 131*

### *Transitional arrangements regarding compliance with the Minimum Capital Requirement*

*By way of derogation from Articles 139 and 144, where insurance and reinsurance undertakings comply with the Required Solvency Margin referred to in Article 28 of Directive 2002/83/EC, Article 16a of Directive 73/239/EEC or Article 37, 38 or 39 of Directive 2005/68/EC respectively on 31 October 2012 but do not hold sufficient eligible basic own funds to cover the Minimum Capital Requirement, the undertakings concerned shall comply with Article 128 by 31 October 2013.*

*Where the undertaking concerned fails to comply with Article 128 within the period set out in the first paragraph, the authorisation of the undertaking shall be withdrawn, subject to the applicable processes provided for in the national legislation.*

## *Article 136*

### *Identification and notification of deteriorating financial conditions by the insurance and reinsurance undertaking*

*Insurance and reinsurance undertakings shall have procedures in place to identify deteriorating financial conditions and shall immediately notify the supervisory authorities when such deterioration occurs.*

## *Article 137*

### *Non-Compliance with technical provisions*

*Where an insurance or reinsurance undertaking does not comply with Chapter VI, Section 2, the supervisory authorities of its home Member State may prohibit the free disposal of its assets after having communicated their intentions to the supervisory authorities of the host Member States. The supervisory authorities of the home Member State shall designate the assets to be covered by such measures.*

## *Article 138*

### *Non-Compliance with the Solvency Capital Requirement*

*1. Insurance and reinsurance undertakings shall immediately inform the supervisory authority as soon as they observe that the Solvency Capital Requirement is no longer complied with, or where there is a risk of non-compliance in the following three months.*

*2. Within two months from the observation of non-compliance with the Solvency Capital Requirement the insurance or reinsurance undertaking concerned shall submit a realistic recovery plan for approval by the supervisory authority.*

*3. The supervisory authority shall require the insurance or reinsurance undertaking concerned to take the necessary measures to achieve, within six months from the observation of non-compliance with the Solvency Capital Requirement, the re-establishment of the level of eligible own funds covering the Solvency Capital Requirement or the reduction of its risk profile to ensure compliance with the Solvency Capital Requirement.*

*The supervisory authority may, if appropriate, extend that period by three months.*

*4. In the event of an exceptional fall in financial markets, the supervisory authority may extend the period set out in the second subparagraph of paragraph 3 by an appropriate period of time taking into account all relevant factors.*

*The insurance or reinsurance undertaking concerned shall, every three months, submit a progress report to its supervisory authority setting out the measures taken and the progress made to re-establish the level of eligible own funds covering the Solvency Capital Requirement or to reduce the risk profile to ensure compliance with the Solvency Capital Requirement.*

*The extension referred to in the first subparagraph shall be withdrawn where that progress report shows that there was no significant progress in achieving the re-establishment of the level of eligible own funds covering the Solvency Capital Requirement or the reduction of the risk profile to ensure compliance with the Solvency Capital Requirement between the date of the observation of non-compliance of the Solvency Capital Requirement and the date of the submission of the progress report.*

*5. In exceptional circumstances, where the supervisory authority is of the opinion that the financial situation of the undertaking concerned will deteriorate further, it may also restrict or prohibit the free disposal of the assets of that undertaking. That supervisory authority shall inform the supervisory authorities of the host Member States of any measures it has taken. Those authorities shall, at the request of the supervisory authority of the home Member State, take the same measures. The supervisory authority of the home Member State shall designate the assets to be covered by such measures.*

## *Article 139*

### *Non-Compliance with the Minimum Capital Requirement*

*1. Insurance and reinsurance undertakings shall inform the supervisory authority immediately where they observe that the Minimum Capital Requirement is no longer complied with or where there is a risk of non-compliance in the following three months.*

*2. Within one month from the observation of non-compliance with the Minimum Capital Requirement, the insurance or reinsurance undertaking concerned shall submit, for approval by the supervisory authority, a short-term realistic finance scheme to restore, within three months of that observation, the eligible basic own*

*funds, at least to the level of the Minimum Capital Requirement or to reduce its risk profile to ensure compliance with the Minimum Capital Requirement.*

*3. The supervisory authority of the home Member State may also restrict or prohibit the free disposal of the assets of the insurance or reinsurance undertaking. It shall inform the supervisory authorities of the host Member States accordingly. At the request of the supervisory authority of the home Member State, those authorities shall, take the same measures. The supervisory authority of the home Member State shall designate the assets to be covered by such measures.*

#### *Article 140*

##### *Prohibition of free disposal of assets located within the territory of a Member State*

*Member States shall take the measures necessary to be able, in accordance with national law, to prohibit the free disposal of assets located within their territory at the request, in the cases provided for in Articles 137 to 139 and Article 144(2) of the undertaking's home Member State, which shall designate the assets to be covered by such measures.*

#### *Article 141*

##### *Supervisory powers in deteriorating financial conditions*

*Notwithstanding Articles 138 and 139, where the solvency position of the undertaking continues to deteriorate, the supervisory authorities shall have the power to take all measures necessary to safeguard the interests of policy holders in the case of insurance contracts, or the obligations arising out of reinsurance contracts.*

*Those measures shall be proportionate and thus reflect the level and duration of the deterioration of the solvency position of the insurance or reinsurance undertaking concerned.*

#### *Article 142*

##### *Recovery plan and finance scheme*

*1. The recovery plan referred to in Article 138(2) and the finance scheme referred to in Article 139(2) shall, at least include particulars or evidence concerning the following:*

*(a) estimates of management expenses, in particular current general expenses and commissions;*

*(b) estimates of income and expenditure in respect of direct business, reinsurance acceptances and reinsurance cessions;*

*(c) a forecast balance sheet;*

*(d) estimates of the financial resources intended to cover the technical provisions and the Solvency Capital Requirement and the Minimum Capital Requirement;*

*(e) the overall reinsurance policy.*

2. Where the supervisory authorities have required a recovery plan referred to in Article 138(2) or a finance scheme referred to in Article 139(2) in accordance with paragraph 1 of this Article, they shall refrain from issuing a certificate in accordance with Article 39 for as long as they consider that the rights of the policy holders, or the contractual obligations of the reinsurance undertaking are threatened.

#### Article 304

##### *Duration-based equity risk sub-module*

1. Member States may authorise life insurance undertakings providing:

(a) occupational retirement provision business in accordance with Article 4 of Directive 2003/41/EC, or

(b) retirement benefits paid by reference to reaching, or the expectation of reaching, retirement where the premiums paid for those benefits have a tax deduction which is authorised to policy holders in accordance with the national legislation of the Member State that has authorised the undertaking;

where

(i) all assets and liabilities corresponding to the business are ring-fenced, managed and organised separately from the other activities of the insurance undertakings, without any possibility of transfer;

(ii) the activities of the undertaking related to points (a) and (b), in relation to which the approach referred to in this paragraph is applied, are pursued only in the Member State where the undertaking has been authorised; and

(iii) the average duration of the liabilities corresponding to the business held by the undertaking exceeds an average of 12 years;

to apply an equity risk sub-module of the Solvency Capital Requirement, which is calibrated using a Value-at-Risk measure, over a time period, which is consistent with the typical holding period of equity investments for the undertaking concerned, with a confidence level providing the policy holders and beneficiaries with a level of protection equivalent to that set out in Article 101, where the approach provided for in this Article is used only in respect of those assets and liabilities referred in point (i). In the calculation of the Solvency Capital Requirement those assets and liabilities shall be fully considered for the purpose of assessing the diversification effects, without prejudice to the need to safeguard the interests of policy holders and beneficiaries in other Member States.

Subject to the approval of the supervisory authorities, the approach set out in the first subparagraph shall be used only where the solvency and liquidity position as well as the strategies, processes and reporting procedures of the undertaking concerned with respect to asset-liability management are such as to ensure, on an ongoing basis, that it is able to hold equity investments for a period which is consistent with the typical holding period of equity investments for the undertaking concerned. The undertaking shall be able to demonstrate to the supervisory authority that that condition is verified with the level of confidence necessary to provide policy holders and beneficiaries with a level of protection equivalent to that set out in Article 101.

*Insurance and reinsurance undertakings shall not revert to applying the approach set out in Article 105, except in duly justified circumstances and subject to the approval of the supervisory authorities.*

*2. The Commission shall submit to the European Insurance and Occupational Pensions Committee and the European Parliament, by 31 October 2015, a report on the application of the approach set out in paragraph 1 and the supervisory authorities' practices adopted pursuant to paragraph 1, accompanied, where appropriate, by adequate proposals. That report shall address, in particular, cross-border effects of the use of that approach with a view to preventing regulatory arbitrage by insurance and reinsurance undertakings.*

## **OPC reports**

10.2.20. According to the OPC report "Survey on fully funded, technical provisions and security mechanisms in the European occupational pension sector" from March 2008 there is a great variety of security mechanisms chosen by Member States to secure their pension commitments.

10.2.21. The following security mechanisms were identified:

- a. Regulatory own funds and additional solvency buffers
- b. Subordinated loans
- c. Sponsor commitment and increases to contractual premiums/sponsor contributions
- d. Guarantee funds (pension protection schemes)
- e. Mechanisms to reduce accrued pension rights
- f. Reduction of future conditional inflation

10.2.22. The OPC Report "Initial review of key aspects of the implementation of the IORP Directive" from March 2008 reported fundamental differences between Member States regarding the treatment of subordinated loans under the IORP Directive. Some Member States were of the opinion that loans are not permitted at all, while others were of the opinion that subordinated loans are allowed.

10.2.23. Those members that permit them suggested that subordinated loans serve as a useful security mechanism. Other states, that do not permit subordinated loans, were not in the position to comment on their potential as a security mechanism.

10.2.24. The report concluded that further clarification would be needed to explore the extent to which subordinated loans - as used in different Member States - fulfil the characteristics necessary to make them compliant with the IORP Directive.

10.2.25. The CEIOPS OPC SSC Report concludes that subordinated loans can serve as a security mechanism. The subordination feature requires that all payments

on the loan are subordinated to the pension liabilities and offers unlimited loss absorption.

### 10.3. Explanatory text

#### **Specific Call for Advice**

The material elements of Article 87-99 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to own funds; the advice should include an assessment as to whether there is an advantage to keep a three-tier system;

#### **EIOPA view on issues in the CfA**

- 10.3.1. The provisions for own funds and classifications into tiers as stated in the Articles 87 – 99 can also be made applicable to IORPs. The basic definition of own funds, excess of assets over liabilities, is the same. The classification of own funds into different categories, and the limitation of the amounts of eligible capital, are present in the amendment of the IORP Directive as well as in the Solvency II Directive for insurance companies.
- 10.3.2. However, to reflect the specificities of IORPs some amendments to the Articles 87 - 99 are necessary. These refer to provisions that should not (fully) apply to and therefore requiring additional provisions for IORPs.
- 10.3.3. The Articles 87 - 99 vary to the extent they need to be modified, but they may need a change of wording to be adapted to all kinds of IORPs.
- 10.3.4. In particular, in Article 88 the last section needs to be adapted to the specific circumstances of the different kinds of IORPs, in order to avoid artificial creation of own funds between the IORP and its sponsor (or several IORPs and sponsors).
- 10.3.5. Article 89 needs to be amended with the ancillary own funds, if any, that should be recognised for IORPs. This is particularly true if the option to consider sponsor support as ancillary own funds is chosen (see CfA 5).
- 10.3.6. Article 91 could be further amended to allow for the specificities of IORPs with regard to the inclusion of discretionary benefits as surplus funds if the discretionary benefits are not included in technical provisions (as discussed in CfA 5, 9.3.125-126)
- 10.3.7. A tiering system with quantitative limits will contribute to an overall good level of protection for IORPs. The content of Articles 93, 94, 95, 96 and 98 shall be kept as it is, only the wording should be adapted to all types of IORPs and reflect the provisions on subordinated loans (CfA 6, 10.3.8-28), SCR and MCR (CfA 6, 10.3.59-70 and 10.3.81-104).

#### **Policy options**

Option 1: Change the IORP Directive by applying Articles 87-99 with the minimum necessary wording amendments as explained above, with a particular attention to Article 88 in order to avoid artificial creation of capital.

### **Specific Call for Advice**

The adequacy of using subordinated debt as own funds in the light of the borrowing restriction for IORPs contained in Article 18(2) of the IORP Directive;

### **EIOPA view on issues in the CfA**

- 10.3.8. A subordinated loan is a loan that is ranked behind the rights of members and beneficiaries and, in most cases, also ranked behind other creditors. A subordinated loan will only be repaid after the rights of members and beneficiaries are secured and (most) other creditors are repaid (CEIOPS – OPSSC-01/08, p. 46).
- 10.3.9. Subordinated loans can be temporary or perpetual. If an IORP commits itself to repay (part of) a perpetual loan on a certain date, (that part of) the loan will transform into a temporary subordinated loan.
- 10.3.10. To ensure that subordinated loans actually offer (additional) protection to the members, legislation could set requirements for subordinated loans that an IORP wants to use as a security mechanism. Examples of such requirements could include:
- a. requirements on the maximum interest rate that the IORP could pay to the issuer of the loan;
  - b. a requirement that a subordinated loan can only be paid off if the total level of protection remains adequate after the payment.
- 10.3.11. Because of such requirements and of the subordinated character of the loan, the most likely issuer of subordinated loans to an IORP will be the IORP's own plan sponsor.
- 10.3.12. The subordination feature offers unlimited loss absorption in case of winding-up, and can also offer loss absorption in problematic, but going concern situations. Subordinated loans can be subject to the supervisor's permission, including special conditions (f.i. a minimum time horizon for temporary subordinated loans).
- 10.3.13. The Commission puts the issue of subordinated loans specifically in relation to IORPs that cover risks themselves. However, EIOPA is of the opinion that the possibility to use subordinated loans should not be limited to a specific type of IORP. In fact, a subordinated loan from the plan sponsor may have complementary value in addition to an employer covenant, in that it provides the employer with the possibility to support the pension scheme while keeping the possibility open that the support provided is later returned.

- 10.3.14. A subordinated loan from the plan sponsor should not be seen as an investment in the plan sponsor, and it does therefore not play a role in assessing the limits regarding investing in the sponsor or the group (article 18(1)(f) of the current IORP Directive). In fact, when assessing whether the IORP's investments comply with the prudent person principle, the issuer of the subordinated loans need not be taken into account at all.
- 10.3.15. Apart from recognising that subordinated liabilities are part of the basic own funds (Article 88), the Solvency II Directive does not contain any rules in respect of subordinated loans. Additional rules will be part of the Implementing Measures, which are currently still under discussion. In the latest version of the Draft Implementing Measures (dated 31 October 2011), articles 58 COF1 till 65 COF8 deal with subordinated loans. As these implementing measures are not yet final, the various articles will be used as an inspiration only.

#### VALUATION AND ASSESSMENT OF THE LEVEL OF PROTECTION

- 10.3.16. Subordinated loans can to a certain extent be considered as own funds. Distinction should nevertheless be made according to some characteristics of subordinated loans, such as:
- a. Is the loan temporary or perpetual?
  - b. In case of temporary loans: what is the residual time to maturity?
  - c. Are there any possibilities / incentives for the undertaking to redeem the loan before maturity?
- 10.3.17. Such criteria can be used to assess the actual loss absorbing capacity of subordinated debt, and therefore the level of protection it provides to the beneficiaries.
- 10.3.18. The protection offered by subordinated loans can be twofold, dependent on the valuation of them:
- a. If the subordinated loan must be valued at nominal value, (part of) the nominal amount of the subordinated loan can be part of the available own funds (as described in article 28 of the Consolidated Life Directive);
  - b. if the subordinated loan must be valued at market value, the actual value of the liability connected to the loan must be calculated, based on the time horizon of the loan and the interest payments agreed between the IORP and the issuer of the loan. The excess of the paid nominal amount over the actual value of the loan will directly feed into the available own funds. Next to that, (part of) the actual value of the subordinated loan can be part of the available own funds (as described in Article 28 of the Consolidated Life Directive).
- 10.3.19. The capital connected to subordinated loans is fully accessible in the event of hard stress. Because the loan is subordinated, it will need to be lapsed (without being paid off) before the accrued benefits of members and beneficiaries can be reduced. In that case, the entire loan capital paid into

the IORP will be part of the available own funds (and has de facto turned into a capital payment by the issuer of the loan).

- 10.3.20. In the event of soft stress, the valuation of the subordinated loan is dependent on whether or not the loan is to be valued at actual value or not:
- a. if the loan is to be valued at the nominal value, soft stress will lead to a decline of the protection value. This is because of the limitation (in Article 28 of the Consolidated Life Directive) that subordinated loans can only form part of the total available own funds. In soft stress, the other available own funds will decline and so will the amount of subordinated loans that can form part of the available own funds;
  - b. If the loan is to be valued at actual value, soft stress leads to two effects with opposing direction. First of all, the soft stress will delay the moment in which the loan will be paid-off (the connected cash-flows will have a longer duration). This delay will decrease the actual value of the loan and thus increase the excess amount of the loan over the value. On the other hand, the other available own funds will decline and so will the amount of subordinated loans that can form part of the available own funds.
- 10.3.21. According to Article 88 of the Solvency II Directive, (all) subordinated liabilities are part of the basic own funds. The various articles in the draft implementing measures state that subordinated liabilities can only form part of the basic own funds if they are valued in accordance with article 75 of the Solvency II Directive.

#### Requirements for subordinated loans

- 10.3.22. Under the current IORP Directive, several requirements are used in order for subordinated loans to be allowed. These requirements refer to (i) the fact that the capital needs to be paid-in, (ii) a minimum maturity of 5 years, (iii) the fact that repayment of a subordinated loan can only be on the contractually agreed payment dates or in case of winding-up of the IORP and (iv) the supervisory approval that is needed to change the loan agreement.
- 10.3.23. Solvency II also requires subordinated loans to be paid-in (articles 58 COF1, 60 COF3 and 64 COF7 of the Draft Implementing Measures).
- 10.3.24. The issue of maturity is, within Solvency II, strongly connected to the tiering of own funds. Subordinated loans must have a maturity of at least 30 years to qualify as tier-1 own funds (article 59 COF2), at least 10 years to qualify as tier-2 own funds (article 61 COF4) and at least 3 years to qualify as tier 3 own funds (article 65 COF8).
- 10.3.25. In respect of repayment of subordinated loans, the Draft Implementing Measures of Solvency II even go further than the current IORP Directive, in order to ensure full availability of the loss-absorbing capacity of the subordinated loan in the event of stress. Solvency II contains (in the articles 59 COF2, 61 COF4 and 65 COF8), amongst others, the following restrictions on the repayment of a subordinated loan:

- a. To qualify as tier-1 or tier-2 own funds, the first contractual repayment date can not occur before 5 years from the date of issuance, for tier-3 own funds this will be 3 years;
  - b. Repayment is not allowed if the institution does not comply with the SCR, or if the repayment would lead to a breach of the SCR; and
  - c. The exchange, conversion, repayment or redemption of a subordinated loan is subject to prior supervisory approval.
- 10.3.26. This last item also highlights improved supervisory powers on subordinated loans. Not only is supervisory approval needed to change the loan agreement, under Solvency II the supervisor also needs to approve repayments and redemptions.
- 10.3.27. The current IORP Directive also contains a requirement with regard to the treatment of subordinated loans in the final stages before repayment. Either the IORP has to submit a plan to the supervisor how it will deal with the situation after repayment in the year before the repayment, or the subordinated loan will no longer be fully part of the own funds in the last 5 years before repayment, under a gliding scale. Within the Solvency II Directive, these requirements are no longer necessary, given that repayment is not allowed if the institution does not comply with the SCR or if the repayment would lead to a breach of the SCR.
- 10.3.28. All in all, the Solvency II Directive and its Implementing Measures, in their current state, keep and extend the loss-absorbing capacity of subordinated loans. The requirements that they set could also apply to the revised IORP Directive. EIOPA therefore advises to integrate the requirements that the Solvency II Directive and its Implementing Measures (as written down in the October version) into the revised IORP Directive and the Implementing Measures to be connected to it.

#### RELATION WITH PROHIBITION OF BORROWING

- 10.3.29. As the OPC Report from 2008 explains, the relation between subordinated loans and the prohibition of borrowing is ambiguous. To resolve this ambiguity, the revision of the IORP Directive should make clear that subordinated loans are allowed, since they can provide additional security. This can be achieved either by explicitly amending the prohibition of borrowing that it does not include a prohibition of subordinated loans or by removing the prohibition of borrowing altogether (please refer to CfA 7, 11.3.88-91).
- 10.3.30. In addition, it needs to be noted that the Solvency II Directive and its Implementing Measures do not require supervisory approval for the start of a subordinated loan. Given that Solvency II does not contain a prohibition of loans, there is no need for such an approval.
- 10.3.31. If the revised IORP Directive were to keep the prohibition of loans, there might be a need to require supervisory approval to enter into a subordinated loan. Within the supervisory approval process, the supervisor would then identify whether the proposed loan agreement constitutes a subordinated loan or any other loan that needs to be prohibited.

## Policy options

- 10.3.32. EIOPA is of the opinion that a revised IORP Directive should explicitly allow the use of subordinated loans by IORPs subject to requirements on their issuance and redemption to be specified on level 1. The question of how to value subordinated loans, at nominal or at actual value, should not be part of the level 1 Directive, but should be an issue for further consideration.

### Specific Call for Advice

The material elements of Articles 100-127 and 304 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the SCR (including the duration approach for the equity risk sub-module). Particular attention should be paid to the adjustment for the loss-absorbing capacity of technical provisions and deferred taxes to take into account the specificities of pension schemes;

### EIOPA view on issues in the CfA

- 10.3.33. EIOPA's views on this section of the CfA is structured into two parts. Firstly, it approaches the issues of confidence level and time horizon for the determination of "solvency capital requirements" (or an equivalent term) with a link to frequency of assessment of the solvency position – which relates to 2nd paragraph of Article 101 (3) of the Solvency II Directive. Secondly, it addresses the remaining items of this CfA on solvency capital requirements in a broad sense (no details for each of the corresponding Articles of the Solvency II Directive).

- 10.3.34. The first part addresses three main topics:

- a. Time horizon. This corresponds to the period for applying the stress test for the determination of the capital requirements. Using the VaR methodology this corresponds to the period of time intrinsic to the VaR (example: on a VaR of 99.5% over 1 year, which is the metric used in Solvency II, this corresponds to the 1 year period);
- b. Confidence level. This determines the level of security used in the calibration of the stress tests. Using the VaR methodology this corresponds to the probability that defines the confidence level (example: on a VaR of 99.5% over 1 year, which is the metric used in Solvency II, this corresponds to the 99.5% which is equivalent to saying that an adverse event would occur once every 200 years);
- c. Frequency of calculation of the SCR. This relates to how often IORPs assess their solvency position, which is highly influenced by the choice of the time horizon used in the valuation assessment (subparagraph a).

### Time horizon

- 10.3.35. The time horizon for the SCR calculation corresponds to the time period to which the confidence level applies that assets exceed technical provisions.
- 10.3.36. Solvency II uses a one year time horizon. Therefore the calibration process of the stress tests underlying the standard formula is based on one-year periods. This constitutes the most common time horizon used in solvency modelling.
- 10.3.37. Alternatively, one can consider the use of a multi-year time horizon (like 3 or 5 years). This may be more appropriate where risks are not observable over a short period, such as long-tailed liability business or mortality developments. An SCR based on a multi-annual term horizon might be conceptually easy to understand, but it may prove much more complex in terms of calibration. Moreover, solvency requirements tend to increase with the measurement horizon when the same confidence level is used, as the potential range of future outcomes widens. The one-year horizon is the standardized approach for determining, collecting and registering financial data covering the risks being addressed by the capital requirements. Therefore, the use of a longer time horizon (3 or 5 years) would require a substantial effort in terms of processing the current financial databases in order to produce the statistics required for the calibration of shocks to determine the SCR.
- 10.3.38. At the same time, there are doubts whether a multi-annual horizon would imply a lower capital charge due to mean-reversion in asset markets. The notion that certain extreme observations in a particular year would tend to be softened by the more favourable results in subsequent years for that specific multi-annual term horizon is questionable. The existence of mean reversion is debated in academic literature. However, Solvency II has established a precedent by recognising mean reversion in equity returns through the equity and duration dampener. The liabilities of IORPs are also very long term in nature and in most cases much longer than those of insurance companies. In that respects, it would seem reasonable for the IORP Directive and supervisors to allow for mean reversion in an enhanced manner compared to Solvency II. Not assuming mean reversion of financial markets, the capital requirement would increase with the lengthening of the horizon of measurement. As a rule of thumb, the requirement increases by the square root of the time horizon. In case of a three year horizon, the requirements would be 1.7 times as high.
- 10.3.39. One other complexity that may arise from using a multi-year period for assessing the capital requirements concerns the difficulty in aggregating the capital requirements for the different risk factors and the corresponding diversification effects. In a multi-year time horizon the estimation of these elements would be more difficult and probably less accurate.
- 10.3.40. One issue that also needs to be addressed in this regard is the inclusion of “new business expected to be written over the following x years”, where x corresponds to the time horizon for the valuation assessment, which for IORPs would correspond to the inclusion of additional rights for the participants who joined the plan in the past (existing business), where applicable.

- 10.3.41. At an informal open forum hosted by the UK Actuarial Profession (25 March 2009) issues of both the time horizon and VAR versus TailVar were discussed and there was a clear conclusion that Solvency II should not be changed as no superior alternative to a one-year VAR could be identified. A similar conclusion can be drawn for pensions, although further investigation would be useful in order to better take into account the long-term nature of pension commitments.

#### Confidence level

- 10.3.42. Within the Solvency II framework the SCR is calibrated to 99.5% confidence over a one-year time horizon. EIOPA is of the opinion that the decision regarding the adoption of a uniform confidence level across EU countries as well as the definition of a specific probability for the confidence level is of a highly political nature. Therefore EIOPA's advice will not propose a specific probability for defining the confidence level. Instead, EIOPA will present a list of technical arguments that should be borne in mind when establishing the confidence level(s), which should then be subject to a substantive quantitative impact study.
- 10.3.43. Taking into account the nature of unconditional benefits and the wider approach of the member perspective to be considered in the elements composing the holistic balance sheet - meaning that security mechanisms to cover sponsor default are also going to be considered - it seems reasonable to establish a very high confidence level. A probability of 99.5% would be consistent with the insurance sector. However, due consideration should be given to the differences between insurers and IORPs, as well as the possibility for Member States to allow IORPs (the option) to adjust pension benefits.
- 10.3.44. Some Member States provide relatively low benefits with high funding/security requirements while others provide higher promised benefits but with a lower level of funding, backed by sponsor security or other security mechanisms. Although the objective of the Commission may be to apply the same level of security of benefit to both, it is a political decision whether that is appropriate in terms of the specific approach to providing retirement security. This is a very different from the objective in the insurance sector to provide policy holders with high and consistent levels of protection, since lower security levels may undermine competition in a market environment.
- 10.3.45. Currently, several jurisdictions allow for the possibility of a future reduction of pension benefits as a way to "keep alive" a DB pension scheme in the event of (serious) underfunding. Alternatively, some Member States do not allow a reduction, but up front funding requirements may be less stringent striking a different balance between security from the perspective of level of confidence, and security from the perspective of member's rights not being reduced if certain events occur. This highlights two different approaches to the concept of security from the perspective of the member. This may imply that national Social and Labour Law allows for different levels of security, at least within the EU, reflecting the social role IORPs play in Member States. Within this context two sets of security levels may be identified: a prudential confidence level that relates to the overall security provided by the solvency framework and a Social and Labour Law confidence level that

derives from the existence of specific benefit adjustment mechanisms. Please see the annex for a discussion on benefit adjustment mechanisms.

- 10.3.46. The implication of this is that EU solvency regulation should recognize the different levels of security accepted by national Social and Labour Law, in particular deriving from (ex-post) benefit adjustment mechanisms and on-going legal obligations of sponsors to provide the full level of benefits. This implies that the level of confidence in the calculation of solvency requirements may not be the same in all situations. Let's assume, for instance, that - from the perspective of the IORP - the SCR is calibrated using a 99.5% confidence level in case no benefit adjustment mechanism is in place or alternatively the sponsor has a legal obligation to ensure benefits are paid. A lower level of confidence that the IORP can meet its commitments could be allowed when such a benefit adjustment mechanism is in place or such a sponsor obligation is absent. However, in contrast to this, if we are to view security from the members perspective, the ability of an IORP to reduce benefits reduces the security of those benefits so it could be appropriate to set a higher confidence level to limit the situations in which this could occur.
- 10.3.47. If the level of security were set uniform across the EU, regardless of the presence of (ex-post) adjustment mechanisms of pension benefits, this would risk communicating to members a false sense of "uniform" security. The underlying benefits are not secured in the same way across countries because if a reduction of benefits happens the real level of security is lowered down. Different levels of security would be more transparent towards members compared to a unique level by reflecting the different risk-sharing arrangements in place in different Member States. At the same time, different levels of security would be problematic when considering cross-border schemes depending on whether the elements that affect the level of security (benefit adjustment mechanisms) are considered as part of the prudential regulation or Social and Labour Law. Either way, for Member States where this benefit adjustment mechanism exists, it is relatively clear that in order to manage expectations of participants and beneficiaries proper communications should be pursued. Please see CfA 23 on Information to members and beneficiaries.
- 10.3.48. It is also important to note that the possibility of ex-post adjustment mechanisms is conceivable only for occupational pensions and not for insurance companies. Therefore it is an element that fully justifies, on very fundamental grounds (based on the different risk-sharing mechanisms considered acceptable in national Social and Labour Law) different (and lower) capital requirements for IORPs than for insurance companies. Among other things, IORPs differ from insurance companies because they (often) have this risk-sharing mechanism, e.g. the reduction of accrued rights. If an insurance company's assets are lower than liabilities it is technically insolvent and the way to restore solvency is to raise new capital. If an IORP has assets lower than liabilities it is indeed underfunded, but underfunding does not mean insolvency when such ex-post benefit adjustment mechanisms, based on solidarity, exist.
- 10.3.49. The assessment of the confidence level that is to be applied to IORPs should take into account other security measures, especially last resort measures to reduce benefits. To the extent that these cannot be taken into account

adequately in the holistic balance sheet, a lower confidence level could be justified in which case these benefit adjustment mechanisms would be taken into account off balance sheet. Such elements may be related to the longer term horizon that IORPs typically have to implement policies and adjust their balance sheet. The additional security could be assessed through long-term analyses and could e.g. be part of the governance requirements like ORSA (please refer to CfA 16).

- 10.3.50. It is also important to acknowledge that some practical issues may arise regarding the calibration of the capital requirements in case of a very high degree of confidence (say 99.5%). There is little relevant data to allow it to be assessed objectively. This has not proved so much of a problem in practice for Solvency II but it did need some consensus around the extrapolation of the probability distribution. The use of a lower confidence level (say 97.5%) would make it easier since 1:40 year probabilities are easier to think about than 1:200. It should also be borne in mind when assessing the parameters for calibrating a confidence level for IORPs whether the same ones used for insurance are also appropriate for pensions as risks may materialize in different ways and over different time horizons. This is a discussion for level 2.
- 10.3.51. The issue of cyclicity (please see the mean reversion discussion in paragraph 10.3.38) may also be relevant to the confidence level. Ideally, the confidence level should be established on a 'through the cycle' basis, varying upwards and downwards so as to dampen market influences. However, this is easier said than done and the subject of cyclical variation remains an hot topic. Solvency II includes various safety valves such as the equity dampener, provision for flexible recovery periods and most recently a 'counter-cyclical premium' in the discount rate.

#### Frequency of the calculation of solvency capital requirement

- 10.3.52. The frequency of fully assessing the SCR is related to the issue of the valuation assessment time horizon as the two must be consistent. Solvency II uses a one year horizon for both the valuation assessment and frequency of assessment.
- 10.3.53. Taking into consideration the long-term nature of IORPs, the OECD acknowledges that the periodic full assessment of the funding position can involve a significant cost and administrative burden in terms of financial and human resources. These costs also stem from the fact that in many Member States the balance sheet for supervisory purposes (including the calculation of technical provisions) is not consistent with national GAAP. Therefore it might be considered to extend the frequency to for instance three years, provided that this is supplemented with annual reports of the adjusted development of the liabilities and changes in risks assuming these do not have changed significantly. This is also the current approach under the IORP Directive. If the risks have changed significantly, a full assessment would have to be required. The volatility of assets and liabilities can be significant which underlines the need for frequent monitoring and measurement of the solvency position.
- 10.3.54. This solution entails risks because market conditions and financial policies of IORPs may change rapidly. As a result, a three year assessment frequency

may not give an accurate picture of the risk profile and may not enable a timely response if needed. It must be noted that the long-term nature of the IORP does not imply that the solvency position cannot deteriorate severely in the short run, thereby hampering its long term objectives. There is also the need to have a long-term view of the risks to avoid pro-cyclical policy reactions to market fluctuations.

- 10.3.55. A lower frequency of assessment may - in some specific circumstances like a quick deterioration of the financial situation of a plan sponsor or IORP - imply a slower identification of a possible problem and also a slower response in terms of supervisory action. This would probably trigger the need to perform proportionate on-going supervision during the specified time horizon (e.g. during the years until the following solvency assessment) rather than more frequent valuations.
- 10.3.56. The volatility resulting from an annual solvency assessment may be resolved in different way, namely by a short-medium supervisory response that is consistent with counter-cyclical measures. The supervisory response could accommodate such volatility by allowing IORPs longer periods to recover.
- 10.3.57. There is also the possibility to use the one-year time horizon to evaluate the solvency situation of the IORP, not requiring this assessment on a yearly basis but rather on a three-yearly basis. In practice, and taking into account the arguments laid down in paragraphs 10.3.35 to 10.3.41 about the multi-year approach, the consistency criteria between the time horizon and the frequency of the assessment would be a significant drawback of such approach. In order to ensure adequate monitoring, supervisors should have the possibility to demand more frequent assessments of the solvency position.
- 10.3.58. A way to reconcile the arguments mentioned above might be the possibility to have a full assessment of the solvency requirements at least three-yearly combined with an assessment based on estimations for the technical provisions in the years in between. The supervisory authority would be afforded the opportunity to require an exact calculation when deemed necessary. The costs for IORPs would be significantly lower. Using estimations for the technical provisions in the years between the main assessments could be justified given the deterministic development of pension liabilities. It goes without saying that figures for the asset side of the balance sheet should be available any time and should not be based on estimations. Given the small average size of IORPs in many Member States compared to life insurance companies this solution might be more proportionate for IORPs.

#### Solvency capital requirement

- 10.3.59. According to Article 17 of the IORP Directive, only IORPs that provide guarantees themselves must have additional assets above the level of technical provisions to serve as a buffer. These IORPs do not have full recourse to sponsor support, which is why they have to hold regulatory own funds.

- 10.3.60. In the holistic balance sheet approach, IORPs (partly or completely) backed by the sponsor will have to show explicitly that they have sufficient resources to meet the commitments to members and beneficiaries with a similar security level. In this case the existence of sponsor support (and other security and benefit adjustment mechanisms) would have to be taken into account when assessing the capital requirement. This would apply to all IORPs with recourse to additional security mechanisms provided that these security mechanisms are accessible from the perspective of members and beneficiaries.
- 10.3.61. The risk-based approach of calculating the required solvency capital used for insurance companies as stated in Articles 100 to 127 and 304 can also be made applicable to IORPs. The promises made to members and beneficiaries by IORPs and/or employers are comparable to those made by life insurance companies to policy holders. The same holds true for the risks IORPs are exposed to. IORPs invest in the same asset classes as insurance companies. The risks on the liability side resemble those of annuities offered by life insurers. However, to reflect the specificities of IORPs some amendments are necessary to the provisions of the IORP Directive.
- 10.3.62. Some of the mentioned articles only apply to some types of IORPs. For example, the loss-absorbing capacity of technical provisions and deferred taxes in Article 108 only applies to IORPs with conditional or discretionary benefits and taxable institutions respectively. However, there does not seem to be an article that can be left out completely. The same holds true for the articles concerning the use of internal models. As a principle it makes sense to allow IORPs to make use of internal models although given the administrative capacity (human resources and technological infrastructure) required only some of the IORPs would be in a position to build and use such models.
- 10.3.63. The SCR is an amount calculated by first computing the SCR before risk-mitigating mechanisms and then subtracting the value of risk-mitigating mechanisms (Article 101(5)). The same approach as described above should apply to IORPs as regards the risk-mitigating mechanisms that both insurers and IORPs use in the same way (e.g. reinsurance and derivatives).
- 10.3.64. The question is how the special mechanisms only IORPs dispose of (security mechanisms such as sponsor support and pension protection schemes and adjustment mechanisms like the possibility to reduce benefits) should be treated. One could either regard these mechanisms as equivalent to own funds and use them to cover the SCR or treat them as risk-mitigation techniques that lower the SCR. One could argue that for reasons of greater transparency and comparability between different (types of) IORPs the SCR should be calculated regarding these mechanisms as own funds. The SCR would then be covered by own funds and the IORP-specific mechanisms. However, there are reasons against this approach and in favour of treating the named mechanisms as risk-mitigation techniques:
- a. Firstly, the SCR is calculated by means of different risk modules (market risk, life underwriting risk etc.) each of which is composed by different sub-modules (e.g. mortality risk and longevity risk as sub-modules of the life underwriting risk). The SCR is not just the sum of all the (sub) modules but a result of different aggregations: the SCRs for the sub-

modules within the risk modules are aggregated to the SCR of the respective risk module by the use of correlation coefficients. Subsequently, the SCRs for the risk modules are aggregated to the overall SCR again by using correlation coefficients. Since security and adjustment mechanisms – such as sponsor support – could be confined to some sub-modules (e.g. longevity risk) or risk modules (e.g. market risk) it appears to be consistent to consider the sponsor support as a risk-mitigation technique within the respective module. Otherwise, IORPs would employ the correlation between the modules differently from insurance undertakings.

- b. Secondly, the risk margin in Solvency II is based on the SCR. Assuming that the framework for IORPs would follow this risk margin concept based on the transfer value to another IORP, the SCR would have to be lessened by the (security and adjustment) mechanisms because otherwise the risk margin would be unjustifiably high.
- c. Thirdly, the MCR – assuming that it is determined for IORPs in the same way as for insurance companies – also depends on the SCR for it cannot fall below 25% nor exceed 45% of the SCR.

10.3.65. These arguments show that security and adjustment mechanisms of IORPs should be reflected in the SCR as risk-mitigation techniques. Given their importance and the fact that they are also treated as an asset or considered in the calculation of the technical provisions they should be stipulated in separate provisions in a detailed way.

10.3.66. From the risk modules listed in Article 101(4) IORPs are only subject to life underwriting risk (which should be renamed), market risk, credit risk and operational risk; and within these risk categories some sub-modules might not apply or be negligible for IORPs.

10.3.67. Solvency II requires the consideration of credit risk in the calculation of the SCR both in the use of risk-mitigation techniques (Article 101(5)) and the counterparty default risk module (Article 105(6)). The question is whether this should also apply to security and adjustment mechanisms.

- a. The adjustment mechanism providing the possibility to reduce benefits is not subject to credit risk.
- b. As for sponsor support and Pension Protection Schemes EIOPA is of the opinion that the credit risk should in principle be taken into account, for the additional support that could be provided to the IORP and the members and beneficiaries is exposed to that risk. However the effects of the consideration of credit risk depend on various factors such as the current strength of the respective security mechanism and the potential amount that could be provided by it, the needed amount to cover all liabilities (including capital requirements), the technique applied to measure the value of the support and the assumed worsening of the credit standing. With regard to sponsor support it can only be generally stated that a possible difference between the liabilities and the financial assets of the IORP can be fully covered if the ability of the sponsor to cover losses of the IORP is sufficiently strong and either the probability

of default of the sponsor is (close to) zero or sponsor support is sufficiently backed by a Pension Protection Scheme. With regard to the latter it has to be considered that the Pension Protection Scheme should be strong enough to potentially back not only one, but all relevant employers to the necessary extent.

- 10.3.68. The Solvency II Directive contains two provisions for the sub-module equity risk. Apart from the provision Article 106 (which contains the symmetric adjustment mechanism and is discussed in CfA 8), there is a special provision in Article 304, the so-called duration dampener. The latter provision was designed for the domestic, (both occupational and third pillar) retirement business of life insurance companies. It gives Member States the opportunity to apply a solvency capital in line with the longer investment horizon of insurers with long-term pension commitments. It results in a solvency capital requirement for equity risk below the requirement based on Article 106.
- 10.3.69. Article 304 only applies to the domestic retirement activities of insurance undertakings and not to cross-border activities. In that respect, it would make sense not to include the duration dampener in a revised IORP Directive that applies to domestic as well as pan-European IORPs. However, this might result in inconsistent application of EU rules as the domestic activities of insurers covered Article 4 of the IORP Directive would be able to make use of Article 304. This could be resolved by deleting Article 304 from the Solvency II Directive. The alternative is to include the duration based approach in the IORP Directive as well.
- 10.3.70. The Solvency II Directive contains a provision for implementing measures to lay down further rules for the calculation of the SCR. Such a provision would also be needed for IOPRs.

## **Policy options**

### Confidence level

- 10.3.71. EIOPA's technical advice is provided in the specific context of the European Commission's objective of a uniform confidence level. Taking into consideration the arguments laid down in paragraph 10.3.42, EIOPA considers that it should not advise on the specific probability of the confidence level.

### Option 1: Harmonized confidence level

- 10.3.72. This option consists of setting up a harmonized prudential confidence level, which would be used to calibrate the stress tests for the solvency capital requirements. In this option, benefit adjustment mechanisms defined by Social and Labour Law of Member States would have to be taken into account in the calculation of the best estimate component of technical provisions similarly to conditional and discretionary benefits. See the options in CfA 5 regarding discretionary benefits.

### Option 2: Non-harmonized confidence level

10.3.73. Under this option the last resort benefit adjustment mechanism would be reflected in a lower confidence level used for the determination of the solvency capital requirements. This would imply different calibrations according to the existence or not of this mechanism and seriously hamper the comparability between prudential frameworks. From a member perspective, the transparency in terms of the final confidence level would be greater.

#### Comparison of policy options

10.3.74. EIOPA recognises that only option 1 is consistent with the requirement of the Commission of having a harmonized prudential confidence level.

#### Time horizon and frequency of the calculation of the SCR

Option 1: one year time horizon assessed at least three-yearly, estimations in intervening years

10.3.75. This option starts from annual calibration model in Solvency II, but allows for a three-yearly frequency of assessment. These three-yearly assessments should be combined with annual reports of the adjusted development of the liabilities (estimations) and changes in risks assuming these do not have changed significantly. If the risks have changed significantly, a full assessment would have to be required. This option represents the current IORP Directive's view of allowing for a three-yearly frequency of assessment.

Option 2: one year time horizon assessed at least yearly

10.3.76. Option based on the Solvency II solution in which the solvency framework is assessed on a yearly basis and uses one-yearly calibration model.

#### Solvency capital requirement

Option 1: leave the IORP Directive unchanged

10.3.77. This option maintains the current state of affairs, i.e. non risk-based solvency rules. These rules would only apply to Article 17 IORPs where the risk is borne by the IORP itself and the obligation of the employer ends with the payment of the contribution.

Option 2: change the IORP Directive by applying a risk-based calculation of solvency capital requirements as in the Solvency II Directive for all IORPs, but taking into account the specificities of IORPs such as the existence of security and adjustment mechanisms

10.3.78. This option would represent the introduction of a risk based solvency capital requirement which would in principle be consistent with the solvency frameworks being adopted in the other financial sectors, but taking into account the specificities of IORPs.

### Comparison of policy options

- 10.3.79. EIOPA's view is that any decision over the introduction of a risk-based approach for all types of IORPs should be taken at the political level.
- 10.3.80. However, it was agreed to consider only those options in the advice that are compatible with the holistic balance sheet approach following the clarification of the Commission.

#### **Specific Call for Advice**

The material elements of Article 128-131 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the MCR.

#### **EIOPA view on issues in the CfA**

- 10.3.81. According to the "holistic balance sheet approach", EIOPA views on this issue apply to all kinds of IORPs.

#### Existence of a MCR

- 10.3.82. In the Solvency II framework, the MCR represents a level of eligible own funds, below which particular supervisory and recovery actions must be undertaken (the other triggering level being the SCR).
- 10.3.83. One view is that such an additional triggering level would be excessive in the case of IORPs. In a prudential framework for IORPs, it could be enough to trigger specific supervisory actions when the SCR is breached, and to set up a recovery plan if and when the IORP becomes underfunded.
- 10.3.84. Therefore, one option will be considered, where no MCR would be included in the future prudential framework.

#### Coverage of the MCR

- 10.3.85. The Solvency II Directive requires that undertakings cover their MCR with eligible basic own funds, implicitly excluding ancillary own funds. The justification for such a requirement follows from the assumption that MCR represents the last resort buffer, which shall therefore be covered by immediately available own funds.
- 10.3.86. It can also be noted that a restriction of the same kind applies to the coverage of the 'guarantee fund' in the IORP Directive as amended by the Solvency II Directive.

#### Structure of the calculation

- 10.3.87. The MCR calculation is intended to be simple and auditable. The number of variables used in its calculation would be small and easily observable. On the other hand, the drawback of this simplicity is a low sensitivity to risk. Nevertheless, provided that the risk sensitivity is properly captured in the SCR calculation, it seems sensible to have a low complexity MCR formula.

Therefore, the broad principle of simplicity for the MCR shall be kept also for IORPs, along with the linearity of the core component of the MCR.

- 10.3.88. Once agreed on a low complexity formula, the following characteristics may be dealt with:
- a. The choice of the variables for the calculation
  - b. The existence and choice of an absolute floor
  - c. The existence and choice of a relative floor and cap
- 10.3.89. The variables 'technical provisions', 'written premiums', 'deferred tax' and 'administrative expense' seem to be appropriate for the calculation. The written premiums shall be net of reinsurance, and the technical provisions shall be net of reinsurance and sponsor covenant, provided and to the extent that the sponsor covenant is recognised as a mechanism similar to reinsurance.
- 10.3.90. Although the variable 'capital-at-risk' could be considered as not so relevant in the pension field, it could be wise not to exclude it, in case the products proposed by IORPs would evolve in the future. Anyhow, at the time being, its impact is likely to be near zero.
- 10.3.91. The existence of an absolute minimum for the MCR makes sense for IORPs as well as for insurance companies, in order to avoid small or nil capital requirements for instance for largely reinsured undertakings.
- 10.3.92. The absolute minimum shall be determined in relation to the threshold of exclusion from the scope of the Directive. For instance, for life insurance companies, the absolute MCR floor is set to 3.2 M€, for an exclusion threshold of 5 M€ of gross written premium and 25 M€ of gross technical provisions.
- 10.3.93. It should be also noted that, in the amended version of the IORP Directive, the guarantee fund is subject to a minimum amount of 3 M€, close to the amount of 3.2 M€ set for life insurance undertakings in the Solvency II Directive. It should be noted however that the provision on the guarantee fund in Article 17c (1) is not mandatory ("Member States may provide"). The minimum guarantee fund in Article 17c (2) ("shall not be") could be interpreted as referring to Article 17c(1). Furthermore this requirement so far only applies to Article 17(1) IORPs.
- 10.3.94. The existence of a relative floor and cap as a function of the SCR allows the MCR to be related to a confidence level, despite its lack of risk sensitivity (actually the core component of the MCR is supposed to correspond to a 85% VaR with a 1 year horizon, but this aim can hardly be achieved with a simple linear formula).
- 10.3.95. From a purely theoretical point of view, in a Gaussian framework, the ratio between the 85<sup>th</sup> percentile and the 99.5th percentile is 40%. Hence a [25%, 45%] corridor, as defined in the Solvency II Directive, could make sense, but a slightly higher corridor, such as [30%, 50%], could also be an option to consider.

10.3.96. It should be also noted that, in the amended version of the IORP Directive, the guarantee fund is set to one third of the required solvency margin (though based on a Member States option even for Art. 17(1) IORPs). Anyhow, this issue shall be determined only when the target levels of confidence are set for both the SCR and the MCR.

#### Level of confidence of the linear component

10.3.97. The level of confidence for the MCR depends on the level of security which is expected from the prudential framework. EIOPA reckons this issue is mainly political, and have no reason for giving a particular advice.

#### Frequency of calculation

10.3.98. In the Solvency II framework, the MCR shall be calculated and reported on a quarterly basis.

10.3.99. For the IORPs, it could be argued that, given the long term profile of the business, a quarterly reporting of the MCR is too frequent. On the other hand, experience shows that capital requirements for pension products can change quickly. Therefore, the supervisor may want to have a frequent reporting, at least in some particular cases (new IORPs, IORPs which level of solvency is low).

10.3.100. Moreover, it should be noted that the calculation of the linear part of the MCR calculation is not burdensome (linear formula of a few macro variables), provided that the use of approximations is allowed for. Allowing estimations instead of exact calculations would be especially necessary for the technical provisions and the capital-at-risks given the costs that would result otherwise. Such estimations could be based on the predictable character of pension liabilities. The corridor formula could introduce additional burden if the SCR was also required on a quarterly basis. If it were chosen to have a MCR reporting more frequent than the SCR reporting, this additional burden could be addressed by allowing the IORPs to use the last known SCR in order to determine the lower and upper bounds for the MCR.

10.3.101. The determination of the frequency for the MCR also depends on the frequency chosen for the SCR calculation.

#### Implementing measures

10.3.102. If the Solvency II structure for the MCR were chosen, implementing measures would be necessary.

#### Transitional measures

10.3.103. As it has been done for insurance undertakings, it could be possible to allow IORPs which comply with Article 17 of the current IORP Directive, but not with MCR provisions, for an additional year before full MCR compliance.

10.3.104. Nevertheless, as MCR represent the last buffer, under which the rights of members and beneficiaries would be seriously endangered, this

transitional period should not be extended beyond 1 year since the entry into force of the new Directive.

## **Policy options**

### Existence of the MCR

Option 1: no MCR calculation required

Option 2: MCR calculation is required in the future prudential framework

### Coverage of the MCR

Before any further analysis, two options might be presented:

Option 1: ancillary own funds are excluded from the coverage of the MCR

Option 2: ancillary own funds can be eligible for covering the MCR

### Structure of the calculation

10.3.105. It is proposed to consider only one option, conserving the main characteristics of the Solvency II structure, with adjustments taking into account the specificities of IORPs.

Option 1 (unique):

10.3.106. The structure includes a linear component, an absolute floor, and a corridor in terms of the SCR

10.3.107. The absolute floor might be adjusted, according to the exclusion thresholds that will be eventually chosen

10.3.108. The corridor in respect to the SCR might be adjusted, according to the confidence levels chosen for the SCR and the MCR

### Frequency of calculation

Two options can be considered for frequency of calculation of the MCR:

Option 1: the MCR is calculated quarterly

Option 2: the MCR is calculated annually, but the supervisor can require more frequent calculations if necessary.

Both options might allow for the use of approximations, in particular with respect to technical provisions, capital-at-risk, and SCR, if and when these variables appear in the MCR formula.

### Implementing measures

10.3.109. As it seems very likely that implementing measures will be necessary, EIOPA suggests as a unique option to keep the Article 130 of the Solvency II Directive as it is, by only updating the references to the relevant Articles of the future IORP II Directive.

### Transitional measures

10.3.110. Acknowledging that there might be a need for a transitional measure such as the one presented in Art. 131 of Solvency II Directive, EIOPA proposes as a unique option to keep the provisions of this article as they are, by:

- a. replacing “insurance and reinsurance undertakings” by “institutions for occupational retirement provision”
- b. updating, where necessary, the references to other articles
- c. replacing the dates defining the transitional period according to the entry into force of the future IORP II Directive; however, the duration of the transitional period shall not exceed 1 year

### **Specific Call for Advice**

The EIOPA advice should address at least the following subjects:

Where the IORP itself covers risk (in the meaning of Article 17(1) of the IORP Directive):

- [..]
- As a particular treatment of this, the extent to which a similar approach can be adopted for pension schemes where the risk is covered by the IORP and the sponsoring undertaking.

### **EIOPA view on issues in the CfA**

10.3.111. This item is discussed in the introductory chapter to CfA 5 and 6.

### **Specific Call for Advice**

The EIOPA advice should address at least the following subjects:

Where the risk (in the meaning of Article 17(1) of the IORP Directive) is covered by the sponsoring undertaking:

- The possibility to restate the value of assets in the IORP and liabilities of the sponsoring undertakings into a single balance sheet, including the possibility to recognise sponsor covenants and claims in pension protection schemes as an asset similar to reinsurance.

## **EIOPA view on issues in the CfA**

- 10.3.112. The first part of this specific CfA, which addresses the possibility to restate the value of assets in the IORP and liabilities of the sponsoring undertakings into a single balance sheet is dealt with in the introductory chapter to CfA 5 and 6. The remaining part of the CfA deals then with the possibility to recognise sponsor covenants and claims in pension protection schemes as an asset similar to reinsurance. Since the last part of CfA 5 already deals with the feasibility to treat sponsor covenants like reinsurance contracts this CfA item would deal exclusively with the claims in pension protection schemes.
- 10.3.113. Financial commitments arising from pension promises can be secured in different ways. Member States have chosen different ways and mechanisms to secure these commitments. Some have chosen mechanisms in addition to the pre-funding of the benefits which are different from those applied to insurance companies, namely pension protection schemes, benefit adjustment mechanisms and various forms of sponsor support. Although it is questionable whether a pension protection schemes can be said to be a mechanism for securing the benefits from the IORP's perspective, from the perspective of members and beneficiaries it certainly plays an important role.
- 10.3.114. Some countries with pension protection schemes currently may take this security mechanism into account in an implicit way by allowing for calculation bases with different levels of safety margins depending on whether there is a pension protection scheme in place for an IORP or not. For example, in the case of IORPs which are backed by the sponsor and by a pension protection scheme, the technical interest rate might be based on the yield on the corresponding assets held by the IORP (Article 15(4) b) second alternative) while in other cases interest rates have to be used for the calculation of technical provisions which include an explicit safety margin.
- 10.3.115. The intended harmonization of calculation bases across Europe could inhibit this way of allowance in the future. Since, all other things being equal, the pension protection scheme increases the level of security for the members and beneficiaries, one may look for an appropriate way to allow for it within the prudential framework.
- 10.3.116. Some of the mechanisms mentioned above provide security by payments to the IORP while others (pension protection scheme, subsidiary liability of the sponsor) result in paying benefits directly to members and beneficiaries. The CfA focuses on the level of protection of the scheme members and beneficiaries which should be similar irrespective of the security mechanisms used.
- 10.3.117. Therefore, the response to the CfA should include practical options allowing for the recognition of such mechanisms in the calculation of quantitative elements, including technical provisions, assets and capital requirements.

- 10.3.118. These options will imply the valuation of elements that are not commonly recognized in an "ordinary" balance sheet based on generally agreed accounting standards.
- 10.3.119. This valuation might be made by using the same principles applied for the valuation of sponsor covenants (e.g. kind of entitlement (legal or other), the height of benefits covered, the creditworthiness of the pension protection scheme), assuming that the payments made directly to the members and beneficiaries would be made to the IORP.
- 10.3.120. Since valuation of security mechanisms is a complex issue there should be implementing measures dealing with these valuation issues and possible simplifications.
- 10.3.121. Some drawbacks might arise if pension protection schemes were to be taken into consideration within the solvency framework.
- 10.3.122. Accounting properly for pension protection schemes would necessitate a broad systemic analysis of each Member State using this mechanism, in order to quantify the right impact on assets and capital requirements. This analysis should be regularly updated in order to reflect any changes in the volume of the pension protection scheme.
- 10.3.123. Moreover, one should make sure that there is no multiple accounting of the pension protection scheme. In other words, the global impact of the pension protection scheme on the whole industry of IORPs should not be greater than the security the pension protection scheme can actually provide.
- 10.3.124. In the case of cross border activities, where an IORP operates in Member States with and without a pension protection scheme, it would be of particular importance to have adequate measures in place to avoid that the lower financial requirements implied by the pension protection scheme for the part of the promises where a pension protection scheme exists jeopardize the rights of the members and beneficiaries in the Member State without a pension protection scheme.
- 10.3.125. Accounting for pension protection schemes with regard to IORPs might result in an unlevel playing field with the insurance sector. All other things being equal, an insurer backed by an insurance guarantee scheme will have to face higher financial requirements than an IORP backed by a pension protection scheme.
- 10.3.126. Nevertheless differences between pension protection and insurance guarantee schemes remain:
- a. The strength of the pension protection scheme may differ from that of insurance guarantee schemes. Insurance guarantee schemes protect policy holders if the insurer becomes insolvent. Depending on the funding structure (ex ante or ex post) the contributions come from the insurers which means that in a financial crisis the insurers may not have sufficient resources to make the necessary ex post contributions. In contrast, pension protection schemes either do not get levies from the IORPs but from the employers or they get levies from the IORPs which in turn may

be backed by sponsor support. In that respect, pension protection schemes are comparable to sponsor support. Since there are far more employers than insurance companies the basis for financing a pension protection scheme can be more reliable than for insurance guarantee schemes. Other elements that determine the solidity of such schemes are e.g. the number of potential claims, the size of claims, the correlation between claims and its ex ante funding ratio.

b. The second difference between insurance guarantee and pension protection schemes relates to the triggers that put them into play. Insurance guarantee schemes would come into play only after the security level provided by the supervisory framework is breached. The trigger for the pension protection scheme depends on specific arrangements of the scheme. Protection from a pension protection scheme may only commence if neither the IORP nor the sponsor can pay the promised benefits. It may even only apply in the case of insolvency of the sponsor.

10.3.127. Accounting for all possible security mechanisms in the prudential framework, will make it more difficult for the competent authorities (such as the European Commission) to enhance the protection given to the members beyond the chosen confidence level.

10.3.128. For these reasons, in our response to the CfA, we will also consider policy options which exclude the pension protection scheme from the quantitative framework. The pension protection scheme would therefore become a security mechanism supplementing the solvency requirements, in the same way as insurance guarantee schemes are for the insurance industry. Notwithstanding the exclusion of pension protection schemes from the quantitative requirements, an alternative recognition in Pillar II might be considered.

## **Policy options**

Option 1: Include pension protection schemes in the solvency framework as a contingent asset in balance sheet and with effects in the calculation of capital requirements

10.3.129. This option entails amending the IORP Directive in order to allow the pension protection scheme as a security mechanism to the pension promises. It would appear as a contingent asset in the balance sheet and it would also have an influence in the calculation of capital requirements.

10.3.130. This option assumes pension protection schemes would be treated separately from other security mechanisms and its value and effect on capital requirements would be also calculated separately. It must also be made sure that pension protection scheme should only be considered if they contribute to the security of the pension promise in a reliable and effective way.

10.3.131. There should be provision for implementing measures concerning valuation and inclusion of these mechanisms when calculating capital requirements as well as the way of treating them as a (contingent) asset.

Option 2: Include pension protection schemes in the solvency framework through the credit risk of the sponsor used in the valuation of sponsor support

10.3.132. This option entails amending the IORP Directive in order to allow the pension protection scheme as a security mechanism to the pension promises as described in Option 1 but with the modification that the existence of a pension protection scheme should have an impact only on the credit risk of the sponsor used in the valuation of sponsor support as an asset to cover liabilities and in the calculation of capital requirements. The credit risk could be lowered more or less depending on the strength of the pension protection scheme.

Option 3: Include pension protection schemes in the solvency framework through a lower security level in the calculation of the SCR

10.3.133. This option is equivalent to option 2 – Non-harmonized confidence level regarding the confidence level in CfA 6. The positive and negative arguments are also the same.

Option 4: Do not include pension protection schemes in the solvency framework

#### Comparison of policy options

10.3.134. Option 3 is not consistent with the holistic balance sheet approach, therefore it would not be included in EIOPA advice.

10.3.135. Among the options 1 and 2, which are both compatible with the holistic balance sheet approach, option 2 could be regarded as the preferred option, if the decision was made to use the holistic balance sheet approach. This is because option 2 does allow for the PPS as part of the prudential framework, but avoids some of the negative impacts of option 1, in particular some part of the difficulties in valuation. On the other hand, one could argue that valuing sponsor support and pension protection schemes separately - as required in option 1 - would increase transparency.

10.3.136. EIOPA's view is that any decision over these options should result from a political decision reflecting cost and security (option 1 and 2 being more efficient in terms of cost, and option 4 in terms of security). Any such decision relates to a political decision taken over the structure and nature of occupational pension provision in Member States.

### Specific Call for Advice

The level of protection of the scheme members and beneficiaries provided by the security mechanisms in the various systems.

### EIOPA view on issues in the CfA

- 10.3.137. For the description of the level of protection for each of the security mechanisms being analysed there would be reference to stress situations because some of the security mechanisms are only triggered if a certain event occurs that negatively impacts the balance between assets and liabilities (therefore the label "stress"). This analysis also looks at how the security mechanism responds to a stress situation.
- 10.3.138. As the level of the stress situation may have an influence on the extent to the security mechanism the following distinction will be made:
- Soft stress – This is related to a low to medium stress situation (low to medium impact to the balance between assets and liabilities);
  - Hard stress - This is related to a high stress situation (high impact to the balance between assets and liabilities);

### Sponsor support

- 10.3.139. The actual effectiveness of the level of protection that a sponsor support provides will be dependent on a number of characteristics of the actual sponsor undertaking: is it a large employer or a small employer, what is the relative size of the employer compared to the pension fund assets, is the employer active in a cyclical market environment or in a non-cyclical environment.
- 10.3.140. A table with the description of the level of protection will be made for each of the identified types of sponsor support: a) unlimited support, b) limited support or c) no automatic recourse and forms of sponsor support. For a brief explanation of these terms please read the section of CfA 5 on the treatment of sponsor covenants.

#### a) Unlimited support

Form of sponsor support	Strength (ability) of the sponsor	
	Strong	Weak
A. Increase in contributions	1. If there is an unlimited support from the sponsor then there is an automatic recourse to require increases in the contributions. If the sponsor has a financial sound situation the ability of this security mechanism to protect members and beneficiaries benefits would be high both to soft and hard stresses.	2. If the financial strength of the sponsor is weak this means that even if there is a legal, unlimited sponsor support the level of protection of members benefits may be low to medium because if the situation leads to the insolvency of the IORP and/or the sponsor he is only able to respond to the stress to the extent possible by its financial capacity.

<b>B. Subsidiary liability of the sponsor</b>	3. The classification is the same has above (A. Increase in contributions). The difference relies on the fact that the sponsor support is not be made through contributions to the pension fund but directly by the sponsor who assumes direct payment to the members and beneficiaries.	4. The classification is the same has above (A. Increase in contributions). The difference relies on the fact that the sponsor support is not be made through contributions to the pension fund but directly by the sponsor who assumes direct payment to the members and beneficiaries.
<b>C. Contingent assets on the sponsor</b>	5. The level of protection can vary because the security of the collateral held by the IORP on the sponsor is limited to the value of the collateral in comparison to the stress situation. In the soft stress it is more likely that the contingent assets will be sufficient to cover the low and medium impact on the balance between assets and liabilities than in the case of hard stress. The higher the amount of contingent assets the higher the level of security will be. In this form of sponsor support the level of protection is more or less independent of the strength of the sponsor as it relies essentially on the characteristics of the contingent assets attributed to the IORP.	
<b>D. Claims on the sponsor (insolvency of the sponsor)</b>	N/A	6. In case of an insolvency of the sponsor, which would classified as a hard stress, the level of security provided would be medium because in case of a wind-up of the scheme with priority creditor rights for the insolvency of the sponsor it is usually possible to recover contributions due but it might not be sufficient to guarantee all the promised benefits.
<b>D. Claims on the sponsor (issues of transfer or changes of the sponsor)</b>	7. In case of discontinuance situations where it occurs a change of sponsors or transfer situations (which would classified as a soft stress only) the level of security provided would be high because any under funding situations will likely to be covered by either the old or new sponsor if they are financial strong.	8. In case of discontinuance situations where it occurs a change of sponsors or transfer situations (which would classified as a soft stress only) in which either old and new sponsor strength is limited the level of security provided would be medium because there might be situations in which the eventual deficits may not be covered.

b) Limited support

Form of sponsor support	Strength (ability) of the sponsor	
	Strong	Weak
<b>A. Increase in contributions</b>	9. For the soft stress the level of security is medium to high because there is high likelihood of the increases in the contributions to be under the limits of the contract agreement or contingent to the sponsor being willing to maintain the pension commitments. Because there is a strong sponsor covenant there is a medium probability that the sponsor continues to support the IORP and therefore is willing to maintain the pension commitments or the contributions are within the boundaries of the contract agreement.	10. For the soft stress the level of security is medium because there is a medium probability the sponsor would be able to sustain the increase in the contributions (because it is a soft stress). On a hard stress situation, because of the weak sponsor strength, it is more likely that the sponsor takes the decision winding up the IORP or adjust the benefits (if not insolvent itself) and not making further support to cover the high unbalance between assets and liabilities – therefore ranking the security level as low.

c) No automatic recourse

Form of sponsor support	Strength (ability) of the sponsor	
	Strong	Weak
<b>A. Increase in contributions</b>	11. The security level provided by this security mechanism in this type of sponsor support is low because there is no legal/ contractual/statutory obligation to require an automatic call for contributions from the sponsor regardless of the sponsor strength. In some circumstances there might be a very limited potential increase in the contributions but is subject to negotiation with social parties or is detailed in the contract.	

### Pension protection schemes

- 10.3.141. The level of protection afforded by a pension protection scheme is highly dependent on the structure and organisation of the pension protection scheme itself.
- 10.3.142. In general, the protection offered is dependent on two broad areas, Firstly, the level of benefits it has promised to cover, and secondly, the on-going sustainability of the pension protection scheme, i.e. to have the required assets to meet its liabilities.
- 10.3.143. This security mechanism is only triggered in a hard stress situation of insolvency of the sponsor. The level of security is generally high although there are some constraints to this assessment, namely:
- a. the level of benefits guaranteed by the pension protection scheme may differ from those promised to the member as there can be caps on maximum pensions / lump sum or exclusions of certain benefits (like pension indexation). The higher the restrictions the lower the level of the protection for the participants;
  - b. sustainability of the pension protection scheme itself because it is also subject to its own solvency. The sustainability depends on whether it operates on a full or partial fund basis and whether it has the ability to call further assets from the IORPs / sponsors to cover its deficits.

### Regulatory own funds, SCR and MCR and preferential share capital and subordinated loans

#### Generic available own funds

- 10.3.144. Own funds are immediately and unconditionally available to respond to stress situations.
- 10.3.145. In overall terms the existence of own funds provides a high level of protection in case of soft stresses.
- 10.3.146. In hard stress situations the level of protection is also high because the amount of own funds required are determined with reference to the SCR which is calibrated in order to ensure the solvency of the undertaking at a given time horizon with a given confidence level. The protection offered by own funds may nevertheless be altered depending on the characteristics of the capital instruments that determines its availability to absorb the stress situations depending on the tier structure of own funds and its quantitative limits.

#### Preferential share capital

- 10.3.147. Preferential share capital is subordinated and the capital connected to it is fully accessible in the event of hard stress.
- 10.3.148. In soft stress the valuation of preferential share capital in relation to common share capital is dependent on the precedence and relation of the level of dividends (not a given quantity) and interest payments.

### Subordinated loans

- 10.3.149. In order for subordinated loans to actually offer (additional) protection to the members the loan must fulfil certain requirements (type of loan: temporary or perpetual, residual time to maturity, possibility to redeem the loan).
- 10.3.150. In hard stress situations the level of protection is high because the subordinated loan is fully accessible to absorb the losses. In that case, the entire loan capital paid into the IORP will be part of the available own funds (and has de facto turned into a capital payment by the issuer of the loan).
- 10.3.151. In the event of soft stress, the valuation of the subordinated loan is dependent on whether or not the loan is to be valued at actual value:
- a. If the loan is to be valued at the nominal value, soft stress will lead to a decline of the protection value. This is because of the limitation that subordinated loans can only form part of the total available own funds. In soft stress, the other available own funds will decline and so will the amount of subordinated loans that can form part of the available own funds;
  - b. If the loan is to be valued at actual value, soft stress leads to two effects with opposing direction. First of all, the soft stress will delay the moment in which the loan will be paid-off (the connected cash-flows will have a longer duration). This delay will decrease the actual value of the loan and thus increase the excess amount of the loan over the value. On the other hand, the other available own funds will decline and so will the amount of subordinated loans that can form part of the available own funds

### Discretionary or conditional benefit promises

- 10.3.152. The degree of protection of the discretionary or conditional benefits (in particular conditional indexation) depends on the conditions for them to be allocated, whether they are to be accounted for as technical provision and, as such, irrevocable or not as well as the level of available capital in relation to required capital in the event they are not to be accounted for as technical provisions.
- 10.3.153. In the case where the discretionary benefits are not accounted for as technical provisions the value of the allocated benefits could be dependent on the capital available, as a maximum the full value of the allocated benefits. In soft stress this value could be capped by the capital available before taking into account (full) capital charges for risk exposure. In hard stress the level of protection for the discretionary and conditional benefit promises are low because they could be capped by capital available after full capital charges, given that reductions are possible.
- 10.3.154. However, the other (non-discretionary and non-conditional) benefit promises are further protected because the flexibility linked to discretionary and conditional benefits enables institutions to save

resources for peak periods when it will be difficult to generate surpluses and allows an institution not to become insolvent, or even under funded.

Reduction of accrued benefits and the possibility for an IORP to demand additional contributions from active participants

- 10.3.155. The unconditional accrued benefits that belong to the members and beneficiaries may, by legislation, a contract or a statute, be reduced as a last resort mechanism to guarantee the sustainability of the IORP. Because the reduction in accrued benefits is only applied as the ultimate measure it can only happen in a hard stress.
- 10.3.156. The level of protection is low because participants see their pension benefits decrease although it must be acknowledge that it may be better to have some security over a reduced benefit than no security in the original pension promise.
- 10.3.157. From an economic view point, and focusing only on the participants perspective (not including beneficiaries) mandatory additional contributions from active participants is equivalent to a reduction of benefits if one supposes that the participant privately invests the additional contribution in a similar way as the pension scheme.

**Specific Call for Advice**

The treatment of operational risk where the investment risk is borne by the scheme member or beneficiary.

**EIOPA view on issues in the Cfa**

- 10.3.158. The solvency rules in a revised IORP Directive could also cover capital requirements with regard to operational risk for schemes where the investment risk is borne by the scheme members or beneficiaries. Losses due to operational risk situations (such as contributions and investment returns allocated to an incorrect account) could be relevant because they may ultimately be borne by members/beneficiaries (making them worse off). This is in contrast to other kinds of pension schemes where operational risk is borne by the other stakeholders (e.g. IORP itself, sponsoring undertaking or pension fund managing entities).
- 10.3.159. For the evaluation of how operational risk could be handled in case members and beneficiaries bear the investment risk, it is useful to analyse how operational risk is treated in similar contexts such as insurance unit-linked products or UCITS investment funds. Indeed, investment risk is ultimately borne by policy holders in case of unit-linked products and investors in case of UCITS investment funds.
- 10.3.160. In general, Solvency II sets a specific capital requirement for the operational risk; this requirement represents a component of the solvency capital requirement (SCR). In the particular case of unit-linked business, the capital requirement for the operational risk, computed according to a simplification of the standard formula, is set taking into account only the annual expenses incurred in respect of these insurance operations.

- 10.3.161. The UCITS IV Directive sets general capital requirements (which in practice cover operational risk) that take into account the fixed overheads or the size of the assets under management (above a certain threshold). A maximum quantitative limit is set for the capital to be held to cover operational risk.
- 10.3.162. A further aspect to take into consideration regards the legal personality of the IORP. For example, when the IORP has no legal personality and it is managed by entities duly authorized according to relevant EU directives (e.g. pension fund managing entities), losses arising from operational risk are bound on those entities and not on members/beneficiaries.
- 10.3.163. In terms of principles to be adopted in the level 1 text, the application of the capital requirements should be required to all types of IORPs regardless of the type of legal personality to ensure protection of members and beneficiaries of all IORPs. However, there might be reasons to duly justify different capital requirements to cover operational risk, but this requires further analysis and evidence.
- 10.3.164. The details of the capital requirement, such as the formulas to determine it (in percentage of the expenses/operating costs or in percentage of assets under management) or the introduction of a limit indicating a maximum level for the capital to be set aside for operational risk are matters for the level 2 implementing measures.
- 10.3.165. When the IORP has outsourced functions, the need for capital requirements against operational risk could take into account the capital requirements already imposed on external asset managers through MiFID or AIFMD. In this case, it would still be important that the IORP is responsible for ensuring that the outsourced entity (e.g. managing company or administrator) has appropriate controls and security mechanisms in place to cover against applicable operational risks.
- 10.3.166. Also the existence of sound and comprehensive risk management policies along with internal control mechanisms may have an influence in the determination of the capital requirement. The stronger the risk management processes the lower might be the need for a capital requirement.
- 10.3.167. How these mechanisms (outsourced functions and risk management policies) can really work as risk mitigating techniques is unclear. For instance, capital requirements for operational risk both for insurance companies managing unit-linked products and asset management companies managing UCITS investment funds are calculated according to a standard formula that does not reflect risk mitigating techniques. However, the extent to which capital requirements can be reduced due to these mechanisms would be determined in the level 2 implementing measures.
- 10.3.168. Some Member States have the view that from a management principle perspective, there are no reasons to distinguish the situations of an IORP where risks are borne by members and beneficiaries (a pure DC plan where neither the IORP nor the sponsoring undertaking assume any risks) from an IORP where the sponsoring undertaking assumes some of the

risks (regarding biometric risks or regarding a certain return on the investments or considering a certain level of benefits to the scheme members and beneficiaries).

## **Policy options**

Option 1: Leave the IORP directive unchanged

10.3.169. This option maintains the current state of affairs and leaves the IORP Directive unchanged with regard to the issue of operational risk.

Option 2: Introduction of capital requirement for operational risk

10.3.170. This option consists on the introduction of a uniform capital requirement to cover operational risk in case investment risk is borne by members and beneficiaries.

Option 3: Introduction of a capital requirement for operational risk that could be reduced under specific circumstances

10.3.171. This option proposes the introduction of a capital requirement to specifically address the operational risk, with the possibility that it could be reduced under specific circumstances where there is other provision against operational risk

### **Specific Call for Advice**

The material elements of Articles 136-142 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the recovery plan and, where necessary, the finance scheme; particular attention should be paid to (i) the length of the recovery period allowed and (ii) the need to maintain a specific wording for cross-border activity.

## **EIOPA view on issues in the CfA**

10.3.172. The Solvency II Directive requires that undertakings produce recovery plans when they do not meet the technical provisions or capital requirements. The provisions are in Articles 136-142 of the Directive.

10.3.173. Monitoring of the financial position is as important for IORPs as it is for insurance companies. The need for active and timely monitoring increases as the financial position of an institution worsens and the capacity to deal with deterioration diminishes. It is equally important for supervisors to be informed about a deterioration of the financial conditions in a timely manner. However, the precise provisions and timing of requirements may differ for IORPs and insurers.

10.3.174. Article 136 requires undertakings to monitor their financial position and to notify the supervisor when such deterioration occurs. The principle of Article 136 is therefore relevant in the context of IORPs. It includes two issues: (i) a requirement for IORPs to monitor their financial position

continuously, and (ii) a requirement to report a deterioration to the supervisor.

- 10.3.175. The requirement for monitoring in Article 136 may overlap with the processes for Risk Management (Article 44) and the ORSA (Article 45) in the Solvency II Directive. It may be disproportionate to have all three provisions to achieve the objective of appropriate monitoring of an IORP's financial position. That said, although these articles may aim for similar objectives, the application of these articles to IORPs would in principle be no different than to insurance companies.
- 10.3.176. Regarding the accrual of new business, there are differences in the nature of insurance companies and IORPs. The "new business" which IORPs might take on in future is of the same nature as liabilities already accrued. Whilst the future is uncertain, new accrual of liabilities is to some extent predictable once the known financial changes and the information already available to the supervisor are taken into account. Insurance companies are different. Depending on the type of insurance business, they may write different (or a different mix of) new business, which requires such regular monitoring. However, financial conditions of IORPs, their sponsors and insurers may be affected by changes in investment policy and the financial climate alike.
- 10.3.177. For IORPs this monitoring objective is in practice met at present by the responsibilities of the managers and trustees to have proper internal controls in place, and more formally as a result of the required actuarial valuation reporting cycle. If such a monitoring process were also to be more formal and continuous, it would potentially be an extra administrative burden on IORPs and supervisors. All the same, procedures should be such that adequate and timely monitoring of the financial conditions would be safeguarded.
- 10.3.178. To guarantee a timely supervisory response and safeguard the interests of the members and beneficiaries, it is necessary that supervisors are informed in a timely manner of deteriorating financial conditions. Where regulatory boundaries are breached, provisions may be stricter. The supervisor will have data available from the latest actuarial valuation and be able to take account of the nature of financial market changes to the funds' assets and liabilities. To the extent that this information is sufficient and timely, the sort of reporting process required by Article 136 could be unnecessary. However, depending on precisely what deteriorating financial circumstances have to be reported, the possible low frequency of these processes may require the need for additional requirements such as in Article 136.
- 10.3.179. As the same financial changes affect all IORPs in broadly similar ways, it may be unnecessary for negative trends common to all IORPs to be reported to supervisors by every IORP. That said, since the risk profile of IORPs may differ, e.g. because of their hedging policy or changes to the characteristics of their sponsoring undertaking, requirements for individual monitoring and reporting may be applicable, with specific events affecting the IORP or the sponsor being notifiable to supervisors.

- 10.3.180. Article 136 includes notification to the supervisor when deterioration occurs. The financial position of an IORP is subject to market volatility of both the liabilities and the assets. It would seem appropriate for consideration to be given to the particular times when “deterioration” needs to be reported to supervisors.
- 10.3.181. EIOPA is of the view that Article 136 is in principle suitable for IORPs, with consideration to be given in the implementing measures to when reporting to supervisors need occur to ensure appropriate implementation for IORPs.
- 10.3.182. Article 137 sets out provisions where the insurer does not “comply” with the technical provisions, although it appears to relate only to the ability of the supervisor to prohibit the disposal of certain assets, and to relate specifically to insurers operating cross-border.
- 10.3.183. Here “not comply with Chapter VI Section 2” means that technical provisions have not been established in a correct way. However, a similar provision exists in Article 14(2) of the IORP Directive. EIOPA is of the view that such a provision should remain, but that the precise wording of the article could be reviewed to make it consistent with changes which may be made to the provisions for recovery plans for IORPs.
- 10.3.184. Article 138 includes the provisions for non-compliance with the SCR, and is relevant here for those options including a solvency margin in the holistic balance sheet.
- 10.3.185. Article 138 contains four issues:
- a. The need to report to the supervisor as soon as the SCR requirements are not met or there is a risk they will not be met in the following 3 months.
  - b. The submission of a recovery plan within 2 months with a suitable financial position being reached within 6 months, and regular progress reports to the supervisor.
  - c. The ability to set somewhat different timetables under exceptional circumstances.
  - d. Powers for the supervisor if the recovery plan does not appear likely to be successful.
- 10.3.186. In Article 138, the term ‘recovery plan’ is applied to the action taken to restore the SCR to its required level. However, in the IORP Directive, the term is used in Article 16 to refer only to a plan to restore assets to cover technical provisions. There is no provision in Article 17 of the IORP Directive for a recovery plan to restore regulatory own funds. In the remainder of this section, the term will be taken to mean a plan to restore the assets of the IORP to the level required by regulation.
- 10.3.187. On a), there should be a regulatory approach for IORPs informing supervisors when regulatory boundaries are breached. If in the future, not all IORPs are subject to continuous financial monitoring the

implementation of this approach should take account of that. For instance, IORPs could be obliged to report to the supervisor when scheduled financial reporting discloses that SCR or other requirements are breached, or when financial conditions are such that it is likely that they have been or shortly will be breached.

- 10.3.188. As in the comments on Article 136, this requirement could place a large burden on the supervisor in those Member States with large numbers of IORPs, bearing in mind that all of them are likely to be subject to broadly similar impacts from changing financial and economic conditions.
- 10.3.189. It would be necessary to consider how to take account of the volatility of the funding position (if an IORP Directive approach is taken to technical provisions) or of the regulatory balance sheet (if a Solvency II approach is taken). It would be undesirable to overreact to such fluctuations and might be unnecessary and pro-cyclical. Pro-cyclicality issues are further discussed in CfA 8. In taking account of volatility, any assessment period used should be such that protection of members and beneficiaries is safeguarded.
- 10.3.190. On b) regarding appropriate lengths of recovery plans, EIOPA recognises that the implementation of a common solvency standard may require a consistent framework for setting recovery plans among Member States.
- 10.3.191. Such very short recovery periods as required for insurers in Article 138 could have very significant financial effects on IORPs and their sponsors and unnecessary pro-cyclical impacts on the financing of IORPs which, given the long term nature of their liabilities and investment time horizons, would not be appropriate.
- 10.3.192. It is EIOPA's view that it would seem more appropriate to set or allow longer periods reflecting the nature of the liabilities and investment time horizons applicable for IORPs. The length of the recovery period should be determined taking into account factors including: the long term viability of the IORP and sponsor if any, the short and long term protection of (different cohorts) of members and beneficiaries (taking into account considerations of intergenerational fairness) and characteristics of the institution and the national system it operates in. It could be appropriate for recovery plans of the order of 15 years to be possible, although they should be as short as is reasonable affordable.
- 10.3.193. The possible effect of ring-fencing, tiering, the operation of different security mechanisms, and possible reductions of benefits mean that it may be appropriate to have different points of intervention by supervisors and different requirements for recovery plans, depending on the situation and structure of the IORP.
- 10.3.194. On c), EIOPA is of the view that it seems appropriate for the supervisory authority to be able to allow longer recovery plans if appropriate.
- 10.3.195. On d), EIOPA is of the view that it seems appropriate for the supervisory authority to have powers to restrict the actions of the IORP where it does not appear likely that a recovery plan will be successful and the financial position of the IORP will deteriorate.

- 10.3.196. Article 139 sets out the provisions in respect of failure to meet any MCR. It contains provisions similar to those in Article 138 in relation to an SCR. Given the weaker financial position of a regulated entity which fails to meet any MCR the provisions in Article 139 are more severe than in Article 138.
- 10.3.197. EIOPA is of the view that it seems necessary for the approach taken to Article 139 to follow that of Article 138 if an MCR is included in the option, taking into account the weaker financial position. The principle that the recovery to an MCR would have to take place in a shorter time frame than recovery to an SCR measure would equally apply to IORPs.
- 10.3.198. Article 140 makes provision for prohibiting the free disposal of assets in case capital requirements are not met. This is similar to Article 136, although is a more general provision. It may be appropriate to reconsider the action prohibited by this article to reflect the IORP practice (e.g. the application of restrictions to the pension premiums paid, payment of discretionary indexation, etc.).
- 10.3.199. Article 141 gives the supervisory authority powers to protect policy holders in deteriorating circumstances, provided the measures taken are proportionate. It seems appropriate to include a provision of this nature with suitable detailed amendment for IORPs.
- 10.3.200. Article 142 sets out the provisions to be included in a recovery plan. They include revenue accounts and a forecast balance sheet as well as the resources which are intended to meet the SCR and MCR in future.
- 10.3.201. It seems appropriate to set out the main requirements of a recovery plan, whether it relates to inadequate financial provision relative to an SCR or any MCR. The specific details needed in a recovery plan for an IORP should be changed from those in Article 142 to make them more appropriate to IORPs. The specific details would depend on which approach is taken to technical provisions and any solvency margin.
- 10.3.202. Under the current IORP Directive, a recovery plan is required if the assets of the IORP are less than the technical provisions. That would still apply if the option to keep the current IORP rules for technical provisions were retained in future. The main strength of the current approach is that it is flexible, which enables it to deal with the differences between Member States in the nature of their pension provision, and the ways in which members' benefits are made secure.
- 10.3.203. If the option on technical provisions consistent with the holistic balance sheet were adopted then the requirements for the recovery plan could continue as under the current IORP, with amendments or implementation measures to set out how such an approach would apply and specifically what circumstances were classed as needing a recovery plan and what the objectives of such a plan would be. It would depend on the approach taken to setting the technical provisions, and the values of (and nature of) the assets which can meet the different types of liability where any solvency margin is to be included in a "holistic balance sheet". This would retain the flexibilities of the current system as far as the recovery plan is

concerned, whilst meeting the Solvency II approach to the holistic balance sheet.

- 10.3.204. In particular, the timescale for recovery plans could be much longer than is necessary under Solvency II for insurers, to take account of factors depending on the circumstances of the individual IORP as well as of the financial market conditions at that time.
- 10.3.205. As stated earlier, this is reasonable given that the objective of the recovery plan provisions for IORPs is broadly similar to that of insurance companies, namely the protection of the members and beneficiaries. But the terms and conditions that would be applicable to IORPs could however be very different from insurance entities.
- 10.3.206. For insurers, to safeguard the interests of clients, the objective of setting the terms and conditions of recovery plans, together with the requirements for the technical provisions and solvency margin, is that where an entity fails to meet the solvency requirements and is unable to produce a self-standing recovery plan, then it should be possible to transfer the business to another insurance entity.
- 10.3.207. This objective could reasonably be taken to apply to IORPs where they act in a manner similar to insurance companies. However, the terms and conditions should be set differently to reflect the characteristics of IORPs and pension arrangements.
- 10.3.208. If a Solvency II approach were to be adopted for employer sponsored IORPs, then the financial implications for sponsors and members of IORPs would have to be carefully considered.
- 10.3.209. It will be necessary to consider the specific requirements on cross-border schemes to ensure they provide at least the same security as now under whichever options are chosen.

## **Policy options**

- 10.3.210. The following options set out alternative approaches to the recovery plan itself. EIOPA is of the view that the provisions of Articles 136, 137, 140, 141 and 142 should be included in any holistic balance sheet approach, although the precise provisions and wording of the articles would need to be reconsidered to take account of the nature and practice of IORPs.

### **Option 1: Retain IORP Directive**

- 10.3.211. This option retains the current flexible position on recovery plans.
- 10.3.212. It is clearly possible for this approach to apply where the current IORP approach is retained for technical provisions and assets. It is also possible to use this approach to recovery plans where a Solvency II approach is taken to the holistic balance sheet, although the detailed nature of the recovery plan could be different. It would depend on the approach taken to setting the technical provisions, and the values of (and nature of) the assets which can meet the different types of liability where any solvency margin is to be included in a "holistic balance sheet".

Option 2: Adopt the principles of the Solvency II Directive for all IORPs.

- 10.3.213. Option 2 would require an IORP which has a shortfall of assets (including contingent assets as well as the assets in the IORP) as compared with the liabilities (including the solvency margin requirements as well as the technical provisions) to produce a plan to “correct” the position in the short term. If the principles were to be applied, adaptations would however have to be made regarding the length of the recovery period for IORPs
- 10.3.214. The impact of option 2 on the extra amounts which sponsors might have to pay into IORPs, or any other changes they might make, are difficult to estimate. They would depend on:
- a How the technical provisions were calculated when compared to the assumption under the current IORP – and the Solvency II provisions for annuities are not yet finalised.
  - b How the solvency margin requirements were calculated, including the confidence level.
  - c How the sponsor support would be valued for the purpose of the regulatory balance sheet, and how any value attributed to the sponsor support would be taken into account for the purpose of establishing the need for and nature and level of any recovery plan
  - d How any pension protection system would be valued for the purpose of the regulatory balance sheet, and how any value attributed to the pension protection scheme would be taken into account for the purpose of establishing the need for and nature and level of any recovery plan
- 10.3.215. The above factors are considered elsewhere in the response to CfA 5 and 6. Where the options could lead to significant extra funding costs, with implications for sponsors, members and IORPs, these would automatically flow through in practice as impacts on the recovery plan. Although, other things being equal, the longer the recovery plan the less would be the immediate burden of any extra annual cost, the overall impact remain the same over time.

Option 3:

- 10.3.216. Option 3 could be a variant of Options 1 and 2 combined, requiring a short term recovery plan to ensure that the assets in the IORP were at least at the level of the technical provisions, but with more flexibility in the timescale and nature of the recovery plan needed to meet the full financial requirements for the technical provisions and the solvency margin if the holistic balance sheet followed the Solvency II approach. As with Option 2, the length of each the recovery period should be determined taking into account the nature of IORPs and characteristics of the institution and the national system it operates in.
- 10.3.217. There would be a need to be a very significant transitional period prior to implementing such a requirement if the durations chosen were significantly

different to the current practice in Member States and if higher funding targets were required.

#### **10.4. Impact assessment**

10.3.218. This section describes the potential impacts of the various options presented in the explanatory text regarding security mechanisms, such as the:

- Availability and eligibility of own funds to cover the SCR
- Treatment of subordinated loans
- Inclusion and determination of the solvency capital requirement (SCR)
- Inclusion and determination of the minimum capital requirement (MCR)
- Treatment of pension protection arrangements
- Capital requirement to cover for operational risk
- Recovery plans in case of non-compliance with capital requirements

10.3.219. It should be emphasized that these are qualitative assessments, which are partial in nature. In practice the impacts of the various options will be very much related to other choices made within the holistic balance sheet framework. For example:

- The overall funding requirement - including solvency capital requirement - will depend on the required level of technical provisions as prescribed by the options in CfA 5.
- The impact of a solvency capital requirement will - for some types of IORPs - depend on whether sponsor support (CfA 5) or even pension protection arrangements (CfA 6) can be employed as a risk-mitigating mechanism.
- The impact of capital requirements may be cushioned by the options with extended recovery periods in CfA 6.

10.3.220. To arrive at a comprehensive impact assessment of the holistic balance sheet approach, it is essential to quantify the various elements to make them comparable. EIOPA will undertake such a quantitative impact study (QIS) of its advice in the coming months.

10.3.221. It should also be emphasised that the impact of the different elements of the holistic balance sheet proposal may vary substantially between Member States due to differences in existing occupational pension systems:

- The existing IORP Directive takes a minimum harmonisation approach and allows Member States to impose additional prudential regulation upon IORPs. This means that the impact of a revised IORP Directive will depend on national prudential regimes rather than the IORP Directive.
- Pension schemes typically provided by IORPs differ widely as well. The impact of a new solvency regime will depend crucially on whether the risks are borne by plan members, the sponsor or the IORP itself.

#### Provisions for own funds and classification into tiers

Option 1: Change the IORP Directive by applying Articles 87-99 with the minimum necessary wording amendments as explained above, with a particular attention to Article 88 in order to avoid artificial creation of capital.

The following Impact Assessment aims at presenting the various impacts of the following provisions:

- Deduction of cross participations from the IORP's own funds
- Classification of own funds, and calculation of eligible own funds
- Supervisory approval of ancillary own funds
- Identification of discretionary benefits in a surplus fund

#### Positive impacts

##### ➤ Members/beneficiaries

- The classification of own funds would ensure a minimum quality and availability of the own funds of the IORP, contributing to a better protection of the rights of members and beneficiaries.
- Limitations on investments by the IORP in the sponsor (adaption of article 88) would avoid the creation of artificial own funds, hence contributing to a sound financial situation of the IORP, and consequently strengthening the promise to the members/beneficiaries.
- In general, the preliminary approval of ancillary own funds by the supervisory authority would contribute to a finer and more transparent assessment of the solvency position of the IORP. This would apply in particular to sponsor support, if allowed for as ancillary own funds.

##### ➤ IORPs/sponsoring employers

- The own funds provisions would allow IORPs/sponsoring employers to use a variety of financing instruments such as subordinated loans and ancillary own funds as a complement to direct capital injections, yet with a prudent prospective.

##### ➤ Supervisory authorities

- This option would allow for all types of IORPs to be properly taken into account in a unified framework as well as a framework comparable to that for insurance undertakings.
- The supervisory authorities would be given the opportunity to protect the rights of the policyholders by implementing the regulations for instruments such as

subordinated loans and ancillary own funds (as well as rules for investments in the sponsor).

### Negative impacts

- Members/beneficiaries
  - None.
- IORPs/sponsoring employers
  - Depending on the final rules criteria for the eligibility of own funds, the provisions on “classification of own funds” might lead to the de-recognition of some elements compared to the present situation, and consequently to the need for additional financing. This particular issue should be evaluated through a Quantitative Impact Study.
- Supervisory authorities
  - More resources required for supervision, relating in particular to the approval of ancillary own funds.

### Estimated impact

As explained above the impact of provisions on own funds are very much related to the provisions on assets, liabilities, capital requirements and risk-mitigation mechanisms (including sponsor covenants). The ultimate impact depends on these provisions rather than on the provisions on own funds themselves.

### Subordinated loans

EIOPA is of the opinion that a revised IORP Directive should explicitly allow the use of subordinated loans by IORPs subject to requirements on their issuance and redemption to be specified on level 1.

### Positive impacts

- Members/beneficiaries
  - No impact foreseen.
- IORPs /sponsoring employers
  - No impact foreseen
- Supervisory authorities
  - The current IORP Directive does not directly refer to subordinated loans, but only indirectly through the reference in Article 17(2) of the IORP Directive to article 28 of the Consolidated Life Directive. The confusion that is caused by this indirect reference would end if a revised IORP Directive would explicitly allow the use of subordinated loans.

### Negative impacts

- Members/beneficiaries
  - No impact foreseen.
- IORPs /sponsoring employers
  - No impact foreseen
- Supervisory authorities
  - None.

### Solvency capital requirement (SCR)

#### Confidence level

Option 1: harmonized confidence level

Option 2: non-harmonized confidence level

#### Positive impacts

Option 1:

- Members/beneficiaries
  - Comparability and consistency would be higher.
- IORPs/sponsoring employers
  - See above, for employers who want to provide occupational pension provision and look for an IORP.
- Supervisors
  - See above.

Option 2:

- Members/beneficiaries
  - Transparency regarding the final confidence level would be a direct outcome of the solvency framework so it would be easier for each member to perceive the final confidence level of their benefits.

#### Negative impacts

Option 1:

- Members/beneficiaries
  - This option might pose communication problems for the members regarding the true security level of the benefits.
- Supervisors
  - It would be difficult to define a consistent methodology to consider ex-post reduction of benefits mechanism in the best estimate of technical provisions.

Option 2:

- IOPRs/sponsoring employers
  - Enhancing cross-border IORPs for DB schemes could be seriously compromised.
- Supervisors
  - Having a different confidence level according to Social and Labour Law in each Member State would undermine the principle of harmonisation of the security level. It would imply different calibrations according to the existence or not of the benefit adjustment mechanism.

#### Time horizon and frequency of the calculation of the SCR

Option 1: one year time horizon assessed at least three-yearly, estimations in the intervening years

Option 2: one year time horizon assessed at least yearly

#### Positive impacts

Option 1:

- Members/beneficiaries
  - Lower cost should be beneficial for members and beneficiaries, because discretionary benefits should be higher and the willingness of employers to maintain occupational pension provision increases.
- IOPRs/sponsoring employers
  - Lower on-going compliance costs for IORPs and sponsors due to the requirement of a three year full solvency assessment instead of an annual one (assuming there are no major events that require a more frequent solvency assessment).
- Supervisors
  - This option would be consistent with Solvency II, meaning that the structure of the risk based solvency requirement could be used and the calibration process would follow the same standardized approach. Both IORPs and supervisors should benefit from that.
  - Lower implementation costs for EIOPA and National Supervisors because the structure of the model is already built (only a few adjustments are necessary to cope with pension specificities).
  - The longer assessment periods will also limit the supervisory resources needed for the solvency framework, especially if one considers the cost of analysing and evaluating the strength of the sponsor in a holistic balance sheet approach.
  - This option takes into consideration the needs of the supervisory authority for a yearly assessment, although allowing for a less accurate one for the years in between full assessments.

Option 2:

- Members/beneficiaries
  - Increased level of protection for members and beneficiaries because of the higher frequency of the solvency assessments which allows for quicker problem identification and supervisory action.
- Supervisors
  - Option most consistent with Solvency II, meaning that the structure of the risk based solvency requirement could be used and the calibration process would follow the same standardized approach.
  - Lower implementation costs for EIOPA and National Supervisors because the structure of the model is already built (only a few adjustments are necessary to cope with pension specificities).

### Negative impacts

#### Option 1:

- Members/beneficiaries
  - Decreased level of protection for members and beneficiaries because of the lower frequency of the full solvency assessments which may defer the identification of a possible problem. In terms of SCR it is ambiguous whether the level of protection increases or decreases due to the overall risk level and the quality of security mechanisms.
- IOPRs/sponsoring employers
  - Volatility in the solvency assessments of IORPs may increase due to the longer term period between assessments, although the yearly estimation of solvency situation mitigates this. Since fewer full solvency assessments are made the volatility will not be noticed. In fact, the volatility of the balance sheet may increase when there is a larger period between two measurements as more time has passed.

#### Option 2:

- IOPRs/sponsoring employers
  - May imply high volatility in the solvency assessment which could be problematic for IORPs/employers.
  - This may imply higher compliance costs for IORPs and sponsors due to the administrative burden of producing an annual assessment of the solvency situation. There are views that an accurate calculation of technical provisions on an annual basis should be no more onerous than rolling forward and adjusting the results from the last formal valuation, and clearly more accurate.
- Supervisors
  - Long-term nature of pension arrangements is not directly brought into the solvency capital adequacy test, but can be addressed in the governance requirements (ORSA).

### Solvency capital requirement

#### Option 1: leave the IORP Directive unchanged

Option 2: change the IORP Directive by applying a risk-based calculation of solvency capital requirements as in the Solvency II Directive for all IORPs, but taking into account the specificities of IORPs such as the existence of security and adjustment mechanisms

#### Positive impacts

Option 1:

No impact

Option 2:

- Members/beneficiaries
  - At least existing members and beneficiaries could benefit from a new supervisory approach because the security of their benefits could rise or at least be made more transparent.
- Supervisors
  - Supervisors would have a risk-based, transparent (and internationally comparable) framework that provides insight in the financial position of IORPs. The basic elements would be consistent with Solvency II which should be beneficial especially for supervisors in charge of both insurers and IORPs.
  - Notwithstanding the accommodation of the IORPs' specificities (security and benefit adjustment mechanisms), there would be level playing field in terms of regulatory environment with other financial sectors, especially insurance companies subject to the Solvency II Directive.

#### Negative impacts

Option 1:

No impact

Option 2:

- Members/beneficiaries
  - In pension schemes with surplus sharing the discretionary benefits will be lower for future surplus will be reduced by higher administrative cost. Members and beneficiaries of these schemes would be negatively affected.
  - The impact on future employees depends on the reaction of employers, which may include closure of existing schemes for new entrants.
- IOPRs/sponsoring employers
  - The transition from the current approach to the risk-based approach as regards capital requirements will cause higher costs for IORPs/employers for various reasons:
    - a. The calculation of the SCR is complex and costlier than the assessment of the solvency margin which means additional costs for all IORPs. For Article 17(1) IORPs there would be additional costs; for sponsor backed IORPs these costs would be completely new; for Article 17(3) IORPs the impact would depend on the current requirements in the respective Member States.
    - b. In some countries the statutory balance sheet follows other valuation principles than those needed for the calculation of the SCR. Therefore the

IORPs of these Member States would have to set up an additional balance sheet only for the purpose of proving their solvency status.

c. There are strong indications that the SCR could be significantly higher than the required solvency margin. This assessment is based on the results of life insurance companies in quantitative impact studies especially for long term business.

d. The upfront capital needs would rise depending on the consideration of security and adjustment mechanisms of IORPs in the calculation of the SCR and the extent to which an IORP can actually make use of them. For IORPs with no recourse to any sponsor support and other mechanisms (Article 17(1) IORPs) the upfront requirements would rise by the difference of the SCR and the solvency margin.

e. Of course the height of additional cost also depends on the decision on the frequency of the calculation of the SCR, the confidence level and other issues such as the calculation of technical provisions and the concrete consideration of security mechanisms (especially the possibility to cover technical provisions).

- The additional cost could undermine the cost-efficiency of occupational retirement provision in the EU. The higher the additional administrative cost and the less the specificities are quantitatively considered the higher will be the risk that employers reduce occupational retirement provision or even close pension schemes for new entrants. However, a quantification of the reactions of employers is not possible without a quantitative impact study supplemented by a survey among employers.
- Given the higher complexity of a risk-based approach and the smaller average size of IORPs compared to life insurers it is to be expected that IORPs will have to hire additional personnel or buy external expertise. The need for additional expertise will be higher in the first years of the implementation of the new IORP Directive and would tend to decrease over time.

➤ Supervisors

- For many supervisors the introduction of a risk-based approach will mean a major change in the supervisory system which might entail the necessity to strengthen regulatory resources.

### Provisions on minimum capital requirement (MCR)

#### Existence of MCR

Baseline: a guarantee fund exists for some kind of IORPs, in Member States which will implement this option (following the IORP Directive as amended by the Solvency II Directive).

Option 1: no MCR and no guarantee fund

Option 2: MCR

#### Positive impacts

Option 1:

➤ Members/beneficiaries

- None

➤ IORPs/sponsoring employer

- None

➤ Supervisory authorities

- None

Option 2:

➤ Members/beneficiaries

- Increased level of protection, provided that a breach in the MCR would trigger some specific financing and supervisory actions

➤ IORPs / sponsoring employer

- None

➤ Supervisory authorities

- Better assessment of the actual solvency situation of the IORPs
- Increased powers for imposing recovery actions

Negative impacts

Option 1:

➤ Members/beneficiaries

- Lower level of protection for members and beneficiaries of Article 17 IORPs subject to a guarantee fund. However, this impact seems likely to be rather slight, as there is no specific supervisory action associated with a breach of guarantee fund in the IORP Directive as amended by the Solvency II Directive.

➤ IORPs/sponsoring employers

- None

➤ Supervisory authorities

- Less insight on the solvency situation of these IORPs which will be subject to the guarantee fund requirement.

Option 2:

➤ Members/beneficiaries

- None

➤ IORPs/sponsoring employers

- Increased burden for the calculation of the MCR (to an extent varying according to the frequency of calculation and the allowance for approximations)
- Possible need for upfront financing in order to comply quickly with the associated requirements (provided that the 3 tier approach for own funds is chosen, along with restrictions on the eligibility to cover the MCR)

➤ Supervisory authorities

- More supervisory actions to be undertaken; the extent of this additional burden could be further assessed depending on the result of the QIS mentioned above

Possible coverage of the MCR by ancillary own funds

Baseline: the issue is not explicitly covered in the current directive, however the guarantee funds (if implemented) cannot be covered by the listed items which could qualify as ancillary own funds. Therefore the baseline will be set as “no coverage of MCR by ancillary own funds” (option 1), and only option 2 “ancillary own funds can be eligible for the coverage of the MCR” will be assessed.

Option 1: No coverage of MCR by ancillary own funds

Option 2: Ancillary own funds can be eligible for the coverage of the MCR

## Positive impacts

### Option 2:

#### ➤ Members/beneficiaries

- None

#### ➤ IORPs/sponsoring employers

- Reduced 'hard capital' requirements for those IORPs which have ancillary own funds; this impact will be particularly significant if the 'sponsor support' is recognised as ancillary own funds.

#### ➤ Supervisory authorities

- None

## Negative impacts

### Option 2:

#### ➤ Members/beneficiaries

- Possible reduced level of security, to an extent depending of the actual strength of the items recognised as ancillary own funds

#### ➤ IORPs/sponsoring employers

- None

#### ➤ Supervisory authorities

- The supervisory authority should be particularly cautious when approving ancillary own funds

## Structure of the calculation

Baseline: calculation of the guarantee fund as 1/3 of the required solvency margin, with an absolute floor, for Article 17 IORPs in Member States where this option will be implemented; no calculation for other IORPs.

Assessed option: linear core structure, with a corridor in terms of SCR and an absolute floor.

### Positive impacts

#### ➤ Members/beneficiaries

- The structure of calculation in itself has no direct impact on the members and beneficiaries. Only the final calibration can have some impact.

#### ➤ IORPs/sponsoring employers

- Slightly more risk-sensitive approach

#### ➤ Supervisory authorities

- Slightly more risk-sensitive approach

### Negative impacts

#### ➤ Members/beneficiaries

- None

#### ➤ IORPs/sponsoring employers

- More burdensome calculation (the extent of the increased complexity should be adequately evaluated)

#### ➤ Supervisory authorities

- Necessity to perform a QIS on this issue, in order to derive an appropriate calibration

### Frequency of the calculation

Baseline: annual calculation.

Option 1: quarterly calculation

Option 2: annual calculation, with the possibility for supervisory authorities to require more frequent calculations

### Positive impacts

#### Option 1:

➤ Members/beneficiaries

- Potentially increased security, due to a closer monitoring of the financial position of the IORP

➤ IORPs/sponsoring employers

- None

➤ Supervisory authorities

- Possibility to take appropriate action more quickly if needed

#### Option 2:

➤ Members/beneficiaries

- Potentially increased security, to a limited extent

➤ IORPs/sponsoring employers

- None

➤ Supervisory authorities

- More flexibility given to the supervisor, which could therefore be in a position to impose quick appropriate action if necessary

#### Negative impacts

#### Option 1:

- Members/beneficiaries
  - None
- IORPs/sponsoring employers
  - Increased burden
- Supervisory authorities
  - More data to supervise

#### Option 2:

- Members/beneficiaries
  - None
- IORPs/sponsoring employers
  - Possible increased burden, if and when the supervisory authority asks for a more frequent reporting of the MCR
- Supervisory authorities
  - Increased liability towards the IORP and the members and beneficiaries
  - Necessity to set up a decision making process for the requirement of a more frequent MCR calculation

#### Pension protection arrangements

Option 1: Include pension protection schemes in the solvency framework as a contingent asset in balance sheet and with effects in the calculation of capital requirements

Option 2: Include pension protection schemes in the solvency framework through the credit risk of the sponsor used in the valuation of sponsor support

Option 3: Include pension protection schemes in the solvency framework through a lower security level in the calculation of the SCR

Option 4: Do not include pension protection schemes in the solvency framework

#### Positive impacts

#### Option 1:

- Members/beneficiaries
  - If coupled with appropriate disclosure requirements, provides for an increased transparency of the security benefits.
- IORPs/sponsoring employers
  - Prevents a stark increase in funding requirements for employers by ensuring that all security mechanisms – including those which result in payments not to the IORP but to members and beneficiaries – are taken into account.
- Supervisory authorities
  - Makes transparent on the balance sheet that – like a sponsor - a pension protection scheme is an institution outside the IORP that fulfils the promise made in case the assets of the IORP alone might not be sufficient.

#### Option 2:

- Members/beneficiaries
  - Same as option 1.
- IORPs/sponsoring employers
  - Same as option 1.
- Supervisory authorities
  - Recognises explicitly that pension protection arrangements provide cover against insolvency risk of employers through risk pooling.

#### Option 3:

- Members/beneficiaries
  - None foreseen
- IORPs/sponsoring employers
  - Avoids the costs of valuing the effects of pension protection schemes as foreseen in option 1 and 2, which could technically be difficult.
- Supervisory authorities
  - The application of a lower security level is easier to oversee than the demanding calculations needed in option 1 and 2.

#### Option 4:

- Members/beneficiaries
  - Excluding pension protection schemes from the solvency financial requirements would imply a higher level of protection of the members and beneficiaries, with the possibility to enhance afterwards the protection given by the prudential framework.
- IORPs/sponsoring employers
  - None foreseen.
- Supervisory authorities
  - It is a necessary condition for achieving a level playing field between all operators in the pensions field.

### Negative impacts

#### Option 1:

- Members/beneficiaries
  - In a multi-employer IORP where not all employers are covered by a pension protection scheme, a reduction of the “excess assets over liabilities”<sup>54</sup> could cause an uncovered risk for the members and beneficiaries of employers without a pension protection scheme if there were no measures taken to avoid this (e.g. ring-fencing).
- IORPs/sponsoring employers
  - The valuation of IORP-specific security mechanisms will be difficult in practice and will require an in-depth analysis at the level of each Member State to derive the proper impacts on valuation principles. This could be tackled by appropriate implementing measures and simplifications.
- Supervisory authorities
  - Moral hazard may induce IORPs to engage in excessive risk-taking. This danger - which also applies to sponsor support - can be dealt with by adequate risk management rules.

#### Option 2:

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<sup>54</sup> As defined in the holistic balance sheet presentation in the introductory section to CfA 5 and 6.  
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- Members/beneficiaries
  - Same as option 1.
- IORPs/sponsoring employers
  - Same as option 1.
  - If the pension protection arrangement covers more than only insolvency risk this would mean that not the whole risk-mitigating capacity of the protection scheme would be taken into account. This could have negative financial consequences for employers.
- Supervisory authorities
  - Same as options 1.
  - There is no clear distinction between the value of sponsor support and the value of the pension protection fund if such arrangements are taken into account through reducing insolvency risk.

#### Option 3:

- Members/beneficiaries
  - None foreseen.
- IORPs/sponsoring employers
  - There would be major practical difficulties because when calculating capital requirements different stress scenarios were needed for each single level of security.
  - If pension protection schemes only protect some of the benefits an IORP is responsible for - which can be the case especially in case of cross-border operations - then different security levels would have to be applied to/within one IORP. Even though this might technically be possible it would cause material technical difficulties.
- Supervisory authorities
  - There would be no harmonised security level for IORPs in all Member States.
  - Deciding in advance that a pension protection scheme is always worth a certain reduction in security level contradicts a risk-based approach.

#### Option 4:

- Members/beneficiaries
  - Not allowing pension protection schemes at all would risk undermining future accruals in voluntarily provided occupational retirement plans in countries with pension protection schemes.
- IOPRs/sponsoring employers
  - If pension protection schemes were not considered in the framework, employers would have to front more financial capital, which in turn would have a negative impact on the overall economy.
- Supervisory authorities
  - Not foreseen.

#### Estimated impact

At this moment, it is difficult to assess the impact of considering pension protection schemes or not. The pension protection scheme is only one security mechanism among others and exists only in a few Member States. The impact in the individual case depends on the strength of the employer. If the employer itself is strong enough to cover the technical provisions and the solvency capital requirements, the consideration of pension protection schemes would not be necessary. Without a quantitative impact study an assessment of the concrete impact will not be possible which is why EIOPA gives the advice to carry through such study before taking any decision about the consideration of pension protection schemes.

#### Capital requirements for operational risk

Option 1: Leave the IORP directive unchanged

Option 2: Introduction of capital requirement for operational risk

Option 3: Introduction of a capital requirement for operational risk that could be reduced under specific circumstances

#### Positive impacts

Option 1:

No impact.

Option 2:

##### ➤ Members/beneficiaries

- The solvency framework would strengthen the protection of members/beneficiaries against losses coming from operational failures.

##### ➤ IORPs/sponsoring employers

- For some types of IORPs (e.g. IORPs who are managed by managing entities who already have capital requirements that cover these risks) there would be no major changes in their prudential regulation.

##### ➤ Supervisory authority

- Operational risk is better addressed;
- The computation of the capital requirement according to a standard formula would simplify the work of the supervisor.

Option 3:

➤ Members/beneficiaries

- The solvency framework would strengthen the protection of members/beneficiaries against losses coming from operational incidents

➤ IORPs/sponsoring employers

- For some types of IORPs there would be no major changes in its prudential regulation (e.g. IORPs who are managed by managing entities who already have capital requirements that cover these risks) especially if a “reduced” capital requirement is applied.

➤ Supervisory authority

- Operational risk is better addressed

Negative impacts

Option 1:

No impact.

Option 2:

➤ Members/beneficiaries

- Additional costs for members if the buffer to cover operational risk is (partly) paid for by the members’ contributions. The impact depends on the amount of the buffer and how it is established (one off type of cost or according to a smoothed implementation).

➤ IORPs/sponsoring employers

- Increase in the administrative burden for the IORP in implementing the capital requirement for operational risk
- Additional costs for sponsoring undertakings if they have to finance the additional capital

➤ Supervisory authority

- This requirement will increase the number of items to be supervised. However, the administrative burden could be reduced if a proportionate approach is applied. For example, by only requiring evidence.
- Additional costs (depending on approach followed).

Option 3:

➤ Members/beneficiaries

- Additional costs for members if the buffer to cover operational risk is (partly) paid for by the members. The impact depends on the size of the buffer and the way it is implemented (one off type of cost or according to a smoothed implementation).
- The protection of members/beneficiaries could be undermined when the capital requirement is reduced in an “inappropriate” way.

➤ IORPs/sponsoring employers

- Implementation of the buffer requirement will increase the administrative burden on IORPs
- Uncertainty regarding the way capital requirements would be reduced when mitigation mechanisms are in place.
- Additional cost for sponsoring undertakings if they bear the burden of financing the buffer for operational risk.

➤ Supervisory authority

- From the supervisor’s perspective, this requirement will increase the number of elements of an IORP to supervise.
- The presence of mitigation mechanisms reducing the capital requirement may increase the burden on supervisors.
- Additional costs (depending on supervisory approach followed).

Recovery plans

Option 1: Retain flexibility on recovery plans of current IORP Directive

Option 2: Solvency II principles with extended length of recovery periods

Option 3: Short-term Solvency II-type recovery plans combined with long-term flexible recovery plans

Positive impacts

Option 1:

No impact

Option 2:

- Members/beneficiaries
  - Prevents funding shortfalls being disproportionately shifted forward in time to future plan members
- IORPs/sponsoring employers
  - None foreseen
- Supervisory authorities
  - Reduces the scope for regulatory arbitrage between Member States with short and Member States with long recovery periods
  - Ensures consistency with insurance regulation

#### Option 3:

- Members/beneficiaries
  - Prevents that funding shortfalls are excessively shifted forward in time burdening future plan members
- IORPs/sponsoring employers
  - None foreseen
- Supervisory authorities
  - Reduces scope for regulatory arbitrage by imposing a Solvency II-type short-term recovery plan with respect to minimum funding requirement

#### Negative impacts

#### Option 1:

No impact

#### Option 2:

- Members/beneficiaries
  - Higher risk exposure of current plan members – in schemes where risks are (partially) borne by the members – as there is less scope to smooth financial shocks over time
- IORPs/sponsoring employers
  - Higher volatility contributions as there is less scope to smooth shocks over time
- Supervisory authorities
  - Pro-cyclical impact of financial shocks on benefits, contributions and economy

#### Option 3:

- Members/beneficiaries
  - Higher risk exposure of current plan members as there is less scope to smooth financial shocks over time, but less than in option 2
- IORPs/sponsoring employers
  - Higher volatility contributions as there is less scope to smooth shocks over time, but less than in option 2
- Supervisory authorities
  - Pro-cyclical impact of financial shocks on benefits, contributions and economy, but less than in option 2
  - Scope for regulatory arbitrage remains through flexible long-term recovery plans with respect to full funding requirements

## 10.5. EIOPA advice

The Commission Services would like EIOPA to advise, in close cooperation with the actuarial profession, on detailed rules by which supervisors can ensure that IORPs have proper rules to protect pension liabilities.

### EIOPA's general position

EIOPA supports the following principles for the valuation and capital requirements of IORPs:

- Transparency i.e. derivation of how a valuation was reached should be clear
- Comparability – it should therefore be possible to compare valuation of one IORP's liabilities with another, and likewise the value of the assets which support that liability
- Comprehensiveness – all potential security mechanisms and benefit adjustments should be included

EIOPA therefore recommends:

- Valuations should be market consistent
- Valuation should include the actuarial value of all enforceable pension promises of the IORP
- The holistic balance sheet as the means in principle of including all security mechanisms
- Its adoption in practice is subject to further investigation and in particular, the feasibility of the development and adoption of a methodology for the quantification of the security and benefit adjustment mechanisms, and whether that methodology is effective in terms of its costs and benefits.

EIOPA wishes to note further that some elements of its advice are conditional on the following three factors:

- The Commission's objective of a common level of security for retirement benefits. Whether this objective is accepted is a political matter which also potentially has other implications . Its rejection would necessitate a review of some of the advice.
- The results of a quantitative impact study. This will provide further information about whether a common level of security is feasible in practice and effective in terms of its costs and benefits, given the diversity of IORPs in the different member states, and EIOPA will consider whether to offer further views on this matter in light of the results.
- That the typical question in CfAs 5 and 6 on which EIOPA is asked to provide advice is whether the material elements of articles of the Solvency II directive should be amended or removed to adequately address the specificities of IORPs. EIOPA's response therefore does not consider the question of whether or not Solvency II is the correct starting point, though it is noted that many consultation respondents stated

the view that Solvency II is the wrong initial framework for considering the capital requirements of IORPs.

EIOPA's advice in this section is consistent with the Call for Advice's objective to increase the level of harmonisation, with the holistic balance sheet proposal, and with the Commission's objective of achieving a common level of security for all IORPs. EIOPA would like to stress that this not necessarily implies that these options are preferred over the other options presented in the explanatory text, which are more in line with the existing IORP Directive. It would therefore be preferable to achieve agreement about the question of a common level of security before making decisions about the other matters considered in this section. In addition, although the various options in the advice on CfA 5 and CfA 6 may be in line with the holistic balance sheet approach, they may not always be consistent with each other.

The advice in this section has been considered in principle only, and without the results of any quantitative impact studies or detailed cost/benefit analysis.

EIOPA proposed response is as follows:

*The material elements of Article 87-99 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to own funds; the advice should include an assessment as to whether there is an advantage to keep a three-tier system;*

EIOPA is of the opinion that the provisions for own funds and classifications into tiers as stated in the Articles 87 – 99 of the Solvency II directive can also be made applicable to IORPs.

Some amendments to the Articles 87 - 99 are necessary. These refer to provisions that should not (fully) apply to and therefore requires additional provisions for IORPs.

#### Article 87

No changes are proposed to article 87.

#### *Own funds*

*Own funds shall comprise the sum of basic own funds, referred to in Article 88 and ancillary own funds referred to in Article 89.*

#### Article 88

In order to avoid artificial creation of own funds between the IORP and its sponsor (or several IORPs and sponsors), the last section of Article 88 needs to be adapted to the specific circumstances of the different kinds of IORPs. The proposed wording represents a broad principle, which should be further specified in the Level 2 text. Insurance or reinsurance undertaking is replaced by IORP where applicable in all articles.

#### *Basic own funds*

*Basic own funds shall consist of the following items:*

*(1) the excess of assets over liabilities, valued in accordance with Article 75 and Section 2;*

*(2) subordinated liabilities.*

*The excess amount referred to in point (1) shall be reduced by:*

*(a) the amount of own shares held by the IORP,*

*(b) the cross-participations between the IORP and its sponsoring undertaking, and/or the IORP and several other IORPs and sponsoring undertakings.*

#### **Article 89**

Article 89 needs to be amended with the ancillary own funds, if any, that should be recognised for IORPs.

#### **Ancillary own funds**

*1. Ancillary own funds shall consist of items other than basic own funds which can be called up to absorb losses.*

*Ancillary own funds may comprise the following items to the extent that they are not basic own-fund items:*

*(a) unpaid share capital or initial fund that has not been called up;*

*(b) letters of credit and guarantees;*

*(c) any other legally binding commitments received by IORPs.*

*In the case of a mutual or mutual-type association with variable contributions, ancillary own funds may also comprise any future claims which that association may have against its members by way of a call for supplementary contribution, within the following 12 months.*

*2. Where an ancillary own-fund item has been paid in or called up, it shall be treated as an asset and cease to form part of ancillary own-fund items.*

#### **Article 90**

No changes are proposed to article 90.

#### **Supervisory approval of ancillary own funds**

*1. The amounts of ancillary own-fund items to be taken into account when determining own funds shall be subject to prior supervisory approval.*

*2. The amount ascribed to each ancillary own-fund item shall reflect the loss-absorbency of the item and shall be based upon prudent and realistic assumptions. Where an ancillary own-fund item has a fixed nominal value, the amount of that item shall be equal to its nominal value, where it appropriately reflects its loss-absorbency.*

*3. Supervisory authorities shall approve either of the following:*

*(a) a monetary amount for each ancillary own-fund item;*

*(b) a method by which to determine the amount of each ancillary own-fund item, in which case supervisory approval of the amount determined in accordance with that method shall be granted for a specified period of time.*

*4. For each ancillary own-fund item, supervisory authorities shall base their approval on an assessment of the following:*

*(a) the status of the counterparties concerned, in relation to their ability and willingness to pay;*

*(b) the recoverability of the funds, taking account of the legal form of the item, as well as any conditions which would prevent the item from being successfully paid in or called up;*

*(c) any information on the outcome of past calls which IORPs have made for such ancillary own funds, to the extent that information can be reliably used to assess the expected outcome of future calls.*

## **Article 91**

Article 91 could be further explained in Level 2 to allow for the specificities of IORPs with regard to recognising discretionary benefits as surplus funds, depending on the options chosen for discretionary benefits. No changes are proposed here, except for replacing 'policy holders' by 'members and beneficiaries' and 'insurance and reinsurance liabilities' by 'technical provisions' (in all articles where applicable).

### **Surplus funds**

*1. Surplus funds shall be deemed to be accumulated profits which have not been made available for distribution to members and beneficiaries.*

*2. In so far as authorised under national law, surplus funds shall not be considered as technical provisions to the extent that they fulfil the criteria set out in Article 94(1).*

## **Article 92**

### **Implementing measures**

One set of specifying criteria (a) is proposed to be added to the implementing measures.

*1. The Commission shall adopt implementing measures specifying the following:*

*(a) the criteria for the appropriate identification of cross-participations, as referred to in Article 88,*

*(b) the criteria for granting supervisory approval in accordance with Article 90;*

*(c) the treatment of participations, within the meaning of the third subparagraph of Article 212(2), in financial and credit institutions with respect to the determination of own funds.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

*2. Participations in financial and credit institutions as referred to in paragraph 1(b) shall comprise the following:*

*(a) participations which IORPs hold in:*

*(i) credit institutions and financial institutions within the meaning of Article 4(1) and (5) of Directive 2006/48/EC,*

*(ii) investment firms within the meaning of point 1 of Article 4(1) of Directive 2004/39/EC;*

*(b) subordinated claims and instruments referred to in Article 63 and Article 64(3) of Directive 2006/48/EC which IORPs hold in respect of the entities defined in point (a) of this paragraph in which they hold a participation.*

*A tiering system may improve a good level of protection for members and beneficiaries of IORPs if subordinated loans or any ancillary own funds are permitted.*

#### **Article 93**

No changes are proposed to articles 93-95 except for wording mentioned earlier.

#### **Characteristics and features used to classify own funds into tiers**

*1. Own-fund items shall be classified into three tiers. The classification of those items shall depend upon whether they are basic own fund or ancillary own-fund items and the extent to which they possess the following characteristics:*

*(a) the item is available, or can be called up on demand, to fully absorb losses on a going-concern basis, as well as in the case of winding-up (permanent availability);*

*(b) in the case of winding-up, the total amount of the item is available to absorb losses and the repayment of the item is refused to its holder until all other obligations, including obligations towards members and beneficiaries, have been met (subordination).*

*2. When assessing the extent to which own-fund items possess the characteristics set out in points (a) and (b) of paragraph 1, currently and in the future, due consideration shall be given to the duration of the item, in particular whether the item is dated or not. Where an own-fund item is dated, the relative duration of the item as compared to the duration of the obligations of the IORP shall be considered (sufficient duration).*

*In addition, the following features shall be considered:*

*(a) whether the item is free from requirements or incentives to redeem the nominal sum (absence of incentives to redeem);*

*(b) whether the item is free from mandatory fixed charges (absence of mandatory servicing costs);*

*(c) whether the item is clear of encumbrances (absence of encumbrances).*

#### **Article 94**

#### **Main criteria for the classification into tiers**

*1. Basic own-fund items shall be classified in Tier 1 where they substantially possess the characteristics set out in Article 93(1)(a) and (b), taking into consideration the features set out in Article 93(2).*

*2. Basic own-fund items shall be classified in Tier 2 where they substantially possess the characteristic set out in Article 93(1)(b), taking into consideration the features set out in Article 93(2).*

*Ancillary own-fund items shall be classified in Tier 2 where they substantially possess the characteristics set out in Article 93(1)(a) and (b), taking into consideration the features set out in Article 93(2).*

*3. Any basic and ancillary own-fund items which do not fall under paragraphs 1 and 2 shall be classified in Tier 3.*

#### Article 95

##### *Classification of own funds into tiers*

*Member States shall ensure that IORPs classify their own-fund items on the basis of the criteria laid down in Article 94.*

*For that purpose, IORPs shall refer to the list of own-fund items referred to in Article 97(1)(a), where applicable.*

*Where an own-fund item is not covered by that list, it shall be assessed and classified by IORPs, in accordance with the first paragraph. That classification shall be subject to approval by the supervisory authority.*

#### Article 96

*Specific insurance related items (3) are removed from article 96.*

##### *Classification of specific IORP own-fund items*

*Without prejudice to Article 95 and Article 97(1)(a) for the purposes of this Directive the following classifications shall be applied:*

*(1) surplus funds falling under Article 91(2) shall be classified in Tier 1;*

*(2) letters of credit and guarantees which are held in trust for the benefit of IORP creditors by an independent trustee and provided by credit institutions authorised in accordance with Directive 2006/48/EC shall be classified in Tier 2;*

*In accordance with the second subparagraph of Article 94(2), any future claims which mutual or mutual-type associations with variable contributions may have against their members by way of a call for supplementary contributions, within the following 12 months shall be classified in Tier 2 where they substantially possess the characteristics set out in Article 93(1)(a) and (b), taking into consideration the features set out in Article 93(2).*

#### Article 97

No changes are proposed to article 97.

#### *Implementing measures*

*1. The Commission shall adopt implementing measures laying down the following:*

*(a) a list of own-fund items, including those referred to in Article 96, deemed to fulfil the criteria, set out in Article 94, which contains for each own-fund item a precise description of the features which determined its classification;*

*(b) the methods to be used by supervisory authorities, when approving the assessment and classification of own-fund items which are not covered by the list referred to in point (a).*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

*2. The Commission shall regularly review and, where appropriate, update the list referred to in paragraph 1(a) in the light of market developments.*

#### *Article 98*

Eligibility and limits applicable to tiers have not been discussed and need to be considered in relation to options chosen for SCR and MCR.

#### *Eligibility and limits applicable to Tiers 1, 2 and 3*

*1. As far as the compliance with the Solvency Capital Requirement is concerned, the eligible amounts of Tier 2 and Tier 3 items shall be subject to quantitative limits. Those limits shall be such as to ensure that at least the following conditions are met:*

*(a) the proportion of Tier 1 items in the eligible own funds is higher than one third of the total amount of eligible own funds;*

*(b) the eligible amount of Tier 3 items is less than one third of the total amount of eligible own funds.*

*2. As far as compliance with the Minimum Capital Requirement is concerned, the amount of basic own-fund items eligible to cover the Minimum Capital Requirement which are classified in Tier 2 shall be subject to quantitative limits. Those limits shall be such as to ensure, as a minimum, that the proportion of Tier 1 items in the eligible basic own funds is higher than one half of the total amount of eligible basic own funds.*

*3. The eligible amount of own funds to cover the Solvency Capital Requirement set out in Article 100 shall be equal to the sum of the amount of Tier 1, the eligible amount of Tier 2 and the eligible amount of Tier 3.*

*4. The eligible amount of basic own funds to cover the Minimum Capital Requirement set out in Article 128 shall be equal to the sum of the amount of Tier 1 and the eligible amount of basic own-fund items classified in Tier 2.*

#### *Article 99*

No changes are proposed to article 99.

### *Implementing measures*

*The Commission shall adopt implementing measures laying down:*

*(a) the quantitative limits referred to in Article 98(1) and (2);*

*(b) the adjustments that should be made to reflect the lack of transferability of those own-fund items that can only be used to cover losses arising from a particular segment of liabilities or from particular risks (ring-fenced funds).*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

*The adequacy of using subordinated debt as own funds in the light of the borrowing restriction for IORPs contained in Article 18(2) of the IORP Directive;*

EIOPA is of the opinion that subordinated loans can serve as a security mechanism for all types of IORPs. The subordination feature offers unlimited loss absorption in case of winding-up, and can also offer loss absorption in problematic, but going concern situations. Subordinated loans should be subject to requirements on their issuance and redemption and to the permission of the supervisors.

EIOPA advises to integrate the requirements that the Solvency II Directive and its Implementing Measures (as written down in the October version) into the revised IORP Directive and the Implementing Measures to be connected to it.

Under Solvency II, the valuation of subordinated loans must take into account the time horizon of the loan and the interest payments agreed between the IORP and the creditor, but no adjustment should be made for the variations in the own credit standing of the institution. Further scrutiny is needed to see if there is a reason to value subordinated loans at nominal value under the revised IORP Directive.

As the OPC Report from 2008 explains, the relation between subordinated loans and the prohibition of borrowing is ambiguous. To resolve this ambiguity, the revision of the IORP Directive should make clear that subordinated loans are allowed, since they can provide additional security. This can be achieved either by explicitly amending the prohibition of borrowing that it does not include a prohibition of subordinated loans (please see CfA 7).

*The material elements of Articles 100-127 and 304 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the SCR*

### Confidence level

Taking into consideration the arguments laid down in paragraph 10.3.36., EIOPA believes it should not advise on the specific confidence level since it considers it to be a political issue.

With respect to the adoption of a uniform level of security across countries and different situations, two policy options have been considered:

**Option 1:** Harmonised confidence level

**Option 2:** Non-harmonised confidence level

EIOPA recognises that only option 1 is consistent with the requirement of the Commission to have a harmonized prudential confidence level.

Time horizon

As regards the time horizon issue for the determination of solvency capital requirements – which relates to 2<sup>nd</sup> paragraph of Article 101 (3) of the Solvency II Directive – EIOPA is of the view that the one-year time horizon should be used, as no superior alternative or analysis could be identified as to date.

Frequency of the calculation of the SCR

EIOPA considers two options with regard to the frequency of the calculation of the SCR:

**Option 1:** SCR assessed at least three-yearly

This option minimises the burden of annual reviews of the solvency position on IORPs and the consequent increase in administrative costs for sponsors to pay for the annual reviews, which may have a significant impact on smaller schemes.

**Option 2:** SCR assessed at least annually

An annual assessment constitutes the option that best safeguards the interests of members and beneficiaries.

Solvency capital requirement

Amend the IORP Directive by articles that stipulate the calculation of a risk-based solvency capital requirement for all types of IORPs. Separate articles would be necessary to take into account security and benefit adjustment mechanisms in the calculation of solvency capital requirements.

*The material elements of Article 128-131 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the MCR.*

Notwithstanding all possible sub-options concerning the coverage of the MCR and the frequency of calculation, EIOPA thinks that two options may be considered:

**Option 1:** No introduction of an MCR

**Option 2:** Introduction of an MCR with amendments to take into account the specificities of IORPs.

Apart from the necessary wording changes mentioned in the explanatory text, Articles 128 – 131 should be amended according to:

- The policy decisions made on the issues raised in the explanatory text (eligibility of ancillary own funds, level of the absolute minimum (if any), corridor with respect to the SCR (if any), frequency of calculation and transitional period)

- The potential need for replacement of numerical values (absolute minima, corridors, level of confidence, dates)
- The results of further investigation with respect to cross-consistency with other parts of the future prudential framework

EIOPA has no strong view on these issues for the time being, as more insight is needed on fundamental issues concerning the global prudential framework.

*The possibility to restate the value of assets in the IORP and liabilities of the sponsoring undertakings into a single balance sheet, including the possibility to recognise sponsor covenants and claims in pension protection schemes as an asset similar to reinsurance.*

**Option 1:** Include pension protection schemes in the solvency framework as a contingent asset in balance sheet and with effects in the calculation of capital requirements

This option entails amending the IORP Directive in order to allow the pension protection scheme as a security mechanism to the pension promises. It would appear as a contingent asset in the balance sheet and it would also have an influence in the calculation of capital requirements.

This option assumes pension protection schemes would be treated separately from other security mechanisms and its value and effect on capital requirements would be also calculated separately. It must also be made sure that pension protection schemes should only be considered if they contribute to the security of the pension promise in a reliable and effective way.

There should be provision for implementing measures concerning valuation and inclusion of these mechanisms when calculating capital requirements as well as the way of treating them as a (contingent) asset.

**Option 2:** Include pension protection schemes in the solvency framework through the credit risk of the sponsor used in the valuation of sponsor support

This option entails amending the IORP Directive in order to allow the pension protection scheme as a security mechanism to the pension promises as described in Option 1 but with the modification that the existence of a pension protection scheme should have an impact only on the credit risk of the sponsor used in the valuation of sponsor support as an asset to cover liabilities and in the calculation of capital requirements. The credit risk could be lowered more or less depending on the strength of the pension protection scheme.

**Option 4:** Do not include pension protection schemes in the solvency framework

*The treatment of operational risk where the investment risk is borne by the scheme member or beneficiary.*

EIOPA recognises that in situations where members or beneficiaries bear the investment risk, losses due to operational risk events could be relevant as they may

ultimately be borne by scheme members or beneficiaries. Therefore, the following policy options have been considered:

**Option 2:** Introduction of capital requirement for operational risk

This option suggests the introduction of a uniform capital requirement to specifically address the operational risk in the situations where the investment risk is borne by members and beneficiaries. However, depending on the legal nature of the IORP operational risk may be already covered by another entity and there would be no need to duplicate these requirements. At level 2 implementing measures the details of the capital requirement (such as the formula to determine it) would be identified.

**Option 3:** Introduction of a capital requirement for operational risk that could be reduced under specific circumstances

According to this option the capital requirement could be reduced in specific circumstances where there is other provision against operational risk.

The details of the capital requirement, the identification of those circumstances according to which the capital requirement could be reduced as well as the extent to which such factors could decrease the capital requirements would be determined the level 2 implementing measures.

*The material elements of Articles 136-142 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the recovery plan and, where necessary, the finance scheme; particular attention should be paid to (i) the length of the recovery period allowed and (ii) the need to maintain a specific wording for cross-border activity.*

Article 136

EIOPA is of the view that Article 136 regarding the identification and notification of deteriorating financial conditions is in principle suitable for IORPs. However, consideration has to be given in the implementing measures to when notification to supervisors needs to occur to ensure appropriate implementation for IORPs.

Article 137

EIOPA is of the view that Article 137 regarding the prohibition of the free disposal of assets in case of non-compliance with the rules on technical provisions can be included in a revised IORP Directive, but that the precise wording of the article could be reviewed to make them consistent with changes which may be made to the provisions for recovery plans for IORPs.

Article 138

The following are options for recovery plans for non-compliance with the capital requirements. The wording of the articles would have to be changed in the light of the option chosen.

**Option 1:** Retain IORP Directive

This option retains the current flexible position on recovery plans.

**Option 2:** Adopt the principles of the Solvency II Directive for all IORPs.

This option would require an IORP which has a shortfall of assets (including contingent assets as well as the assets in the IORP) as compared with the liabilities (including the solvency margin requirements as well as the technical provisions) to produce a plan to “correct” the position in the short term. If the principles were to be applied, adaptations would however have to be made regarding the length of the recovery period for IORPs

**Option 3:** A combination of Options 1 and 2

This option would require a short-term recovery plan to ensure that the assets in the IORP were at least at the level of the technical provisions, but with more flexibility in the timescale and nature of the recovery plan needed to meet the full financial requirements for the technical provisions and the solvency margin if the holistic balance sheet followed the Solvency II approach. As with option 2, the length of each the recovery period should be determined taking into account the nature of IORPs and characteristics of the institution and the national system it operates in.

Article 139

EIOPA is of the view that it seems necessary for the approach taken to Article 139 to follow that of Article 138 where an MCR is included. Taking into account the weaker financial position, the principle that the recovery to an MCR would have to take place in a shorter time frame than recovery to an SCR measure would equally apply to IORPs

Article 140

EIOPA is of the view that Article 140 regarding the ability to prohibit the free disposal of assets is appropriate for a revised IORP Directive. However, it is also appropriate to reconsider the action prohibited by this article to reflect the IORP practice, e.g. the application of restrictions to the pension contributions paid or payment of discretionary indexation.

Article 141

EIOPA is of the view that it seems appropriate to include Article 141 regarding the supervisory powers in deteriorating financial conditions, with suitable detailed amendment for IORPs to protect the members of IORPs, provided the measures taken are proportionate.

Article 142

EIOPA is of the view that Article 142 setting out what should be included in a recovery plan is appropriate. The specific items to be included in a recovery plan for an IORP should be changed from those in Article 142 to make them appropriate to IORPs. The specific details would depend on which approach is taken to technical provisions and any solvency margin

## **10.6. Annex: Benefit adjustment mechanisms**

### Background of the mechanism

- 10.6.1. In the OPC SSC report (Survey on fully funded, technical provisions and security mechanisms in the European occupational pension sector” from April 2008) the possibility of a reduction in pension rights is recognized as an important feature of a pension promise.
- 10.6.2. The reduction of accrued pension rights could potentially assist an IORP to recover from a situation of underfunding. Although this mechanism is ranked under “security mechanisms” it needs to be emphasized that it is of a different nature than the other security mechanisms since accrued rights are not secured, but reduced in order to “resolve” a situation of insolvency.
- 10.6.3. Some countries recognize circumstances in which accrued pension rights, including guaranteed indexation, can be reduced where an IORP is not fully funded and where the IORP will continue to exist. In other countries, a reduction of accrued rights is only possible, and might be inevitable, when the IORP is wound up and no further sponsor support is available.
- 10.6.4. No restrictions seem to exist on the maximum reduction level. The process that must be followed to allow reductions varies markedly across Europe as regards the parties involved (IORP, members, sponsor, unions, supervisor), the consent required, notification procedures and timelines.

### Reasoning of the mechanism

- 10.6.5. In the responses to the specific CfAs, the issue of benefit adjustment is referred to in various contexts, in particular when dealing with the calculation of technical provisions (CfA 5), and capital requirements (CfA 6). This annex attempts to describe benefit adjustment mechanisms in a more detailed way to allow for a better overall understanding of this issue and to function as a supporting material to the main text.
- 10.6.6. Several jurisdictions allow for the option of a future reduction of pension benefits as a way to “keep alive” a DB pension scheme in the event of (serious) underfunding. The reduction of benefits is an obvious alternative to an increase in contributions (that may not always be affordable) and is often an essential part of the recovery plan.
- 10.6.7. In some cases, the mechanism for the reduction is embedded in the by-laws of the IORP. In other instances, there is no precise mechanism defined on an ex-ante basis, and the adjustment of benefits is left to the negotiation between the social partners that takes place ex-post, if and when the underfunding has become evident. Sometimes both ex-ante and ex-post mechanisms are present. Moreover, in some cases a reduction can be applied only to benefits that are not yet in payment, in others also the benefits of retirees can be reduced.
- 10.6.8. A reduction of benefits is not really a security mechanism because if benefits are reduced then the members and beneficiaries will not get the benefits they were originally promised. Therefore this mechanism should not be called a security mechanism, but rather a benefit adjustment mechanism. This mechanism, inherently part of the “social contract” between the main stakeholders (i.e. members, beneficiaries, employers), defines a particular sort

of risk sharing between the stakeholders. The choice of which risk-sharing arrangements to allow is a typical aspect of the national Social and Labour Law that also defines the level of security accepted by the Member State. It is obvious that this mechanism of adjustment of pension benefits can have a material impact on the financial situation of the IORP. Therefore in principle this mechanism should be considered when calculating technical provisions and capital requirements. The following two cases can be distinguished.

#### Type 1 – Ex-post reduction of benefits (trigger event)

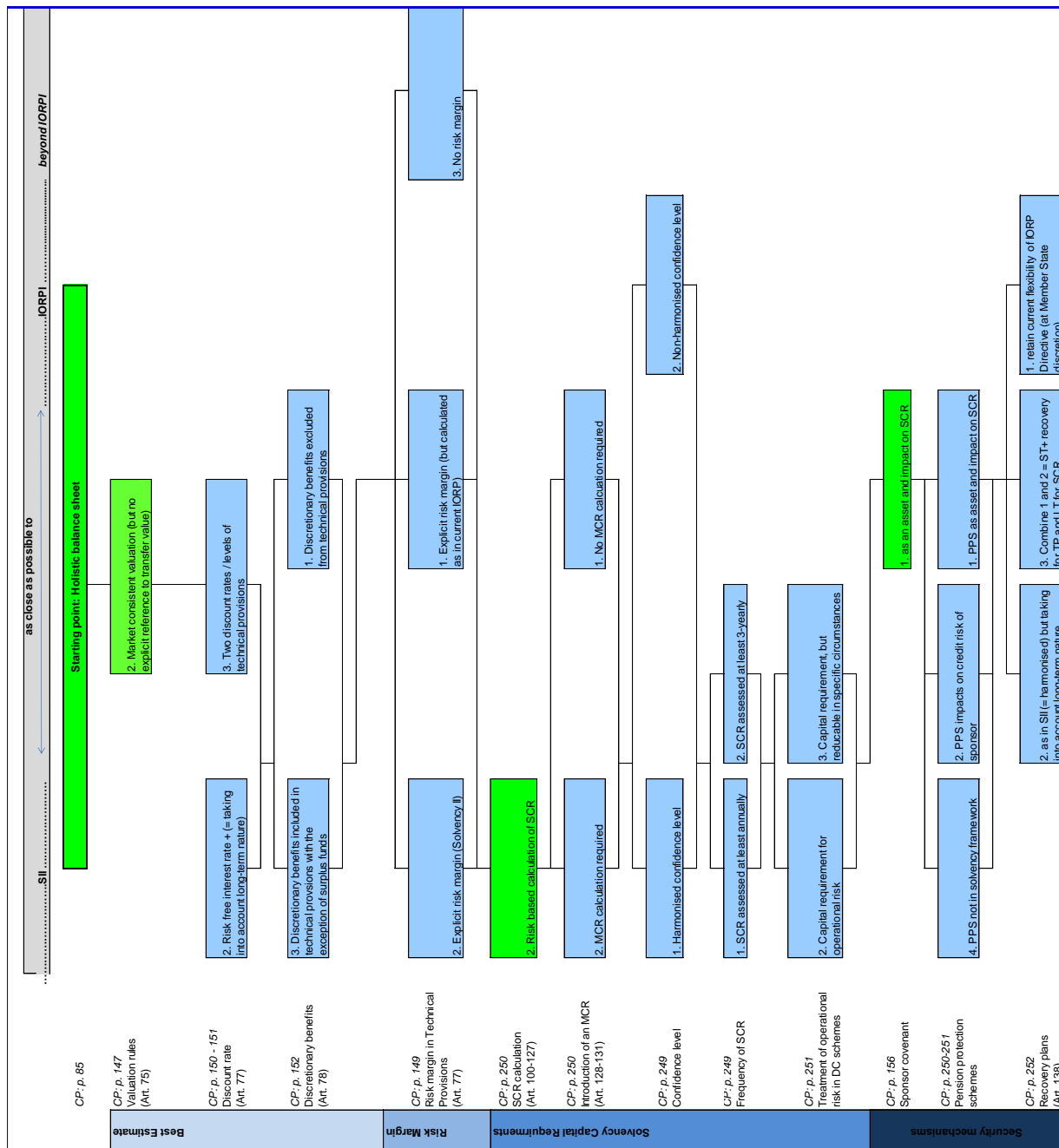
- 10.6.9. In extremely adverse scenarios, where all existing security mechanisms fail to protect benefits, there will inevitably be a reduction of benefits (because benefits cannot be paid if there is no money to pay them) and Member States may have legal provisions for a case like this in their pension law or elsewhere.
- 10.6.10. This type of reduction of benefits is triggered after all security mechanisms failed or were exhausted. The use of such a mechanism usually needs initiation and approval by the supervisory authority but there can also be situations where this initiation is not needed as the reduction may result from an agreement or contractual arrangement between the involved parties (which may be part of Member States' Social and Labour Law) that is made ex-post, after an underfunding occurred.
- 10.6.11. Conceptually, a mechanism of ex-post adjustment of pension benefits defines a particular sort of contingent risk-sharing between the main stakeholders (i.e. members, beneficiaries, employers).
- 10.6.12. Ex-post adjustment mechanisms of benefits in occupational pension schemes are usually dependent on the participation of members in the governance of the scheme: indeed, the mechanism may contain an element of solidarity, in which different cohorts of members may be asked to sacrifice some of their rights in a different measure, in order to keep the pension scheme alive. It is worth noting that this kind of mechanism is conceptually not conceivable in the case of insurance companies, where clients do not take part in the governance and the relationship between insurance companies and clients is that of a contract, with no ex-post solidarity mechanism.
- 10.6.13. There are views that the existence of a Type 1 adjustment mechanism should lead to a lower required security level in the calculation of capital requirements. Following the reasoning above, this different level of security is an aspect determined by the national Social and Labour Law. This implies that the level of confidence in the calculation of technical provisions should not be the same across all situations. For instance, if the solvency capital requirement is calibrated using a 99.5% confidence level over one year when no adjustment mechanism of pension benefits is in place, a lower level should be allowed when such a mechanism is indeed in place.
- 10.6.14. The idea is that this way members and beneficiaries would not get a wrong impression of the level of security provided as the solvency framework would become transparent and require a fair communication to IORP members of the final level of security of their pension provisions.

#### Type 2 – Ex-ante reduction of benefits (embedded in the by-laws or a contract)

- 10.6.15. A benefit adjustment mechanism can be based on a contract concluded beforehand, when the pension liability is transferred to or taken over by the IORP, and which includes an explicit mechanism in which circumstances and to which extent benefits will be adjusted. In this case, the use of the mechanism does not need initiation by the supervisory authority but results from the design of the contract.
- 10.6.16. If a benefit adjustment mechanism is based on a contract of that type (Type 2 benefit adjustment mechanism) the possibility to reduce benefits is agreed upon at the beginning of the contract and the nature of the promised benefits is therefore not unconditional but conditional.
- 10.6.17. Since this type of mechanism is described in the contract beforehand members and beneficiaries know about the existence and mode of operation of this mechanism and therefore - in particular from their view - the mechanism is part of the pension promise.
- 10.6.18. When calculating technical provisions and capital requirements benefits subject to a Type 2 benefit adjustment mechanism can be taken into account more easily than those based on a contract which does not include a benefit adjustment mechanism of that type.
- 10.6.19. Indeed, benefits that are subject to a Type 2 benefit adjustment mechanism are already considered in the framework of chapter 9 as the so called 'conditional benefits'.
- 10.6.20. Currently, in some Member States benefit adjustment mechanisms concluded beforehand are taken into account in an implicit way by allowing calculation bases with lower safety margins. If a high level of harmonization of technical provisions was considered a priority, this way of allowance would no longer be possible. Therefore other ways must be found to take benefit adjustment mechanisms of that kind into account appropriately. Not allowing this mechanism at all would risk undermining the voluntary provision of occupational retirement in countries with benefit adjustment mechanisms of Type 2.
- 10.6.21. In some Member States Type 2 benefit adjustment mechanisms are a relevant part of the existing pensions system and, therefore, they have to be fully recognized to treat the respective systems appropriately in a risk-based supervisory approach.
- 10.6.22. Type 2 benefit adjustment mechanisms could in principle either have a lowering impact on technical provisions or appear as a (contingent) asset on the balance sheet. Since the value of this asset or the impact on technical provisions changes in a stress situation there would also be an impact of such benefit adjustment mechanisms on the capital requirement.
- 10.6.23. The valuation of a benefit adjustment mechanism of that kind should follow the principles in the Solvency II Directive. When calculating technical provisions the mechanism should be allowed based on a probability-weighted approach. This means that it would not be allowed as a (contingent) asset.
- 10.6.24. With regard to the calculation of the SCR the mechanism should be allowed when measuring the effects of the different stress situations.

## 10.7. Annex: Flows of options in CfA 5 and 6

10.7.1. The flow chart below provides an overview of the options in EIOPA's advice in CfA 5 and 6. The options are bundled from being more consistent with the Solvency II Directive to being more in line with the current IORP Directive. Many of the options have to be further explored in EIOPA's quantitative impact study (QIS).



## 11. CfA 7: Investment rules

### 11.1. Extract from the call for advice

- 11.1.1. In this part of the call for advice the Commission has asked for a response on a number of aspects. For ease, these aspects are numbered e.g. 7.1, 7.2 etc. This numbering is EIOPA's, the Commission did not use it in its call for advice.

The Commission Services would like EIOPA to advise on detailed rules by which supervisors can ensure that IORPs have proper investment rules.

The EIOPA advice should address at least the following subjects:

7.1 The material elements of Article 132(2) of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to risk assessments;

7.2 The application of the quantitative restriction on investment in the sponsoring undertaking in Article 18(1)(f) of the IORP Directive when the IORP is sponsored by two or more undertakings;

7.3 The necessity from a prudential perspective to maintain Article 18(5) first and second sub-paragraphs of the IORP Directive enabling Member States to lay down more detailed investment rules;

7.4 The necessity from a prudential perspective to maintain Article 18(5)(b) of the IORP Directive enabling IORPs to invest up to 30% in foreign currencies;

7.5 The necessity from a prudential perspective to maintain Article 18(5)(c) of the IORP Directive enabling IORPs to invest in risk capital markets;

7.6 The necessity from a prudential perspective to maintain Article 18(6) of the IORP Directive enabling Member States to lay down more stringent investment rules on an individual basis;

7.7 The necessity from a prudential perspective to maintain Article 18(7) of the IORP Directive enabling, in the event of cross-border activity, the host Member States to require IORPs in the home Member State to comply with stricter investment rules as regards assets traded in regulated versus non-regulated markets, exposure to a single issuer or group and currency risk;

7.8 The adequacy of the investment rules in Article 18(5)(a) of the IORP Directive where the pension scheme members bear the investment risk. This should include advice on at least:

7.8.1 The material elements of Article 132(3) first to third subparagraphs of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to retirement products where the members bear the investment risk;

7.8.2 The involvement of the supervisory authorities where pension schemes provide for multi-funds (relative weights of different asset classes in the investment portfolio are decided by the scheme members rather than by the IORP itself), default options (where members in a multi-fund do not make a choice), or life-styling (the relative share of risky assets decreases over time). The supervisory involvement may for example comprise of verifying compliance with specific investment rules for assets such as quantitative restrictions for different investment options, the default fund and life-styling;

7.8.3 The usefulness from a supervisory perspective of a Value-at-Risk type upper limit on the entire portfolio below which the supervisor may require the pension fund to take action (e.g. sell the riskiest assets).

7.9 The necessity from a prudential perspective to introduce specific investment rules for pension schemes where the members and/or beneficiaries bear risks other than investment risk, in particular biometric risk and inflation risk;

7.10 Other requirements for IORPs, if any.

## **11.2. Background**

### **Current legal requirements (IORP Directive)**

11.2.1. The current IORP directive follows the prudent person plus approach meaning that the prudent person principle can be supplemented by more detailed provisions including quantitative restrictions based on a Member State's option.

11.2.2. The current Directive does not generally differentiate between investment rules for DB and DC schemes. Some of the specific calls for advice address both kinds of schemes whereas others explicitly refer to DC schemes only.

### **Article 18: Investment rules**

*1. Member States shall require institutions located in their territories to invest in accordance with the "prudent person" rule and in particular in accordance with the following rules:*

*(a) the assets shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries;*

*(b) the assets shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole.*

*Assets held to cover the technical provisions shall also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits;*

*(c) the assets shall be predominantly invested on regulated markets. Investment in assets which are not admitted to trading on a regulated financial market must in any event be kept to prudent levels;*

*(d) investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued on a prudent basis, taking into account the underlying asset, and included in the valuation of the institution's assets. The institution shall also avoid excessive risk exposure to a single counterparty and to other derivative operations;*

*(e) the assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and accumulations of risk in the portfolio as a whole.*

*Investments in assets issued by the same issuer or by issuers belonging to the same group shall not expose the institution to excessive risk concentration;*

*(f) investment in the sponsoring undertaking shall be no more than 5 % of the portfolio as a whole and, when the sponsoring undertaking belongs to a group, investment in the undertakings belonging to the same group as the sponsoring undertaking shall not be more than 10 % of the portfolio.*

*When the institution is sponsored by a number of undertakings, investment in these sponsoring undertakings shall be made prudently, taking into account the need for proper diversification.*

*Member States may decide not to apply the requirements referred to in points (e) and (f) to investment in government bonds.*

*2. The home Member State shall prohibit the institution from borrowing or acting as a guarantor on behalf of third parties. However, Member States may authorise institutions to carry out some borrowing only for liquidity purposes and on a temporary basis.*

*3. Member States shall not require institutions located in their territory to invest in particular categories of assets.*

*4. Without prejudice to Article 12, Member States shall not subject the investment decisions of an institution located in their territory or its investment manager to any kind of prior approval or systematic notification requirements.*

*5. In accordance with the provisions of paragraphs 1 to 4, Member States may, for the institutions located in their territories, lay down more detailed rules, including quantitative rules, provided they are prudentially justified, to reflect the total range of pension schemes operated by these institutions.*

*In particular, Member States may apply investment provisions similar to those of Directive 2002/83/EC.*

*However, Member States shall not prevent institutions from:*

*(a) investing up to 70 % of the assets covering the technical provisions or of the whole portfolio for schemes in which the members bear the investment risks in shares, negotiable securities treated as shares and corporate bonds admitted to trading on regulated markets and deciding on the relative weight of these securities in their investment portfolio. Provided it is prudentially justified, Member States may, however, apply a lower limit to institutions which provide retirement products with a long-term interest rate guarantee, bear the investment risk and themselves provide for the guarantee;*

*(b) investing up to 30 % of the assets covering technical provisions in assets denominated in currencies other than those in which the liabilities are expressed;*

*(c) investing in risk capital markets.*

*6. Paragraph 5 shall not preclude the right for Member States to require the application to institutions located in their territory of more stringent investment rules*

*also on an individual basis provided they are prudentially justified, in particular in the light of the liabilities entered into by the institution.*

*7. In the event of cross-border activity as referred in Article 20, the competent authorities of each host Member State may require that the rules set out in the second subparagraph apply to the institution in the home Member State. In such case, these rules shall apply only to the part of the assets of the institution that corresponds to the activities carried out in the particular host Member State. Furthermore, they shall only be applied if the same or stricter rules also apply to institutions located in the host Member State.*

*The rules referred to in the first subparagraph are as follows:*

*(a) the institution shall not invest more than 30 % of these assets in shares, other securities treated as shares and debt securities which are not admitted to trading on a regulated market, or the institution shall invest at least 70 % of these assets in shares, other securities treated as shares, and debt securities which are admitted to trading on a regulated market;*

*(b) the institution shall invest no more than 5 % of these assets in shares and other securities treated as shares, bonds, debt securities and other money and capital-market instruments issued by the same undertaking and no more than 10 % of these assets in shares and other securities treated as shares, bonds, debt securities and other money and capital market instruments issued by undertakings belonging to a single group;*

*(c) the institution shall not invest more than 30 % of these assets in assets denominated in currencies other than those in which the liabilities are expressed.*

*To comply with these requirements, the home Member State may require ring-fencing of the assets.*

### **International standards (OECD/IOPS, etc...)**

11.2.3. Within the "OECD Recommendation on Core Principles of Occupational Pension Regulation" core principle 4 deals with asset management. It stresses the prudent person principle, but also allows for quantitative regulations. It recommends a limit for investments in sponsor undertakings.

11.2.4. The "Survey of investment regulation of pension funds" issued by the OECD in February 2010 reveals the great variety of approaches chosen in different countries stretching from the prudent person principle in pure form to all kinds of additional quantitative restrictions for asset classes.

### **Solvency II Directive**

11.2.5. Article 132 of the Solvency II Directive contains regulations for asset management based on the prudent person principle without the possibility of Member States imposing further quantitative restrictions.

11.2.6. Most of the principles enclosed in Article 132 apply to both situations where the risks are borne by the insurance company and those where the risks are

borne by the policy holders. In addition some principles only apply to the latter situations.

### **Article 132: Prudent person principle**

*1. Member States shall ensure that insurance and reinsurance undertakings invest all their assets in accordance with the prudent person principle, as specified in paragraphs 2, 3 and 4.*

*2. With respect to the whole portfolio of assets, insurance and reinsurance undertakings shall only invest in assets and instruments whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs in accordance with point (a) of the second subparagraph of Article 45(1).*

*All assets, in particular those covering the Minimum Capital Requirement and the Solvency Capital Requirement, shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole. In addition the localisation of those assets shall be such as to ensure their availability.*

*Assets held to cover the technical provisions shall also be invested in a manner appropriate to the nature and duration of the insurance and reinsurance liabilities. Those assets shall be invested in the best interest of all policy holders and beneficiaries taking into account any disclosed policy objective.*

*In the case of a conflict of interest, insurance undertakings, or the entity which manages their asset portfolio, shall ensure that the investment is made in the best interest of policy holders and beneficiaries.*

*3. Without prejudice to paragraph 2, with respect to assets held in respect of life insurance contracts where the investment risk is borne by the policy holders, the second, third and fourth subparagraphs of this paragraph shall apply.*

*Where the benefits provided by a contract are directly linked to the value of units in an UCITS as defined in Directive 85/611/EEC, or to the value of assets contained in an internal fund held by the insurance undertakings, usually divided into units, the technical provisions in respect of those benefits must be represented as closely as possible by those units or, in the case where units are not established, by those assets.*

*Where the benefits provided by a contract are directly linked to a share index or some other reference value other than those referred to in the second subparagraph, the technical provisions in respect of those benefits must be represented as closely as possible either by the units deemed to represent the reference value or, in the case where units are not established, by assets of appropriate security and marketability which correspond as closely as possible with those on which the particular reference value is based.*

*Where the benefits referred to in the second and third subparagraphs include a guarantee of investment performance or some other guaranteed benefit, the assets held to cover the corresponding additional technical provisions shall be subject to paragraph 4.*

*4. Without prejudice to paragraph 2, with respect to assets other than those covered by paragraph 3, the second to fifth subparagraphs of this paragraph shall apply.*

*The use of derivative instruments shall be possible insofar as they contribute to a reduction of risks or facilitate efficient portfolio management.*

*Investment and assets which are not admitted to trading on a regulated financial market shall be kept to prudent levels.*

*Assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings, or geographical area and excessive accumulation of risk in the portfolio as a whole.*

*Investments in assets issued by the same issuer, or by issuers belonging to the same group, shall not expose the insurance undertakings to excessive risk concentration.*

## **OPC reports**

11.2.7. According to the OPC report "Initial review of key aspects of the implementation of the IORP directive" from March 2008 there is a great variety of approaches chosen by Member States as regards investment regulation. Some Member States follow the pure prudent person principle whereas others impose further rules including quantitative restrictions.

11.2.8. The report came to the conclusion that, despite the divergence between investment rules, these seem not to be an obstacle for the convergence process towards a Common Market and cross-border activities of IORPs. However, it is a matter of fact that very few (about 80) schemes do operate cross-border.

### 11.3. Explanatory text

#### 7.1 Specific Call for Advice

The material elements of Article 132(2) of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to risk assessments;

#### EIOPA view on issues in the CfA

- 11.3.1. The prudent person principle is already the key rule in the current IORP Directive. Most aspects of Article 132(2) of the Solvency II Directive are also already covered by Article 18(1a, 1b and 1c) of the current IORP Directive.

#### *Understanding and control of the investment risks*

- 11.3.2. The first sub-paragraph of Article 132(2) of Solvency II states that “insurance and reinsurance undertakings shall only invest in assets and instruments whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs...”. Such a requirement is not specified within the current IORP Directive although, appropriately qualified, it could be seen as being implicitly part of the prudent person rule. Therefore, a first policy option that can be considered is not to introduce any change to the current IORP directive.
- 11.3.3. Nevertheless, EIOPA believes that the principle carried in the text of Article 132 (2) of SII (to ensure knowledge and understanding of the assets in which to invest) is a valid one to be made explicit also for IORPs. This applies both for DB and (possibly more importantly) for DC schemes. A second option is to introduce into the IORP Directive text consistent with that of Article 132 (2) of SII.
- 11.3.4. However, there are different views about whether to introduce the principle without adjustments or whether, especially where DC schemes are concerned, some adjustment should be made in order to take into account the specificities of pensions. In a number of member states, the governing body of the IORP may not be wholly or partly professional and, in some jurisdictions, it is a requirement to include member representatives on this body. Furthermore, in some member states the IORP is obliged to outsource the investment function. It is therefore necessary to consider whether the provisions of Article 132(2) of Solvency II allow appropriately for this situation.
- 11.3.5. One view therefore is that the IORP itself (and its directors/trustees) should not necessarily be expected to possess internally or directly all the expertise needed to “properly identify, measure, monitor, manage, control and report” all the risks connected to the investment in each and every asset their portfolio is invested in and to the way these assets interact (as it is implied by the reference to “the whole portfolio of assets” contained in art. 132.2); indeed, such a requirement would be in contradiction with the very reason to

outsource investment (lack of internal expertise) and, as an unintended consequence, could limit the efficiency of asset management.

- 11.3.6. Moreover, especially when the members of pension schemes bear the investment risk, there is a concern that, were the text of art.132(2) incorporated without adjustment, directors/trustees might be vulnerable to litigation from members and/or stakeholders. This might arise were they held responsible for outsourced investment decisions which they themselves were not competent to make. In this view, such a risk of litigation could be an important disincentive for the provision of supplementary pensions.
- 11.3.7. A further option therefore is to modify the text of Article 132 (2) of SII to distinguish between the overarching responsibility of the IORP for the oversight and supervision of the investment process and the detailed investment management.

#### *Investment risks and solvency needs*

- 11.3.8. We now turn to the final part of the first paragraph of Article 132 (2), where a reference is made to the "solvency needs". This reference is of major importance for DB schemes (and other pension schemes where the IORP or the sponsor undertaking bears the investment risk) where there is an interplay between technical provisions, solvency requirements and the assets. The risks arising out of the assets determine the probability of future coverage of technical provisions and are a dominant factor in the calculation of the solvency requirements based on a risk-based approach.
- 11.3.9. From a DB perspective, EIOPA's view is that the provision in the final part of Article 132(2) first sub-paragraph should also be included in the IORP Directive. However, in order to clarify that this part is not relevant for DC schemes, a "where relevant" clause may be useful.

#### *Localisation of the assets*

- 11.3.10. An additional aspect to consider is that article 132(2) sub-paragraph 2 of SII contains the sentence "In addition the localization of those assets shall be such as to ensure their availability." The current IORP Directive does not contain a provision on the localization.
- 11.3.11. EIOPA's view is that the provision in Article 132(2) sub-paragraph 2 of the Solvency II Directive should be included in the IORP Directive as the availability of assets is as important for an IORP as it is for an insurance undertaking.

#### *Statement of Investment Policy Principles*

- 11.3.12. Finally, it is worth noting that the CfA does not mention the provision of Article 12 of the IORP Directive (Statement of Investment Policy Principles). In the revised IORP Directive, the link between this document and the governance over the overall investment process should be made clear; in addition, care should be taken that the requirement of art. 12 of the current directive does not overlap and duplicate, as regards investments, requirements for written documentation of the risk management system.

## Policy options

Option 1: Leave the IORP directive unchanged

Option 2: Change Article 18 of the IORP Directive in strict accordance with Article 132(2) of the Solvency II Directive by:

- inserting the sentence *"With respect to the whole portfolio of assets, IORPs shall only invest in assets and instruments whose risks the institution concerned can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs in accordance with ..."*;
- adding the sentence in Article 132(2) sub-paragraph 2 of the Solvency II Directive: *"In addition the localisation of those assets shall be such as to ensure their availability."*

It should be noted that the proposed changes contained in this option could entail other changes (e.g. Article 133 and 134 of the Solvency II Directive).

Option 3: Recognize the practical relevance of outsourcing of investment functions in the case of IORPs, mentioning explicitly this possibility, while adding to the current IORP directive the content of the first paragraph of 132(2) of Solvency II directive. This is consistent with the advice provided with respect to CfA 20, in which EIOPA recommends to confirm the principle contained in art 9.4 of the current IORP Directive that (the management of an IORP can be outsourced in whole or in part); however, given the importance and complexity of the investment functions, in addition to the requirements made in general for outsourcing, EIOPA recommends to specify that the IORP itself should be expected to maintain responsibility over the control of the investment process as a whole.

In addition, in the second part of the paragraph "where applicable" is proposed, to take account of DC schemes.

A possible text is as follows:

*"The IORP is responsible for the supervision and control of the investment process. It may outsource some or all of the investment functions, but it will still keep full responsibility for all its aspects and its general consistency."*

*"The IORP shall ensure that its portfolio is invested only in assets and instruments whose risks it, directly or through outsourced functions, can properly identify, measure, monitor, manage, control and report, and, where applicable, appropriately take into account in the assessment of its overall solvency needs in accordance with...."*

In addition, as for the proposed option 2, option 3 would include adding the sentence in Article 132(2) sub-paragraph 2 of the Solvency II Directive: *"In addition, the localisation of those assets shall be such as to ensure their availability."*

The difference between options 2 and 3 is in defining the extent to which the IORP itself is expected to be knowledgeable about the details of investment process. In either case, as set out in CfA20, IORPs remains fully responsible for the function, as well as the process, when they outsource to third parties.

## Positive impacts

### Option 1: no impact

Option 2: The establishment of this robust requirement would reduce the need for additional restrictions on investments imposed by member states. Following this option it would be made clear that IORPs have to be aware of the risks arising out of their assets in the same way as insurance undertakings. The lack of a provision on the localization of assets would be filled.

Option 3: Same as option 2, but taking into account that IORPs are often managed and organised (members' representation, outsourcing) in a different way than insurance companies, while retaining emphasis on the responsibility of the IORP to oversee the entire investment process. The lack of a provision in the current Directive for the localisation of assets would be filled. The clarification in the text would avoid the legal risk caused by a too narrow interpretation that could hamper an effective outsourcing of the asset management.

## Negative impacts

### Option 1: no impact

Option 2: Especially when members bear the investment risk, there is some ambiguity on the level of investment expertise directly required by IORPs and/or its directors/trustees. This ambiguity might reduce the efficiency of the IORPs' investment process and/or give rise to litigation by members and stakeholders. In addition, the lack of adjustment to the specificities of IORPs could make the legislation less acceptable to IORP stakeholders.

Option 3: IORP/Directors/Trustees may feel tempted to relieve themselves of the requirement to "properly identify, measure, monitor, manage, control and report" all the risks connected to the investments even knowing they always bear the ultimate responsibility.

## **7.2 Specific Call for Advice**

The application of the quantitative restriction on investment in the sponsoring undertaking in Article 18(1)(f) of the IORP Directive when the IORP is sponsored by two or more undertakings;

## **EIOPA view on issues in the CfA**

11.3.13. The current quantitative restriction limits the investment exposure of the IORP to the sponsor or to the group to respectively 5% and 10%. The reason behind this rule is to mitigate conflicts of interest and minimize the correlation between the human capital and financial capital. By implementing these quantitative restrictions, the impact of a default of a sponsor on the pension scheme is minimized to its current exposure (5% for sponsors and 10% for the group). There is consensus within EIOPA that this restriction should be maintained and not be reduced.

- 11.3.14. EIOPA distinguishes between investment exposure to the sponsor, discussed here, and the support provided for DB IORPs by the sponsor covenant, including recovery plans and future contributions, which is considered in 7.10 below.
- 11.3.15. For IORPs that are sponsored by two or more undertakings, a mechanical interpretation of this rule could lead to an excessive exposure towards the sponsors of the IORP. Indeed, one IORP could have 20 different sponsors from different groups. If the scheme invests 5% of its assets per sponsor, this would mean that the member is exposed at 100% to a default of the sponsors of the pension scheme.
- 11.3.16. The second paragraph of 18(1)(f) already states the principle that IORPs should be prevented from concentrating a material part of their investments in the sponsoring undertakings. This should be sufficient to avoid the mechanical interpretation mentioned above to occur.
- 11.3.17. In principle, specific quantitative rules could be introduced for the case of more than one sponsor. However, EIOPA's view is that for the sake of simplicity it is appropriate to stick to the current text that defines a specific limit only for the one-sponsor case and is principles-based when there is more than one sponsor.

## **Investment rules**

### **7.3 Specific Call for Advice**

The necessity from a prudential perspective to maintain Article 18(5) first and second sub-paragraphs of the IORP Directive enabling Member States to lay down more detailed investment rules;

## **EIOPA view on issues in the CfA**

- 11.3.18. When discussing investment rules it is important to distinguish between pension schemes where the investment risk is borne by IORPs and where the investment risk is borne by members, since different risk mitigation mechanisms may be thought to be appropriate. Therefore the subsequent advice on investment rules distinguishes between these types of schemes.
- 11.3.19. Several Member States have some quantitative investment limits especially for risky assets such as equities, derivatives, alternatives, etc. These restrictions are meant to complement the prudent person rule in order to make sure that the IORPs limit their exposure to riskier assets and appropriately diversify their investments. They, according to the reports, do not hinder the functioning of the Common Market and cross-border activities of IORPs (page 12 of the OPC Report on the Initial review of key aspects of the implementation of the IORP directive, 31/03/08).
- 11.3.20. For DB IORPs, there is a link between the solvency requirements and the use of the Member States option. The perceived need for additional Member State restrictions may be a result of the lack of a risk-based solvency approach under the current IORP Directive.

- 11.3.21. The Solvency II Directive does not allow Member States to impose further quantitative rules other than where the policyholder bears the risks (Article 133(3)) which in IORP terms relates to pure DC schemes and some hybrids. The capital requirements under Solvency II (SCR) reflect the risks of the different categories of assets by imposing a solvency requirement in the form of a percentage of the fair value of the asset.
- 11.3.22. Assuming that a revised IORP Directive would follow a risk-based approach for solvency requirements (in general applicable to DB but not to DC schemes) one could question the need for a Member State option for further quantitative rules. EIOPA recognises the link between the introduction of risk-based solvency requirements and the fact that there is no need any more for (further) quantitative investment restrictions. Therefore the provision in Article 18(5) can be deleted for DB IORPs on the assumption that a risk-based solvency approach is to be introduced for DB schemes.
- 11.3.23. On the other hand, IORPs where investment risks are borne by pension scheme members are not subject to a solvency regime and their risks are not reflected in capital requirements but instead borne by the members. In this case the objective of quantitative investment rules cannot be replaced by adequate solvency requirements.
- 11.3.24. In some jurisdictions, it is common in pure DC and hybrid schemes that the investment choice is either made by the member or already stipulated in the conditions of the pension scheme (e.g. by a default option). One view is that in these cases the possibility to impose further restrictions should not apply. An alternative view is that for DC pension schemes the option for Member States to introduce quantitative restrictions should be kept in the Directive as in the UCITS IV directive (art. 50-57) since these IORPs are operating in manner that is closer to UCITS than to insurance undertakings.
- 11.3.25. The suggested option for DC schemes should also be available in the case of hybrid pension schemes in which a significant part of the investment risk is borne by the beneficiaries. In such a case, supervisors need to have appropriate power and resources to control the investment policy and risk management of an IORP in order to protect the interest of beneficiaries. This becomes even more relevant as supervisory regimes of hybrid pension plans may not contain a full risk-based solvency approach. Therefore, the possibility to introduce quantitative restrictions (in line with DC schemes) might be an important part of these powers.
- 11.3.26. One further possibility is for any quantitative restrictions thought to be necessary to be agreed at EU level. That would make it easier for IORPs to operate cross border as there would be only one set of investment rules to comply with. So instead of a starting point of restriction subject to some parameters e.g. allowing up to 30% investment in foreign currencies, the starting point would be no quantitative restriction with limitations to that being agreed at EU level, whether in terms of areas of restriction or more precise definitions.

## **Policy options**

Option 1: Leave the IORP directive unchanged

Option 2: Delete Article 18(5) first and second sub-paragraphs of the IORP Directive for all IORPs (which would make CfA 7.4, 7.5 and 7.7 irrelevant)

Option 3: Leave Article 18(5) only to cases when members bear the investment risk, adjusting the restrictions on the limits that home MS may impose;

Option 4: Delete Article 18(5) but permit restrictions to investment to be agreed at EU level where the member bears the investment risk for the purposes of member protection.

## Comparison of policy options

11.3.27. EIOPA proposes option 3 as it believes that there should be no further need for further investment rules for DB IORPs, but this option retains the option of restrictions to protect members who bear the investment risk.

11.3.28. The second sub-paragraph of Article 18.5 should be removed. There is a view that a useful reference for the MS is that of the investment rules laid down in the UCITS Directive.

11.3.29. The third sub-paragraph of Art.18.5 carries restrictions to the power of the home MS to impose additional investment limits. Limits of this kind should be reviewed according to the discussion below of specific CfA 7.4, 7.5 and 7.8, and consistently with the possible revision of Art. 18.7 of the IORP Directive, that imposes restrictions to the power of the host MS to impose investment limits to host IORPs (see below discussion of specific CfA 7.7).

### Investment rules

#### 7.4 Specific Call for Advice

The necessity from a prudential perspective to maintain Article 18(5)(b) of the IORP Directive enabling IORPs to invest up to 30% in **foreign currencies**;

### EIOPA view on issues in the CfA

11.3.30. The goal of this article is to place a ceiling on the extent to which member states can put limitations on foreign currency exposure. Limits are indeed possible, but IORPs have to be allowed to invest in any case at least 30% of their portfolio in assets denominated in a foreign currency. The goal here is to allow a minimum diversification of the IORPs' portfolio in foreign currencies.

11.3.31. It should be noted that the calculation of the actual percentage of assets in foreign currencies should in principle be include any currency hedging in the calculation. In addition, IORPs may invest in certain UCITs that invest in different currencies but their Net Asset Value is calculated in Euro; in such circumstances, it may be necessary to define the concept of currency risk more precisely. Similar issues regarding the "true" currency exposure arise not only with hedging and with investment through UCITs, but also with other financial instruments (stocks and bonds included).

- 11.3.32. The Solvency II Directive does not contain a provision similar to the one in Article 18(5)(b). The risk arising out of a currency mismatch forms part of the solvency requirement. If the revised IORP Directive is to follow the prudent person principle without allowing further quantitative restrictions based on a Member States' option, the provision in Article 18(5)(b) would be redundant.
- 11.3.33. EIOPA agrees that Article 18(5)(b) would be redundant if the option to impose further quantitative restrictions was to be deleted. If not deleted, one position is that by maintaining the provision a minimum level of harmonisation would be achieved; alternatively, it can be argued that the limitation on foreign currency exposure is ineffective as foreign currency exposures are no clear measure of the true foreign exposure of a IORP.
- 11.3.34. Consistently with its view of item 7.3 above, EIOPA distinguishes between IORPs where the member bears the investment risk and other IORPs.
- 11.3.35. If Article 18(5)(b) is to be maintained for pure DC and hybrid plans then there is a need to clarify the current article stating that currency hedging should be taken into account in order to assess the actual exposure.

### **Policy options**

Option 1: Leave the IORP directive unchanged

Option 2: Delete Article 18(5)(b)

Option 3: Maintain Article 18(5)(b) for IORPs where members bear the investment risk, with implementing measures clarifying that currency hedging should be taken into account in order to assess the actual exposure;

### **Comparison of policy options**

- 11.3.36. EIOPA proposes option 3 as it believes that there should be no further need for restrictions for DB IORPs, but this option retains the option of restrictions to protect members who bear the investment risk, recognising that the current wording does not fully recognise all currency risks.

#### **Investment rules**

##### **7.5 Specific Call for Advice**

The necessity from a prudential perspective to maintain Article 18(5)(c) of the IORP Directive enabling IORPs to invest in **risk capital markets**;

### **EIOPA view on issues in the CfA**

- 11.3.37. The goal of this provision is to limit the opportunities for Member States to lay down more detailed investment rules, including quantitative limits.

One could question the value of Article 18(5)(c) for several reasons:

- The first difficulty regarding this article is the implied definition of risk capital markets (see also “Definition of risk capital market”, discussion paper for OPC meeting 25/26 November 2008).
- It should be acknowledged among Member States that IORPs as being long-term investors should not be prohibited completely to invest in risk capital market.

11.3.38. If the revised IORP Directive would follow the prudent person principle without allowing further quantitative restrictions based on a Member State option the provision in Article 18(5)(c) would be redundant.

11.3.39. EIOPA supports the deletion of Article 18(5)(c) in its current form for its limited meaning.

### **Policy options**

Option 1: Leave the IORP directive unchanged

Option 2: Delete Article 18(5)(c).

### **Comparison of policy options**

11.3.40. EIOPA believes that this provision should be dropped, especially as there is no common agreement on its interpretation.

### **Investment rules**

#### **7.6 Specific Call for Advice**

The necessity from a prudential perspective to maintain Article 18(6) of the IORP Directive enabling Member States to lay down more stringent investment rules on an **individual basis**;

### **EIOPA view on issues in the CfA**

11.3.41. EIOPA’s view is of Article 18(6) of the IORP Directive is that it allows Member States to provide supervisors with the powers to intervene in individual IORPs where prudentially justified. If this article is to be maintained, some clarification may be necessary.

11.3.42. From a DC perspective, it is quite clear that more stringent investment rules and limits may be set at the level of individual schemes (and especially of specific investment options) by the IORP itself, consistently with its risk-appetite and the commitments it is willing to take with its members (see also the discussion of Article 18(5)(a)). However, it is unclear whether it is appropriate that these rules may be set by the regulator. For instance, a need for this may arise in the case of default options, or in the case only one option is offered to members .

11.3.43. From a DB perspective it is necessary that a Member State has the right to lay down more stringent investment rules on an individual basis. This is true both in the case of the prudent person principle and when a Member State

has made use of the option in Article 18(5) first sub-paragraph to impose further quantitative restrictions to all IORPs. In either case situations are conceivable in which for instance the asset allocation or the risks arising out of the investments are incompatible with the available own funds or the interests of the members and beneficiaries. In these cases the competent authority must have the right (and the obligation) to intervene on an individual basis.

11.3.44. The question is whether a special provision is necessary that allows an intervention on an individual basis. Indeed, according to Article 14 of the IORP Directive the competent authorities shall have the power to take “any measures, where appropriate, those of an administrative or financial nature ... to prevent or remedy any irregularities prejudicial to the interests of the members and beneficiaries.” It could be argued that imposing more stringent investment rules on an individual basis is covered by Article 14. That would mean that the special provision in Article 18(6) could be deleted.

### Policy options

Option 1: Leave the IORP Directive unchanged, but modified to make it clear that the objective of the provision is to allow the supervisor to have appropriate powers of intervention.

Option 2: Delete Article 18(6) (and amend Article 14 if necessary).

### Comparison of policy options

11.3.45. EIOPA supports the retention of this provision in the Directive.

#### Investment rules

##### 7.7 Specific Call for Advice

The necessity from a prudential perspective to maintain Article 18(7) of the IORP Directive enabling, in the event of **cross-border activity**, the host Member States to require IORPs in the home Member State to comply with stricter investment rules as regards assets traded in regulated versus non-regulated markets, exposure to a single issuer or group and currency risk;

#### EIOPA view on issues in the CfA

11.3.46. Article 18(7) allows host Member States to apply some investment rules to the IORP assets that correspond to the activities in the host Member State, with certain ceilings aimed at ensuring that these domestically imposed rules do not limit too much the freedom to invest and the prudent person rule as defined by Articles 18 (1)-18(6) of the IORP Directive. The CfA asks whether this power is grounded on a prudential perspective.

11.3.47. One position is that the prudent person rule as defined at EU level by the IORP directive is too weak and, on a truly prudential basis, has to be complemented by some quantitative rules. Alternatively, the home country competence implies that, for any specific IORP, investment rules should be

the same across Europe, in order to avoid inefficiencies in investment, due to different rules for home and for cross-border activity.

11.3.48. An additional possibility that may be considered is a review of the specific limits stipulated by the current text of Article 18(7). If the provisions of Article 18(7) is kept in the Directive it would be highly advisable to improve the wording of the current article to clarify the scope of these rules because the respective article has been subject to different interpretations before.

11.3.49. If the revised IORP Directive would follow the prudent person principle approach without allowing the Member States to lay down more stringent investment rules including quantitative limits then Article 18(7) could be deleted. Such a change would be against the background of the higher standards recommended in the advice in the governance of IORPs in areas such as risk management.

## Policy options

Option 1: Leave the IORP directive unchanged

Option 2: Delete 18(7). This removes the host state ability to restrict investment and relies on the prudent person rule plus the safeguards on investment in the existing directive plus the move to Solvency II standards for risk management and other governance requirements.

## Comparison of policy options

EIOPA considers that the retention of Article 18(7) of the IORP Directive should be assessed together with the changes to article 18(5), first sub-paragraph. Indeed, the admissible additional rules that the home MS on the one hand, and the host MS on the other, are allowed to impose, should be consistent. Anyway, EIOPA believes that the possibility for the host MS to impose limits to host IORPs should not be extended with respect to the current IORP Directive.

### Investment rules

#### 7.8 Specific Call for Advice

The adequacy of the investment rules in Article 18(5)(a) of the IORP Directive where the pension scheme members bear the **investment risk**. This should include advice on at least:

- The material elements of Article 132(3) first to third subparagraphs of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to retirement products where the members bear the investment risk;
- The involvement of the supervisory authorities where pension schemes provide for multi-funds (relative weights of different asset classes in the investment portfolio are decided by the scheme members rather than by the IORP itself),

default options (where members in a multi-fund do not make a choice), of life-styling (the relative share of risky assets decreases over time). The supervisory involvement may for example comprise of verifying compliance with specific investment rules for assets such as quantitative restrictions for different investment options, the default fund and life-styling;

- The usefulness from a supervisory perspective of a Value-at-Risk type upper limit on the entire portfolio below which the supervisor may require the pension fund to take action (e.g. sell the riskiest assets).

### **EIOPA view on Article 18(5)(a)**

11.3.50. The Call for Advice asks whether Article 18.5(a) of the IORP Directive is appropriate when pension scheme members bear the investment risk. In IORPs where members bear the risk and have a number of investment choices these usually include low-risk investment options including allocations lower than those listed in Article 18.5(a). However, there may be cases where it is the national regulation that imposes, for low-risk options, limits that are not in line with Article 18.5(a).

11.3.51. EIOPA believes that, when members bear the investment risk, the regulation should not discourage IORPs from offering different investment options, including a low-risk option (and possibly a default option – see below). These options may be defined by bands within which the investment in certain securities has to be kept.

11.3.52. The second part of Article 18.5(a) concerns schemes offering interest rate guarantees and carrying the risk that these guarantees imply: therefore, schemes that fall under the DB category. According to the reasoning used in the previous specific CfA of this chapter, if the new solvency regime is adopted, additional investment limits should not be allowed for this kind of schemes. EIOPA supports the retention of 18(5)(a) in cases where members bear the investment risk, but not to restrict the ability of Member States to impose, appropriate limits where low risk or default funds are required, and also where the member does not have an investment choice.

## **SECTION 7: Investment rules**

### **7.8.1 Specific Call for Advice**

The material elements of Article 132(3) first to third subparagraphs of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to retirement products where the members bear the investment risk;

### **Article 132(3) of the SII Directive**

*3. Without prejudice to paragraph 2, with respect to assets held in respect of life insurance contracts where the investment risk is borne by the policy holders, the second, third and fourth subparagraphs of this paragraph shall apply.*

*Where the benefits provided by a contract are directly linked to the value of units in an UCITS as defined in Directive 85/611/EEC, or to the value of assets contained in an internal fund held by the insurance undertakings, usually divided into units, the technical provisions in respect of those benefits must be represented as closely as possible by those units or, in the case where units are not established, by those assets.*

*Where the benefits provided by a contract are directly linked to a share index or some other reference value other than those referred to in the second subparagraph, the technical provisions in respect of those benefits must be represented as closely as possible either by the units deemed to represent the reference value or, in the case where units are not established, by assets of appropriate security and marketability which correspond as closely as possible with those on which the particular reference value is based.*

*Where the benefits referred to in the second and third subparagraphs include a guarantee of investment performance or some other guaranteed benefit, the assets held to cover the corresponding additional technical provisions shall be subject to paragraph 4.*

## **EIOPA view**

- 11.3.53. The first to third subparagraphs of Article 132(3) of the SII Directive state, for unit-linked or index-linked life insurance contracts (where the risk is borne by members), the principle of a strict matching between the value of assets and the value of technical provisions.
- 11.3.54. For DC pension plans, in several jurisdictions no reference is made to technical provisions. In terms of the structure of their balance sheet, DC plans are often treated in a similar way as UCITs: with investments at mark-to-market values on the assets side and units on the liability side, with the sum of all units that at all times exactly matches the value of net assets (so-called NAV). In many member states, when members bear all the investment risk, this kind of accounting structure is considered to be more transparent and easy to communicate to members.
- 11.3.55. On the other hand, in other countries DC pension schemes are set up in a way that is similar to unit-linked life insurance products; in this case, the content of art.132(3) may be appropriate.
- 11.3.56. Overall, where a regulation similar to 132(3) would be introduced in the revised IORP directive, it would have to be adapted to allow for the possibility that the UCITs-like approach to DC IORPs is also applicable.
- 11.3.57. Taking into account the major differences in approach among Member States on this subject the adoption of the Article 132(3) on the European level could also be left as a possibility for Member States where the IORPs are functioning similarly to insurance undertakings.

## **Policy options**

Option 1: Leave the IORP directive unchanged

Option 2: Introduce these provisions at EU level for all schemes where the members bear the investment risk and IORPS are functioning similarly to insurance undertakings and not to UCITS

Option 3: The same as option 2, leaving to MS the option to introduce the new text.

### **Comparison of policy options**

11.3.58. EIOPA favours option 2

## **SECTION 7: Investment rules**

### **7.8.2 Specific Call for Advice**

The involvement of the supervisory authorities where pension schemes provide for multi-funds (relative weights of different asset classes in the investment portfolio are decided by the scheme members rather than by the IORP itself), default options (where members in a multi-fund do not make a choice), or life-styling (the relative share of risky assets decreases over time). The supervisory involvement may for example comprise of verifying compliance with specific investment rules for assets such as quantitative restrictions for different investment options, the default fund and life-styling;

### **EIOPA view**

11.3.59. The current directive does not address such concepts as multi-funds, default options and life-styling. On the other hand it should be noted that these concepts are a significant part of the pension system design for some of the Member States with IORPs providing pension schemes where investment risk is borne by members. For countries where these concepts are present, the supervisory authorities adopt different approaches to ensure adequate protection of the members' rights.

11.3.60. Taking stock of principles, guidelines and papers produced by different international organizations (OECD, IOPS), the best practices regarding investment options currently in place for DC pension plans provide for:

- a. The offer of a number of investment options, with at least one low-risk option;
- b. The introduction of life-styling of the investment,
- c. The introduction of default options for the members not making make the choice.

11.3.61. A specific point relating to default options is that for IORPs where members bear the investment risk, the default mechanisms imply a shift of responsibility for investment decisions away from the individual member to the IORP or to who sets the defaults. In other words, setting a default option may create an additional fiduciary duty that, in practice, may give rise to litigation if members conclude that their interest were not protected appropriately.

- 11.3.62. A way to mitigate the risk of litigation by members (and their representatives) is definition of the so-called “safe harbours”, i.e. categories of default options of a defined standard that, when adopted by IORPs, provide immunity against litigation.
- 11.3.63. Moreover in some Member States there are IORPs where a common investment policy is provided to the members where no options are provided but instead members may opt out of the IORP. In these cases where assets are invested by default, the supervisory authority’s involvement could be considered to ensure that this option is adequate for members risk appetite and that its risk profile is appropriate. The supervisory authorities may act to ensure that involvement of the members in the decision-making process is adequate and, in cases when members refuse to take the decisions themselves, an adequate alternative is provided which takes into account members’ expectations.
- 11.3.64. There is a view is that there is no need to regulate these issues at European level by trying to fit all countries as it is unnecessary/unfeasible taking into account diversity of pension system design among MS.
- 11.3.65. Instead, referring to cases where pension schemes provide for member investment choice, default options where members in a multi-fund do not make a choice, or life-styling (the relative share of risky assets decreases over time), another view is to evaluate the possibility to refer to the principles or best practices, such as:
- DC IORPs should offer an appropriate range of investment options, including at least one low-risk option; The range of options should not be too wide, in order to avoid unnecessary complication;
  - The provision of default options should be made compulsory, in compliance with certain principles set at national level (with the possible guidance of implementing measures at EU level); also the use of life styling would be strongly encouraged; default options that comply with these principles should be considered as a “safe harbour” by national legislation;
- 11.3.66. The supervisory involvement may vary across Member States, from the prior authorisation to the ex-post checking of the compliance of the options offered with the criteria set in the regulation. Member States must ensure that the involvement is adequate to formation of risks arising from the decision making process.
- 11.3.67. Where a default investment option is provided, or in other circumstances where the member does not make a choice, there is a further view that, given the increased risks particularly in a cross-border context, it would be appropriate for it to be decided at a European level what minimum standards should be met in these cases.
- 11.3.68. Against this different views, EIOPA recognizes the importance of multi-funds, default options and life-styling as features that help risk control and sound development of supplementary pensions when members bear the investment risk. EIOPA encourages the identification and diffusion of best practices in this regard. Subsequently, subject to political discussion some aspects of

these features might be made mandatory and/or regulated by European legislation.

- 11.3.69. EIOPA believes that supervisory authorities will inevitably be involved in ensuring an orderly diffusion of these features within MS; the degree of involvement will depend on the way these features are going to be developed within every MS and/or regulated by European legislation.

## **SECTION 7: Investment rules**

### **7.8.3 Specific Call for Advice**

The usefulness from a supervisory perspective of a Value-at-Risk type upper limit on the entire portfolio below which the supervisor may require the pension fund to take action (e.g. sell the riskiest assets).

#### **EIOPA view**

- 11.3.70. Mexico has in place an investment regulation based on the Value-at-Risk (VaR) indicator. It requires pension funds to remain below a certain VaR measure, defined as 5% of the value of the entire portfolio on a one-day horizon.

- 11.3.71. In recent years, the Mexican regulation has been discussed many times in different forums. The main criticisms that have been expressed can be summarized as follows:

- VaR measure is short-term; its relevance is poor for the long-term investment strategies that pension funds should pursue,
- For equity-oriented investment options, it is natural that the short-term risk is high; VaR limits would therefore be a disincentive to offer/adopt these options, that may be appropriate in a long-term perspective and are the ones that many members consider most appropriate;
- VaR is highly pro-cyclical, therefore it implies the selling of assets when volatility is high and prices usually fall, while allowing risks to accumulate in times of market exuberance;
- VaR is a poor means in communicating risk to members;
- VaR is useful when considered together with several other indicators, but may be misleading when considered as the main element of risk management.

- 11.3.72. For all these reasons, taking into account that so far no other country has followed Mexico in its approach to investment regulation EIOPA does not see the prudential justification to introduce this approach at European level.

## **Investment rules**

### **7.9 Specific Call for Advice**

The necessity from a prudential perspective to introduce specific investment rules for pension schemes where the members and/or beneficiaries bear risks other than investment risk, in particular **biometric risk** and **inflation risk**;

#### **EIOPA view on issues in the CfA**

- 11.3.73. The case suggested by CfA 7.9 seems to refer mainly to DB and hybrid schemes where members, in the accumulation phase, do not bear most or all the investment risk, but are indeed exposed to biometric and inflation risk. This may be the case of many Dutch IORPs, where benefits are defined in nominal terms, but price indexation is conditional on the returns actually earned. As regards biometric risk, in most DC schemes the accrued capital at retirement is converted into an annuity on a money-purchase basis, and therefore members are indeed subject to biometric risk during the accumulation phase.
- 11.3.74. An additional, potentially relevant case is a payout phase where some or all biometric and inflation risks are borne by members. This may happen both in DC and DB schemes.
- 11.3.75. All these cases are quite diverse. However, they do not seem to require specific investment regulations over and above those stipulated in general, as no issues appear to have arisen to date.
- 11.3.76. One option is that the best way to deal with these issues would be information requirements instead of investment regulation.

## **Investment rules**

### **7.10 Specific Call for Advice**

Other requirements for IORPs, if any.

#### **EIOPA view on issues in the CfA**

- 11.3.77. EIOPA proposes to consider some additional possible amendments to the revised investment rules of the IORP directive:

#### **Introduction of the geographical criterion for diversification**

- 11.3.78. Article 132 (4) subparagraph 4 of the Solvency II Directive contains criteria for diversification that must be taken into account by insurance companies. For IORPs this provision can be found in Article 18 (1) (e) sentence 1. The difference between the two provisions is that the Solvency II Directive explicitly mentions the geographical breakdown as another criterion that has to be taken into consideration by insurance undertakings. One should assume

that the investment risk arising out of a geographical concentration is equal for IORPs and insurance companies.

- 11.3.79. On balance, EIOPA agrees to the introduction of the geographical concentration into the IORP Directive, subject to appropriate allowance for the specificities of IORPs and for proportionality.

### **Derivatives**

- 11.3.80. In contrast to the Solvency II Directive, the IORP Directive contains a provision for the use and valuation of derivatives (Article 18(1)(d) second sentence).

- 11.3.81. One view is that Article 18(1)(d) can be deleted for the risks arising out of derivatives should already be covered by the general rules on assets. This assumes that the word "assets" (and "instruments" when including Article 132(2) first sub-paragraph) also includes derivatives, though this should be made clearer if necessary.

- 11.3.82. However there is also a view that derivatives should be regarded as being of major importance and therefore a special provision on the possible risks of these instruments should be maintained. If the case to maintain the current provision of the IORP Directive holds then it is suggested that clarification of the permitted use of derivatives and in particular a definition of efficient portfolio management should be subject to Level 2 implementing measures.

- 11.3.83. Regarding valuation, assuming that there will be a general provision on the valuation of assets and liabilities in the revised IORP Directive (whether based on a fair value approach or following other principles) one view is that there is no need for a special valuation provision for derivatives. However, an alternative view is that the Directive should retain the special emphasis on derivatives and risks arising thereof.

- 11.3.84. In Article 18(1)(d) third sentence there is a special provision on certain risks arising out of derivatives: "The institution shall also avoid excessive risk exposure to a single counterparty and to other derivative operations." Such a provision doesn't exist in Solvency II.

- 11.3.85. EIOPA recommends to retain Article 18(1)(d), but clarify the permitted use of derivatives and the definition of efficient portfolio management.

### **Recognition of sponsor support**

- 11.3.86. The issue of how best to recognise and measure sponsor support is considered elsewhere in EIOPA's response. However, it is important to distinguish clearly investment by the IORP in the sponsor and the operation of the sponsor covenant, including but not limited to the commitments by the

sponsor to additional contributions, subordinated loans, contingent assets, escrow accounts etc.

11.3.87. EIOPA's general view is that limitations on investment in the sponsor should exclude these sponsor supports. However, given the complexity of this issue, the wide range of possible approaches to deal with it and the interplay with other issues it seems reasonable not to address this issue on Level 1 but to leave it to further discussion which will possibly lead to a Level 2 solution. However, the need for implementing measures should be on a mandatory basis (inter alia for the relation between investment rules and sponsor support). In Solvency II implementing measures are not stipulated on a mandatory basis (see Article 133(1) "may"). In order to resolve special problems arising out of the specificities of IORPs a revised IORP Directive should foresee implementing measures on a mandatory basis.

### **Prohibition of borrowing**

11.3.88. In contrast to the Solvency II Directive the IORP Directive contains a specific provision in Article 18(2) which prohibits borrowing or acting as a guarantor on behalf of third parties.

11.3.89. Within EIOPA, one view is that the prohibition of borrowing can be removed from the IORP Directive. The underlying reasons for this view are that it is relatively easy to surpass the prohibition by using instruments, such as derivatives, that imply implicit borrowing and that supervisors have sufficient means to prevent exposure to undue leverage. These means will be enhanced if the revision of the IORP Directive introduces elements from the Solvency II Directive such as ORSA and the risk-based capital requirements within the holistic balance sheet approach.

11.3.90. Another view within EIOPA is that the prohibition of borrowing should be retained in the IORP Directive. The main reason for this view is that where occupational pension benefits form a part of the basic retirement income, additional protection for members and beneficiaries would enhance the security of those benefits.

11.3.91. The prevailing view within EIOPA is to retain the prohibition of borrowing in the IORP Directive. However, there is a need to clarify that this only relates to direct borrowing and that subordinated loans are exempted from the prohibition of borrowing.

## **11.4. Impact assessment**

For specific CfA from 7.2 to 7.10, two separate impact assessments are carried out: for defined benefit and defined contribution schemes. The reason is that EIOPA's advice on investment rules differs significantly depending on the type of pension arrangement. The principal difference is that the advice recommends application of the prudent person rule in respect of investments made on behalf of defined benefit schemes. For such schemes sections 7.2, 7.3, 7.4, 7.5, 7.6 and 7.9 of the advice do not therefore apply and their impact is not assessed. CfA 7.1 carries a dedicated

impact assessment, conducted jointly for DB and DC schemes, and to be found above, directly after that section.

### **Defined benefit**

This is specified as where the member does not bear the investment risk.

Option 1: No change from current IORP directive

- Keep extent of existing investment rules
- Keep ability of host state to impose investment restrictions

Option 2: Reliance on the prudent person rule

- Rely on prudent person rule for investments with no additional rules
- No additional supervisory involvement in DB-type IORPs
- Remove ability of host state to impose restrictions on investments

### **Positive impacts**

Option 1: No change from current IORP directive

- Members/beneficiaries
  - No additional costs or benefits compared with current position.
- IORPs/sponsoring employers
  - No additional costs or benefits compared with current position.
- Supervisory authorities
  - No additional costs or benefits compared with current position.

Option 2: Reliance on the prudent person rule

- Members/beneficiaries
  - Impact would be only indirect as members/beneficiaries to not bear the investment risk
- IORPs/sponsoring employers
  - Investment costs will be lower because (i) IORPs will not be subject to investment rules which may prevent selecting the best risk/return investment profile; (ii) it will be easier to establish cross-border schemes if only the investment requirements of the home state need be complied with.
  - In some cases, the removal of further investment restrictions may make the achievement of appropriate investment more practical.
- Supervisory authorities
  - Supervisory costs are likely to be lower. Checks will be required to ensure the quality of the investment process. In general, risks will be evaluated by oversight within a risk-based framework rather than by checking compliance with quantitative limits.

### **Negative impacts**

Option 1: No change from current IORP directive

- Members/beneficiaries
  - No additional costs or benefits compared with current position.
- IORPs/sponsoring employers
  - No additional costs or benefits compared with current position.
- Supervisory authorities

- No additional costs or benefits compared with current position.

#### Option 2: Reliance on the prudent person rule

- Members/beneficiaries
  - Impact would be only indirect as members/beneficiaries to not bear the investment risk
- IORPs/sponsoring employers
  - None identified
- Supervisory authorities
  - This option potentially involves more complex supervision as it will require a qualitative assessment of the adherence of the investment process to the prudent person principle rather than compliance with a set of quantitative investment rules.

### **Defined contribution**

The components of the call for advice and the options have both been grouped in order to keep the impact assessment manageable.

### **Components of the call for advice**

Three categories for the call for advice have been identified:

1. Extent to which there should be investment rules in addition to the prudent person rule (7.2, 7.3, 7.4, 7.5, 7.6, 7.9)
2. Whether there should be additional requirements for DC schemes (7.8 (7.8.1, 7.8.2, 7.8.3))
3. Whether the host state should have the ability to set investment rules (7.7)

### **The options presented in CfA 7**

The options in the draft advice are reduced to three options for the purposes of impact assessment. These are:

#### Option 1: No change from current IORP directive

#### Option 2: Secure member protection by the quality of the design and implementation of the investment process

- Rely on prudent person rule for investments with no additional rules
- Remove ability of host state to impose restrictions on investments

#### Option 3: Secure member protection also using by investment restrictions

- At least retain and possibly enhance existing investment restrictions
- Additional supervisory involvement for DC schemes
- Retain ability of host state to impose restrictions on investments

It must be emphasised that:

- (i) These options are not mutually exclusive. There could for example be a preference for protection both via the quality of the investment process as a whole and via investment limits.
- (ii) The home and host state components are detachable from the rest of the options. There could be a preference for securing member protection by

investment restrictions but for these restrictions only to be imposed by the home state.

#### Positive impacts

Option 1: No impact

Option 2: Secure member protection by the quality of the design and implementation of the investment process

- To the extent that the investment process is designed and implemented correctly, the risk/return profile would be managed optimally.
- IORPs/sponsoring employers
  - Investment costs may be lower because (i) IORPs would not be subject to investment rules which may prevent selecting the best return/lower cost investment; (ii) it would be easier to establish cross-border schemes if only the investment requirements of the home state need be complied with.
- Supervisory authorities

Supervisory costs are likely to be lower and more effective, as they do not have to focus on the compliance of investment limits as such, but rather on the design and implementation of the investment process.

Option 3: Secure member protection by investment restrictions

- Members/beneficiaries
  - Investment restrictions will set some “objective” limits to the risks that members are exposed to. This is may be beneficial where members do not make an investment choice and in cross-border situations.
- IORPs/sponsoring employers
  - none identified
- Supervisory authorities
  - This provides a wide number of means of attempting to secure member protection, both via compliance with investment rules and the ability to impose them on all IORPs in the supervisory authority’s jurisdiction

#### Negative impacts

Option 1: No impact

Option 2: Secure member protection by the quality of the design and implementation of the investment process

- Members/beneficiaries
  - There is a potential increase in risk to members. This option relies on the quality of the investment process and not on “objective”, quantitative limits. In addition, if combined with the removal of the host state’s ability

to impose investment rules, members are reliant on what is regarded as prudent in the home state also being so in the host state.

- IORPs/sponsoring employers
  - none identified
- Supervisory authorities
  - This option exposes the supervisor to greater risk in that it relies more on qualitative judgement on the quality of governance and the investment process as a whole.

#### Option 3: Secure member protection by investment rules

- Members/beneficiaries
  - This option would in principle restrict the investment opportunity set and therefore could prevent members/beneficiaries to profit from an optimal risk/return combination.
- IORPs/sponsoring employers
  - This option increases the costs of continuing compliance because of the need to remain within the investment rules.
  - It could also significantly raise the costs for cross-border schemes, if the host state imposes different investment rules to the home state.
- Supervisory authorities
  - This option could be more costly for supervisors: it could require ongoing assessment of IORPs with investment restrictions and in securing compliance of cross-border IORPs with domestic requirements.

### 11.5. EIOPA advice

The Commission Services would like EIOPA to advise on detailed rules by which supervisors can ensure that IORPs have proper investment rules.

EIOPA proposed response is as follows:

*7.1 The material elements of Article 132(2) of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to **risk assessments**;*

**Option 2:** Change Article 18 of the IORP Directive, in accordance with Article 132(2) of the Solvency II Directive by:

- inserting the sentence *"With respect to the whole portfolio of assets, IORPs shall only invest in assets and instruments whose risks the institution concerned can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs in accordance with ...";*
- adding the sentence in Article 132(2) sub-paragraph 2 of the Solvency II Directive: *"In addition the localisation of those assets shall be such as to ensure their availability."*

It should be noted that the proposed changes contained in this option could entail other changes (e.g. Article 133 and 134 of the Solvency II Directive).

*7.2 The application of the quantitative restriction on investment in the sponsoring undertaking in Article 18(1)(f) of the IORP Directive when the IORP is sponsored **by two or more undertakings**;*

EIOPA does not see the need for a special restriction on investment in the sponsoring undertaking when the IORP is sponsored by two or more undertakings; indeed, possible risk concentration issues should already be covered sufficiently by the provision in Article 18(1)(f) second paragraph which is principles-based in this respect. However, if necessary the current wording could be clarified to exempt from these provisions the normal operation of the sponsor covenant and any commitments by the employers under recovery plans. The issue of subordinated loans is considered separately.

*7.3 The necessity from a prudential perspective to maintain Article 18(5) first and second sub-paragraphs of the IORP Directive enabling Member States to lay down more detailed investment rules;*

EIOPA recommends to maintain Article 18.5, first sub-paragraph only to cases when members bear the investment risk.

The second sub-paragraph of Article 18.5 should be removed. The option to agree at EU level the admissible more detailed rules should be considered (see below discussion on art. 18.7).

*7.4 The necessity from a prudential perspective to maintain Article 18(5)(b) of the IORP Directive enabling IORPs to invest up to 30% in **foreign currencies**;*

EIOPA does not believe it is necessary to maintain this provision for defined benefit IORPS. EIOPA supports the maintenance of this provision where members bear the investment risks, but recommends that the wording be changed to better achieve the original intention.

*7.5 The necessity from a prudential perspective to maintain Article 18(5)(c) of the IORP Directive enabling IORPs to invest in **risk capital markets**;*

EIOPA holds the view that this provision should be dropped, especially as there is no common agreement on its interpretation.

*7.6 The necessity from a prudential perspective to maintain Article 18(6) of the IORP Directive enabling Member States to lay down more stringent investment rules on an **individual basis**;*

EIOPA supports the retention of this provision in the Directive, but the text should be modified to make it clear that the objective of the provision is to allow the supervisor to have appropriate powers of intervention.

*7.7 The necessity from a prudential perspective to maintain Article 18(7) of the IORP Directive enabling, in the event of **cross-border activity**, the host Member States to require IORPs in the home Member State to comply with stricter investment rules as regards assets traded in regulated versus non-regulated markets, exposure to a single issuer or group and currency risk;*

EIOPA considers that the retention of Article 18(7) of the IORP Directive should be assessed together with the changes to article 18(5), first sub-paragraph. Indeed, the admissible additional rules that the home MS on the one hand, and the host MS on the other, are allowed to impose, should be consistent. Anyway, EIOPA believes that the possibility for the host MS to impose limits to host IORPs should not be extended with respect to the current IORP Directive.

*7.8 The adequacy of the investment rules in Article 18(5)(a) of the IORP Directive where the pension scheme members bear the **investment risk**. This should include advice on at least:*

*The material elements of Article 132(3) first to third subparagraphs of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to retirement products where the members bear the investment risk;*

*The involvement of the supervisory authorities where pension schemes provide for multi-funds (relative weights of different asset classes in the investment portfolio are decided by the scheme members rather than by the IORP itself), default options (where members in a multi-fund do not make a choice), or life-styling (the relative share of risky assets decreases over time). The supervisory involvement may for example comprise of verifying compliance with specific investment rules for assets such as quantitative restrictions for different investment options, the default fund and life-styling;*

*The usefulness from a supervisory perspective of a Value-at-Risk type upper limit on the entire portfolio below which the supervisor may require the pension fund to take action (e.g. sell the riskiest assets).*

EIOPA supports the retention of 18(5)(a) but not to restrict the ability of Member States to impose, in cases where members bear the investment risk, appropriate limits where low risk or default funds are required, and also where the member does not have an investment choice.

EIOPA supports the adoption of the Article 132(3) at the European level for all schemes where the members bear the investment risk and IORPs are functioning similarly to insurance undertakings and not to UCITS.

EIOPA recognizes the importance of multi-funds, default options and life-styling as features that help risk control and sound development of supplementary pensions

when members bear the investment risk. EIOPA encourages the identification and diffusion of best practices in this regard. Subsequently, subject to political discussion some aspects of these features might be made mandatory and/or regulated by European legislation.

EIOPA believes that supervisory authorities will inevitably be involved in ensuring an orderly diffusion of these features within MS; the degree of involvement will depend on the way these features are going to be developed within every MS and/or regulated by European legislation.

EIOPA does not believe that a Value at Risk limit would be beneficial.

*7.9 The necessity from a prudential perspective to introduce specific investment rules for pension schemes where the members and/or beneficiaries bear risks other than investment risk, in particular **biometric risk** and **inflation risk**;*

EIOPA holds the view that no specific investment rules for this subject need to be introduced

*7.10 Other requirements for IORPs, if any.*

#### INTRODUCTION OF GEOGRAPHICAL CRITERION

EIOPA supports the introduction of the geographical criterion into the IORP similar to that in Solvency II Article 132 (4) subparagraph 4, subject to appropriate allowance for the specificities of IORPs and for proportionality.

#### DERIVATIVES

EIOPA recommends to retain Article 18(1)(d), but clarify the permitted use of derivatives and the definition of efficient portfolio management.

#### PROHIBITION OF BORROWING

EIOPA recommends to retain the prohibition of borrowing in the IORP Directive. However, there is a need to clarify that this only relates to direct borrowing and that subordinated loans are exempted from the prohibition of borrowing.

## 12. CfA 8: Objectives and pro-cyclicality

### 12.1. Extract from the call for advice

The EIOPA advice should address at least the following subjects:

- (1) The inclusion of the main objective of supervision into the IORP Directive;
- (2) The inclusion of the principle to take into account the potential pro-cyclicality into the IORP Directive.

### 12.2. Background

#### Current legal requirements (IORP Directive)

None

#### International standards (OECD/IOPS, etc...)

IOPS Paper; Guidelines for the supervisory assessment of pension funds, December 2008

*The objectives of pension supervision include protecting the interests of pension fund members and beneficiaries.*

OECD Working Paper; The Impact of the Financial Crisis on Defined Benefit Plans and the Need for Counter-Cyclical Funding Regulations, July 2010. This paper discusses possible pension reforms to make pension schemes more counter-cyclical. It also suggests a number of policy measures that could make funding regulations more counter-cyclical in nature. The policy measures suggested include the following:

- a. Avoid excessive reliance on current market values for purposes of determining contributions. Disclosure to plan stakeholders based on current market values of pension assets and liabilities may be appropriate to increase transparency, and the use of current market values could improve risk management. However, regulators should operate flexibly when reviewing a scheme's funding position or regulators should enable pension funds and plan sponsors to dampen somewhat the volatility of market prices when determining contributions;
- b. Incorporate flexibility into funding rules to reflect the overall volatility of funding valuations. While the primary goal of a pension plan is to provide secure benefits to plan members, funding regulations should aim at avoiding undue pressure on plan sponsors at times when their own profitability or even continuity is under pressure. For instance, regulators could take into account the overall volatility of funding levels when setting the recovery periods required for pension funds to eliminate funding deficits. The level of flexibility of funding rules will also depend on other factors such as the extent to which the fund can rely on additional plan sponsor contributions.

## **Solvency II Directive**

### Recital (61)

*In order to mitigate undue potential pro-cyclical effects of the financial system and avoid a situation in which insurance and reinsurance undertakings are unduly forced to raise additional capital or sell their investments as a result of unsustained adverse movements in financial markets, the market risk module of the standard formula for the Solvency Capital Requirement should include a symmetric adjustment mechanism with respect to changes in the level of equity prices. In addition, in the event of exceptional falls in financial markets, and where that symmetric adjustment mechanism is not sufficient to enable insurance and reinsurance undertakings to fulfil their Solvency Capital Requirement, provision should be made to allow supervisory authorities to extend the period within which insurance and reinsurance undertakings are required to re-establish the level of eligible own funds covering the Solvency Capital Requirement.*

### Article 27: Main objective of supervision

*Member States shall ensure that the supervisory authorities are provided with the necessary means, and have the relevant expertise, capacity, and mandate to achieve the main objective of supervision, namely the protection of policy holders and beneficiaries.*

### Article 28: Financial stability and pro-cyclicality

*Without prejudice to the main objective of supervision as set out in Article 27, Member States shall ensure that, in the exercise of their general duties, supervisory authorities shall duly consider the potential impact of their decisions on the stability of the financial systems concerned in the European Union, in particular in emergency situations, taking into account the information available at the relevant time.*

*In times of exceptional movements in the financial markets, supervisory authorities shall take into account the potential pro-cyclical effects of their actions.*

### Article 106: Calculation of the equity risk sub-module: symmetric adjustment mechanism

- 1. The equity risk sub-module calculated in accordance with the standard formula shall include a symmetric adjustment to the equity capital charge applied to cover the risk arising from changes in the level of equity prices.*
- 2. The symmetric adjustment made to the standard equity capital charge, calibrated in accordance with Article 104(4), covering the risk arising from changes in the level of equity prices shall be based on a function of the current level of an appropriate equity index and a weighted average level of that index. The weighted average shall be calculated over an appropriate period of time which shall be the same for all insurance and reinsurance undertakings.*
- 3. The symmetric adjustment made to the standard equity capital charge covering the risk arising from changes in the level of equity prices shall not result in an equity capital charge being applied that is more than 10 percentage points lower or 10 percentage points higher than the standard equity capital charge.*

## Article 138: Non-Compliance with the Solvency Capital Requirement

4. *In the event of an exceptional fall in financial markets, the supervisory authority may extend the period set out in the second subparagraph of paragraph 3 by an appropriate period of time taking into account all relevant factors.*

*The insurance or reinsurance undertaking concerned shall, every three months, submit a progress report to its supervisory authority setting out the measures taken and the progress made to re-establish the level of eligible own funds covering the Solvency Capital Requirement or to reduce the risk profile to ensure compliance with the Solvency Capital Requirement.*

*The extension referred to in the first subparagraph shall be withdrawn where that progress report shows that there was no significant progress in achieving the re-establishment of the level of eligible own funds covering the Solvency Capital Requirement or the reduction of the risk profile to ensure compliance with the Solvency Capital Requirement between the date of the observation of non-compliance of the Solvency Capital Requirement and the date of the submission of the progress report.*

### **OPC reports**

None

### **12.3. Explanatory text**

#### **Specific Call for Advice**

The inclusion of the main objective of supervision into the IORP Directive;

### **EIOPA view on issues in the CfA**

- 12.3.1. Article 27 of the Solvency II Directive states that the main objective of supervision is to protect policy holders and beneficiaries. The inclusion into the revised IORP Directive of a similar main objective, namely the protection of members and beneficiaries, is important to clearly define the regulatory goals pursued by the legislation and implemented by the supervisory authorities and thus to give guidance for interpretation of the provisions of the Directive.
- 12.3.2. EIOPA recognises that occupational pensions provide for an essential part of the retirement income of pensioners. Hence, EIOPA suggests adding to the objective of supervision to promote sound and prudent management of IORPs, even though it may be argued that this is not an objective in itself but rather a means to protect the rights of members and beneficiaries.
- 12.3.3. Additionally, the specific characteristics of a national pension system may give rise to additional objectives. An example can be found in the United Kingdom, where one of the objectives of the Pensions Regulator is to reduce the risk of situations arising which could lead to claims being made on the UK's Pension Protection Fund.

12.3.4. It will require Member States to provide supervisory authorities with the resources to fulfil their obligations. They should therefore have at their disposal all necessary powers and means.

### **Policy options**

EIOPA is of the view that Article 27 of the Solvency II Directive is applicable to IORPs, with the modification that in respect of the IORP Directive the objective of supervision must be at least (i) to protect the rights of members and beneficiaries and (ii) to promote sound and prudent management of IORPs.

#### **Specific Call for Advice**

The inclusion of the principle to take into account the potential pro-cyclicality into the IORP Directive.

### **EIOPA view on issues in the CfA**

12.3.5. The issue of cyclicity is important for financial institutions. If their financial situation deteriorates, the measures they take should be aimed at restoring their health in the short to medium-long term. These measures should however not unduly reduce their viability in the longer term. Although this concept seems to be pretty straight-forward, the difficulty is to find the right balance between short to medium-long term measures and long-term measures. This balance is dependent on the type of institution and on the national system it operates in.

12.3.6. With regard to the different types of financial institutions, the main difference lies in the duration of the obligations. Banks have a short duration, given that depositors can reclaim their savings any time they like. Insurance companies have a medium-long duration, as they combine short-term obligations with long-term obligations. IORPs usually have long durations, as their obligations are (almost exclusively) connected to retirement (although for many IORPs the duration is getting shorter as the yearly number of their members reaching retirement exceeds the number of new members entering the scheme). The shorter the duration, the greater the need for short-term recovery.

12.3.7. With regard to the national system an IORP operates in, there is firstly the difference in who bears the risks. Where the members bear all the risks (pure DC schemes) the volatility of financial markets is directly transferred to participants. This means that from the point of view of the IORP no cyclicity issues play a role for these schemes. If others, notably the IORP and/or the plan sponsor, bear some or all of the risks, the volatility of financial markets is not, or not entirely, transferred to participants and cyclicity may play a role there.

12.3.8. Secondly, national pension systems differ in the involvement of plan sponsors. In some countries, plan sponsors guarantee pension benefits if the IORP

cannot provide the full pension promise. In other countries, there is no automatic recourse to the plan sponsor.

#### Capital requirements to protect technical provisions

- 12.3.9. The first line of defence against pro-cyclicality is to impose capital requirements that provide protection for the technical provisions. Such additional capital serves as a buffer to cope with market movements. Dependent on the role of the plan sponsor in the national system, additional capital can come in the form of “hard capital”, sponsor support etc.
- 12.3.10. Additional capital may not be sufficient to deal with extreme (downward) market movements. For such stress scenarios, additional counter-cyclical instruments should be available to supervisors and IORPs. The Solvency II Directive contains a general article on financial stability and pro-cyclicality (Article 28) and mentions two specific counter-cyclical instruments: the equity dampener (Article 106) and the Pillar II dampener (Article 138(4)). The next paragraphs will discuss whether the general article and the dampeners might also be useful in the context of IORPs<sup>55</sup>.
- 12.3.11. However, it must be noted that the existence of counter-cyclical funding rules does not necessarily imply pro- or counter-cyclical behaviour from IORPs. Within the limits of the national systems, IORPs are free to make their own decisions. This implies that their choices may be pro-cyclical or counter-cyclical. One example from recent practice relates to IORPs’ asset management. When equity prices fell dramatically in 2008-2009, some IORPs decided to decrease their risk profile by selling equities. This decision limited their exposure to further decrease of prices. Other IORPs decided to buy equity at a low level (for instance, as a result of an investment strategy that included rebalancing), which increased their exposure to equity risk. None of these decisions was, or could be, imposed by pension regulation or supervision.
- 12.3.12. An important element that gives IORPs room to avoid pro-cyclical effects is the length of recovery periods, which can be substantially longer than for insurance companies. As already noted earlier, a longer duration allows for longer recovery periods. And a longer recovery period for IORPs also provides them with sufficient room to deal with volatility.

#### The general article on financial stability and pro-cyclicality

- 12.3.13. Article 28 of the Solvency II Directive requires supervisors to consider the potential impact of their decisions on the stability of the financial systems and to take into account the potential pro-cyclical effects of their actions in case of extreme stress. It must be noted that IORPs are institutional investors, just like insurance companies. The application of such an article

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<sup>55</sup> Article 304 of the Solvency II Directive, the equity risk sub-module, is also connected to pro-cyclicality. However, this article is dealt with in Chapter 6 of the Call for Advice. It is therefore not included in this assessment.

would require supervisors to take into account the possible systemic effects of their actions.

- 12.3.14. Considering the similarities between IORPs and insurance companies, EIOPA proposes to include the general article on financial stability and pro-cyclicality into a future IORP Directive.

#### The equity dampener

- 12.3.15. Article 106 of the Solvency II Directive provides for a symmetric adjustment in the calculation of equity risk in the solvency capital requirement. This so-called equity dampener thus smoothens the equity risk. As it is symmetric, the equity dampener can both lead to a decrease and to an increase of the equity capital that is calculated under the standard formula.
- 12.3.16. The objective of the equity dampener is to build up additional buffers in good times, while in bad times the buffers are eased. After a severe downfall of equity markets, the SCR will be adjusted downward, supporting a timely recovery of the solvency of insurance companies without undesirable pro-cyclical effects, given their relatively short recovery periods. The aim of the equity dampener is to avoid that insurers are unduly forced to raise additional capital or sell their investments as a result of unsustained adverse movements in financial markets and to discourage fire sales which would have further negative impact on equity prices and the economy.
- 12.3.17. An argument against the equity dampener is that it does not provide an answer to risks associated with other asset classes than equity.
- 12.3.18. These considerations regarding pro-cyclicality and financial stability are not only valid for insurers, but also for IORPs. The inclusion of the equity dampener in a revised IORP Directive may diminish pro-cyclical effects. However, pro-cyclical effects can also be reduced through the longer recovery periods that IORPs dispose of. It may therefore not be necessary to apply a symmetric adjustment mechanism, such as the equity dampener, to IORPs.

#### The Pillar II dampener

- 12.3.19. Article 138(4) of the Solvency II Directive provides supervisors with the possibility to increase the standard recovery period to re-establish the level of eligible own funds covering the Solvency Capital Requirement in times of severe stress. When using this so-called pillar II dampener, supervisors have to take into account the specific characteristics of the institution concerned.
- 12.3.20. The pillar II dampener clearly provides for a useful instrument in the area of pensions. During the past years, several supervisors have increased the standard recovery periods for their IORPs, to allow them sufficient time for

recovery. Within this process, it is fair to note that IORPs have more security mechanisms at their disposal than insurance companies. On the one hand, this could reduce the necessity to use the pillar II dampener as the possibilities for a timely recovery are larger. On the other hand, this could also increase the necessity to use the pillar II dampener in order for certain security mechanisms (such as sponsor support) to reach their full recovery potential.

## **Policy options**

### Option 1:

12.3.21. Include the general article on financial stability and pro-cyclicality and the pillar II dampener in the IORP Directive, but leave out the equity dampener.

### Option 2:

12.3.22. Include the general article on financial stability and pro-cyclicality, the pillar II dampener and the equity dampener in the IORP Directive.

## **12.4. Impact assessment**

12.4.1. This impact assessment covers two issues, supervisory objective and pro-cyclicality, and two options have been proposed for the latter.

### (i) Inclusion of the main objective of supervision in the IORP Directive

EIOPA is of the view that Article 27 of the Solvency II Directive is applicable to IORPs, with the modification that in respect of the IORP Directive the objective of supervision must be at least (i) to protect the rights of members and beneficiaries and (ii) to promote sound and prudent management of occupational pension schemes. Member States should have the opportunity to formulate additional objectives of supervision.

### Positive impacts

#### ➤ Members/beneficiaries

- The inclusion in the IORP Directive of the principles of (i) the protection of members and beneficiaries and (ii) the improvement of a sound and prudent management of occupational pension schemes as the main objective of supervision strengthens the adequate protection of member and beneficiaries.

#### ➤ IORPs/sponsoring employers

- No impact foreseen.

#### ➤ Supervisory authorities

- The inclusion in the IORP Directive of the principles (i) to protect the rights of members and beneficiaries and (ii) to promote sound and prudent management of occupational pension schemes as the main objective of supervision clearly defines the regulatory goals pursued by the legislation and implemented by the supervisory authorities.

### Negative impacts

No negative impacts foreseen.

### (ii) Inclusion of the general articles on financial stability and pro-cyclicality, the equity dampener and the equity dampener in the IORP Directive

Option 1: Include the general article on financial stability and pro-cyclicality and the pillar II dampener in the IORP Directive, but leave out the equity dampener.

Option 2: Include the general article on financial stability and pro-cyclicality, the pillar II dampener and the equity dampener in the IORP Directive.

### Positive impacts

Option 1:

#### ➤ Members/beneficiaries

- No positive impacts foreseen

#### ➤ IORPs/sponsoring employers

- Allows for more flexibility when responding to certain scenario's that affect a broad range of IORPs.

#### ➤ Supervisory authorities

- Allows for more flexibility for supervisors to respond to a crisis situation
- Capital requirements connected to actual equity prices, instead of assuming the existence of mean reversion.

Option 2:

#### ➤ Members/beneficiaries

- No positive impacts foreseen

#### ➤ IORPs/sponsoring employers

- The potential inclusion of the equity dampener would lead to lower capital requirements for IORPs when equity prices are dropping.

➤ Supervisory authorities

- Allows for more flexibility for supervisors to respond to a crisis situation
- Allows for lower capital requirements when equity prices are dropping and provides consistency with Solvency II in terms of extent of the pro-cyclical measures.

Negative impacts

Option 1:

- No negative impacts foreseen

Option 2:

➤ Members/beneficiaries

- No negative impacts foreseen.

➤ IORPs/sponsoring employers

- Uncertainty whether a lower capital requirement when equity prices are dropping (as a result of the equity dampener) aligns with the real risks

➤ Supervisory authorities

- Implies the existence of mean reversion
- Uncertainty whether a lower capital requirement when equity prices are dropping (as a result of the equity dampener) aligns with the real risks.

## 12.5. EIOPA advice

*The EIOPA advice should address at least the following subjects:*

- *The inclusion of the main objective of supervision in the IORP Directive*

EIOPA is of the opinion that the main objective of supervision should be explicitly included in a revised IORP Directive. The objective of supervision must be at least (i) to protect the rights of members and beneficiaries and (ii) to promote sound and prudent management of IORPs.

- *The inclusion of the principle to take into account the potential pro-cyclicality into the IORP Directive.*

With regard to pro-cyclicality, EIOPA is of the opinion that the obligation (of Article 28 of the Solvency II Directive) for supervisors to consider the potential impact of their decisions on the stability of the financial systems and to take into account the potential pro-cyclical effects of their actions in case of extreme stress should be included in a revised Directive. In addition to that general obligation, the Pillar II dampener of Article 138(4) of the Solvency II Directive should also be included in a revised IORP Directive. The inclusion of the equity dampener of Article 106 may diminish pro-cyclical effects, provided that the specificities of IORPs have been taken into account. However, the same outcome may be achieved without including the equity dampener through the longer recovery periods that IORPs dispose of.

## **13. Governance and other qualitative requirements**

The next 13 chapters are on governance and other qualitative requirements, including the role of the supervisory authority. The chapters are:

- CfA 9: General principles of supervision, scope and transparency and accountability
- CfA 10: General supervisory powers
- CfA 11: Supervisory review process and capital add-ons
- CfA 12: Supervision of outsourced functions and activities
- CfA 13: General governance requirements
- CfA 14: Fit and proper
- CfA 15: Risk management
- CfA 16: Own risk and solvency assessment
- CfA 17: Internal control system
- CfA 18: Internal audit
- CfA 19: Actuarial function
- CfA 20: Outsourcing
- CfA 21: Custodian/depository

## 14. CfA 9: General principles of supervision, scope and transparency and accountability

### 14.1. Extract from the call for advice

The EIOPA advice should address at least the following subjects:

- The material elements of Article 29 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the **general principles of supervision**;
- The material elements of Article 31 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to **transparency and accountability**;
- Other rules for IORPs, if any.

### 14.2. Background

#### Current legal requirements (IORP Directive)

##### General principles of supervision

- 14.2.1. The IORP Directive does not explicitly list or define general principles of supervision that supervisory authorities are expected to use as a guide to their work.
- 14.2.2. Article 13 of the IORP Directive requires Member States to ensure that supervisory authorities can get the necessary information to do effective off-site supervision and have the power to carry out on-site inspections as appropriate.
- 14.2.3. Recital (15) and Article 5 allow exemptions from certain rules in the case of small schemes.

##### Transparency and accountability

- 14.2.4. The IORP Directive does not contain recitals or articles concerning transparency and accountability with regard to supervisory authorities. However, the objectives of the IORP Directive are set out clearly in the recitals and in the substance of the Articles, so the general principles used by supervisory authorities should presumably be consistent with those objectives.
- 14.2.5. Recital 4 emphasises the importance of the directive in bringing IORPs into a coherent Community legislative framework.
- 14.2.6. Recital 6 and Article 18 sets out the 'prudent person' rule as being the basis for investment by IORPs, while Recital (31) emphasises that decisions must be made that suit the liability characteristics.

- 14.2.7. Recital 7 explicitly cites a high degree of security for pensioners as being the objective of the rules laid down by the IORP Directive. Further recitals and various Articles are therefore concerned with issues which affect this security, e.g. who is bearing the risk in the IORP, investment, underfunding, whether or not the IORP is cross-border, the soundness of the administration of the IORP.
- 14.2.8. Recital 39 and Article 20 address the importance of co-operation between supervisory authorities in different Member States in the case of cross-border schemes.

International standards (OECD/IOPS, etc...)

## **OECD Principles of Occupational Pension regulation**

### Core Principle 7: Supervision

*Effective supervision of pension funds and plans must be set up and focus on legal compliance, financial control, actuarial examination and supervision of managers. Appropriate supervisory bodies, properly staffed and funded, should be established in order to conduct when relevant off and on site supervision, at least for some categories of funds and in particular when problems are reported. Supervisory bodies should be endowed with appropriate regulatory and supervisory powers over individual plans, in order to prevent mis-selling cases arising from irregularities in the distribution and expenses methods.*

## **IOPS Principles of Private Pension Supervision**

### *Principle 1: Objectives*

National laws should assign clear and explicit objectives to pension supervisory authorities

*The principal strategic objectives of the pension supervisory authority should be clearly and publicly specified. They should include a focus on the protection of pension members and beneficiaries' interests. Objectives should also be directed towards the stability and security of pension funds and plans, the sustainability of the pension sector as a whole, the promotion of good governance and the encouragement of pension provision.*

*The responsibilities of the pension supervisor should be clearly and objectively stated, giving a clear mandate and assigning specific duties.*

### *Principle 2: Independence*

Pension supervisory authorities should have operational independence

*The pension supervisory authority should have operational independence from both political authorities and commercial interference in the exercise of its functions and powers.*

*To ensure independence, stability and autonomy are particularly required at the senior director level of the pension supervisory authority. The nomination, appointment and*

removal of the head of the pension supervisory authority should be done via explicit procedures and transparent mechanisms. The head of the authority is usually appointed for a fixed term (normally between 3-6 years) with subsequent reappointment allowed (in order to retain skilled practitioners). The pension supervisory authority should also be funded in such a way as to ensure independence and there should be a transparent budgetary process.

Supervisory acts, including the use of enforcement and sanction powers, should be over-ruled only by judicial decision, including tribunals with relevant powers, or by parliamentary process.

#### *Principle 5: Risk-based Supervision*

*Pension supervisory authorities should adopt a risk-based approach.*

*In order to use their resources efficiently, pension supervisory authorities should adopt a risk-based approach, and a suitable risk-assessment methodology should be established.*

*The move towards risk-based supervision can be undertaken gradually, combining this technique with more traditional rules-based supervision as the supervisory authority and pension industry develop the necessary expertise.*

*The introduction of risk-based supervision should be seen as a movement along a continuum from one extreme of complete reliance on a rules -based system to one where the emphasis of supervision is a function of risk. Risk-based supervision does not mean having no rules or compliance procedures.*

*A legal framework allowing suitable discretion in terms of interpretation and exercise of supervisory powers is required, which should also provide pension supervisory authorities with the necessary powers to adopt a risk-based approach.*

*Staff reorganization and training, in terms of the philosophy as well as the process of risk-based supervision, should be undertaken as the transition to the new approach takes place.*

*The Pension supervisory authority should communicate its risk-based approach to the pension industry, explaining what is expected of them – particularly in relation to risk-management – via guidance notes and possibly providing training.*

*Risk-based supervision will require different types of information, which the pension supervisory authority should obtain from existing sources where possible. Where specific supervisory returns are required they should be designed with care and focused on obtaining information regarding the main risks which the pension supervisory authority is concerned with.*

*Where quantitative risk assessment tools are used, the models involved should be carefully designed and their limitations fully understood.*

*Risk-scoring models should reflect the risk-focus of the pension supervisory authority (which is driven by its objectives and resources), and the net risk of relevant*

*individual entity and systemic risk factors. These factors should be suitably weighted according to the nature of the pension system (including the size and number of pension fund overseen), and a risk-score derived from the probability and impact of their occurrence.*

#### *Principle 6: Proportionality and Consistency*

*Pension supervisory authorities should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated and that their actions are consistent*

*A logical connection should be made between the results of the risk assessment undertaken by the pension supervisory authority and its actions (for example through the use of a supervisory response matrix). The remedial actions and if necessary sanctions imposed by the pension supervisory authority should be proportional to the amount of risk posed by the fund to its members and beneficiaries and the pension system as a whole - taking into account the nature, scale, complexity and seriousness of the potential compliance irregularities relating to the relevant party - and should represent the most efficient use of supervisory resources. The long -term nature of pension funds should be taken in consideration and unnecessary pro-cyclical behaviour should be avoided.*

*The extent of supervisory demands placed on pension funds or plans and associated parties being supervised should be in accordance with the value expected to be derived. During the decision making process, a balance should be struck between the potential benefits of the supervisory action and the costs and impact on pension fund members and beneficiaries and, where appropriate, plan sponsors.*

*Once a problem is identified, a clear and well-defined 'due process' should be followed. Due process describes the checks and balances that a supervisory authority should have in place to ensure that supervised entities are treated fairly, consistently and transparently.*

*To ensure proportionality, requirements should be set out in legislation, secondary regulation or detailed industry guidance (outlining various circumstances and risk as well as the associated intervention measures). Appropriate documentation, guidance and examples should be regulated or provided to staff.*

*Subject to the availability of regulatory and administrative powers and measures, the response should be escalated appropriately to achieve the desired regulatory objectives. Depending on the nature, scale and complexity of the problem detected, a graduated response or exceptional measures should be adopted.*

*In fulfilling its supervisory powers, the pension supervisory authority should give pension funds and plans flexibility, where appropriate, in the way they achieve compliance with regulatory requirements.*

*Supervisory decisions and intervention should be consistent (both horizontally between pension funds and vertically over time), taking appropriately into account circumstances of each individual case. Supervisors should have well-documented procedures (for example, documentation, training, peer review, specialist team reviews and/or senior oversight) for ensuring that similar decisions are taken in similar circumstances and that these decisions are taken on objective and unbiased*

grounds.

## *Principle 9: Transparency*

*Pension supervisory authorities should conduct their operations in a transparent manner*

*Pension supervisory authorities should adopt clear, transparent and consistent supervisory processes. The rules and procedures of the pension supervisory authority, and updates thereof, should be published. The pensions supervisory authority should generally operate in a transparent environment and should provide and publish a regular report – at least annually and in a timely manner – on the conduct of its policy, explaining its objectives and describing its performance in pursuing those objectives.*

*The pension supervisory authority should be subject to regular audit and reporting requirements which allow for the assessment of how well the authority is fulfilling its responsibilities and ensuring the mandate and functions of the pension supervisory authority cannot be changed on an ad hoc basis.*

*Where appropriate, the broad outlines of any supervisory response framework (such as an enforcement pyramid) should be made public by the supervisory authority, so that its actions are well understood by supervised entities and not unexpected.*

*When directing or replacing the management of pension funds or plans pension supervisory authorities should explain and give due notice of the reasons for the supervisory action.*

*A transparent information disclosure mechanism and timely publication of intervention and sanction decisions, where appropriate, should be in place, subject to relevant confidentiality requirements.*

*Pension supervisory authorities should provide and publish clear and accurate information for the pension industry and the general public on a regular basis – such as the financial situation of the pension fund industry and observations on major developments in the pension sector. Disclosure will generally be on an aggregate basis, but could also be on individual pension funds, in which case the rules of confidentiality may be particularly relevant.*

## *Principle 10: Governance*

*The supervisory authority should adhere to its own good governance practices – including governance codes, internal risk-management systems and performance measurement - and should be accountable*

*Pension supervisory authorities should be clearly accountable for their general conduct and activity through accountability arrangements, which will vary according to specific country circumstances and which may include accountability to a range of bodies,*

*from parliament or head of state, Ministry of Finance to the members and beneficiaries of pension funds or plans.*

*Pension supervisory authorities should be subject to an external audit by a state or independent audit institution.*

*Procedures should be in place for the governing body of a pension plan or fund to appeal to the pension supervisory authority or relevant tribunal for decisions taken by the pension supervisory authority that affect them and which they consider unreasonable or inconsistent with legal provisions. Individual members of staff at the supervisory authority should have indemnity from civil prosecution.*

## **Solvency II Directive**

### **Article 29 – General principles of supervision**

- 1. Supervision shall be based on a prospective and risk-based approach. It shall include the verification on a continuous basis of the proper operation of the insurance or reinsurance business and of the compliance with supervisory provisions by insurance and reinsurance undertakings.*
- 2. Supervision of insurance and reinsurance undertakings shall comprise an appropriate combination of off-site activities and on-site inspections.*
- 3. Member States shall ensure that the requirements laid down in this Directive are applied in a manner which is proportionate to the nature, scale and complexity of the risks inherent in the business of an insurance or reinsurance undertaking.*
- 4. The Commission shall ensure that implementing measures take into account the principle of proportionality, thus ensuring the proportionate application of this Directive, in particular to small insurance undertakings.*

### **Article 31 – Transparency and accountability**

- 1. The supervisory authorities shall conduct their tasks in a transparent and accountable manner with due respect for the protection of confidential information.*
- 2. Member States shall ensure that the following information is disclosed:*
  - a. the texts of laws, regulations, administrative rules and general guidance in the field of insurance regulation;*
  - b. the general criteria and methods, including the tools developed in accordance with Article 34(4), used in the supervisory review process as set out in Article 36;*
  - c. aggregate statistical data on key aspects of the application of the prudential framework;*
  - d. the manner of exercise of the options provided for in this Directive;*
  - e. the objectives of the supervision and its main functions and activities.*

*The disclosure provided for in the first subparagraph shall be sufficient to enable a comparison of the supervisory approaches adopted by the supervisory authorities of the different Member States.*

*The disclosure shall be made in a common format and be updated regularly. The information referred to in points (a) to (e) of the first subparagraph shall be accessible at a single electronic location in each Member State.*

3. *Member States shall provide for transparent procedures regarding the appointment and dismissal of the members of the governing and managing bodies of their supervisory authorities.*
4. *The Commission shall adopt implementing measures relating to paragraph 2 specifying the key aspects on which aggregate statistical data are to be disclosed, and the format, structure, contents list and publication date of the disclosures.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

## **OPC reports**

- 14.2.9. The EIOPA Risk Management Rules<sup>56</sup> report concluded that there exists “a wide spectrum of risk management (RM) rules and supervisory practices amongst Member States, mainly reflecting the different stages of development which derives from the varying importance attached to second pillar pensions.”
- 14.2.10. In particular, the report found that “in terms of character of supervision, 10% of countries have a rules-based system while 14% follow a risk based approach. The majority of countries have a mixed supervisory approach”.
- 14.2.11. The report provides some detail regarding the variety of supervisory regimes amongst Member States, investigating such issues as risk sharing between IORPs, sponsoring entities, and members and beneficiaries; rules based supervision vs. risk based supervision and the correlation with the types of risk management rules implemented.
- 14.2.12. For convenience the “Conclusions” section of the report is reproduced here as the supervisory practices discussed are quite relevant to CfA 9.

### *“CEIOPS Report on Risk Management Rules applicable to IORPs - Conclusions*

*The survey revealed a wide spectrum of risk management (RM) rules and supervisory practices amongst Member States, mainly reflecting the different stages of development which derives from the varying importance attached to second pillar pensions.*

*The conclusions presented next were drawn from the 23 responding countries.*

### *General remarks stemming from the survey:*

*Depending on the type of plans, risks can be shared by the different stakeholders (sponsoring undertakings, the IORPs themselves, participant/members). Pure DB plans, where the sponsoring undertaking supports all the risks, and pure DC plans, where the participant/member supports all the risks, are the most common type of plans. However, it is interesting to see the variety of other types of risk sharing options and the countries where they are implemented.*

*In countries with DC pension provision only Spain and the UK have specific legal provisions regarding life cycling, although Bulgaria is working on a draft amendment to the legislation to cater for it. For some countries investment options are a very common feature of their DC pension plans (which addresses the issue of different risk appetites) and life cycle options is a current practice.*

*In terms of character of supervision, 10% of countries have a rules based system while 14% follow a risk based approach. The majority of countries have a mixed supervisory approach, with 33% of countries following a risk based approach with some elements of the rules based system and 43% following a rules based approach with some elements of risk based supervision.*

#### *Findings about risk management rules*

*The risk management rules were segregated into two broad groups, generic rules which comprised five rules (1. Existence of RM function; 2. Fit & proper requirements for RM function; 3. Documentation of RM policies; 4. Proportionality rules; and 5. Definition of a RM process); and specific rules which were further segregated into five types of risk (1. Investment risk (divided into four risks: market, credit, liquidity and ALM); 2. Operational risk; 3. Strategic & External Risk; 4. Scheme specific risk; and 5. Other risks). This segregation of risk management rules were used throughout the report.*

*Globally speaking, slightly more than half the Member States have implemented generic risk management rules although acknowledgement should be made of the fact that 19 of the responding countries (83%) have implemented at least one of the generic RM rules. Concerning the main forms of implementation of these RM rules, only the fit & proper requirements for the RM function is usually established by primary legislation while the remaining four generic rules are mainly established by secondary legislation. Non-binding supervisory guidance is used to establish the proportionality rules and definition of a risk management process.*

*From an overall perspective, more than half the countries have implemented specific risk management rules. Considering the specific rules, one concludes that market risk, credit risk and operational risk are those which are subject to more legislative/regulatory action while strategic & external risk and other risks are the ones subject to less action. In terms of implementation method, the specific rules are more or less consistently implemented in the same way across the specific risks (with the exception of other risks) with secondary legislation being the first form of implementation and primary legislation and non-binding supervisory guidance being the second (with roughly the same weight).*

*The majority of countries who have implemented fit and proper requirements for the people responsible for the RM function have chosen to do it by specifying generic requirements, although three countries have put down specific requirements.*

*In terms of risk management documentation rules, the components of such documentation usually cover the RM objectives, the RM responsibilities and functions and the risk management process. Some countries also extended the requirements to cover the risk register and the risk treatment.*

*Proportionality rules were established in eight countries and they usually follow the lines of "adequate to the IORPs dimension, nature and complexity of the operations and should take into consideration the specificity of the IORPs risks".*

*Eleven countries have additional disclosure requirements to members and beneficiaries about risk management other than those set forth in the Directive. Among the additional disclosures required are: to give advice on risks; to mandatorily provide pension projections and indicate the volatility of pension asset values; to mandatorily explain the risks, the investment options (if applicable), the information on potential risk and the costs related to the investment provided the member bears the investment risk; and finally the requirement for a three yearly report covering all risks attached to the financial instruments and the methods used for management and evaluation of investment risk.*

*A reasonably clear generalisation that can be drawn about the character of supervision is that countries with rules based system tend to have lower level of risk management rules. Apart from this conclusion, the character of supervision seems to have no influence on the level of RM rules.*

*The results of the survey suggests, although without strong evidence, that there is a higher level of RM rules for countries where the pension provision system is characterized by plans where the IORP itself supports most of the risks. For countries where their pension provision system is mainly made of other risk sharing options (either the sponsoring undertaking or the members and beneficiaries takes the majority of the risks) it is difficult to find a pattern.*

#### *Findings about supervisory practices regarding risk management in IORPs*

*In terms of supervisory practices, the supervisory authorities tend to focus on the risk management issues for which they have established rules. However there are cases where RM rules are not established but the supervisory authorities dedicate resources to verify it – that is the case of the investment risk specific rules. The opposite also happens, in which case there are RM rules but they do not get much attention in the supervisory process – that is the case of the proportionality rules and definition of a RM process (both belonging to the generic rules).*

*Although the information required by regulatory reporting plays an important role in the supervisory process the most used instrument of supervision of the RM rules are the on-site inspections. The use of reports from external entities (auditors, actuaries, risk managers) and the information required on ad-hoc basis are also used in the supervisory process but with a marginal relevance.*

*The statement of investment policy is the document most commonly used by supervisory authorities in supervising the investment risk. However, there are other important documents that are being used to a considerable extent in a number of jurisdictions for investment risk supervision: the investment risk management policy, the asset liability management procedures and the investment risk management report.*

*It seems there is a slight relationship between the character of supervision and the supervisory practices of the RM rules. There appears to be some evidence that relates the risk based systems with a higher level of supervision regarding the RM rules and the rules based supervisory approach with a lower level. In the supervisory approaches in between the relationship is not so evident.”*

### **14.3. Explanatory text**

#### EIOPA view on issues in the CfA

- 14.3.1 The Risk Management Rules report confirmed the wide variety of supervisory approaches and practices currently in operation. These reflect both the different histories of the pension systems of the Member States and the differing historical approaches to regulation.
- 14.3.2 Due to the fact that the objective of all pension supervision is to improve the security of members' and beneficiaries' future benefits, only a prospective approach is possible.
- 14.3.3 Where, for whatever reason, a rules-based approach has been adopted, there exists the possibility that this could conflict with a revised IORP Directive requiring a risk based approach.
- 14.3.4 A revised IORP Directive requiring an appropriate combination of off-site activities and on-site inspections would appear to make explicit the implicit objective of the current Directive in this regard.
- 14.3.5 Ensuring that all requirements of the Directive are applied in a proportionate manner with regard to the nature, scale and complexity of the IORP's risks is even more important in the case of IORPs than for other regulated entities, since there the differences of IORPs across Europe are much higher than e.g. in the insurance sector.
- 14.3.6 Supervisory authorities may have a concern as to what precise meaning to attach to the phrase 'verification on a continuous basis', since the frequency of data submissions and the feasibility of such supervisory actions as frequent on-site visits are variable in the context of IORP supervision, depending on the number of IORPs based in a particular Member State. At the IORP level, many IORPs do not have truly continuous operational governance (e.g. IORP governing bodies that meet monthly or less frequently), so their operational characteristics fundamentally differ from insurance entities. For example, daily reporting is not a possibility for most IORPs.
- 14.3.7 The requirement to 'verify on a continuous basis' the proper operation of the undertaking and compliance of the undertaking with supervisory provisions is suitable for IORPs. However, further clarification is needed in order to provide more detail on its proportionate application to the heterogeneous IORP landscape within the European Union.
- 14.3.8 In the context of the supervision of IORPs, it is possible that the goals of Articles 29 and 31 of the Solvency II Directive may be best achieved by means other than revisions to the IORP Directive. One argument in favour of this approach would be to retain the focus of purpose of the Directive as

being the supervision of IORPs, rather than on the objectives and operations of supervisory authorities.

- 14.3.9 Be that as it may, the options considered below are expressed in terms of revisions to the IORP Directive.
- 14.3.10 Overall, it might be expected that there would be broad support from all parties for the adoption of the principles expressed in Article 29, save for any practical reservations, e.g. conflict with pre-existing rules based systems.
- 14.3.11 Addressing the issues raised in Article 31 – transparency and accountability – significant progress has been made already in improving transparency and accountability, e.g., the publication of various reports on the implementation of the IORP Directive by EIOPA/CEIOPS to date; Member States have agreed to publicise the Social and Labour Law they require cross-border IORPs to apply to members; work is ongoing at the present time regarding statistical data to be provided to the ESRB.
- 14.3.12 Going significantly beyond the current position is a difficult undertaking in the context of IORP supervision, owing to the great variety of IORPs across Member States.
- 14.3.13 In particular, the disclosures listed under Article 31(2) may not achieve the stated objective of enabling a comparison of supervisory approaches, owing to the variety of pensions systems under supervision.
- 14.3.14 The degree to which statistical information is easily available to supervisors, or available at all, varies between member states, and, again owing to the variety of pensions systems under supervision, aggregate statistics may not be comparability in a meaningful way.
- 14.3.15 Also, the degree to which disclosures can be made in a common format, as required under Article 31, is limited at the current time, would be of severely limited usefulness and could be burdensome for supervisors and IORPs.
- 14.3.16 However, these concerns are in relation to the current situation regarding IORPs across Member States. A future position involving increased harmonisation of practice would mean that reporting in a common format would become both useful and feasible.

#### Policy options

##### Article 29 (Risk based supervision)

Option 1: Leave the IORP Directive unchanged

Do not adopt Article 29 of the Solvency II Directive into the IORP Directive.

Option 2: Adopt Article 29 into the revised IORP Directive.

##### Article 31 (Transparency and accountability of the supervisor)

Option 1: Leave the IORP Directive unchanged

Do not adopt elements from Articles 31 of the Solvency II Directive into the IORPs Directive.

Option2: Adopt the main elements of Article 31 into the revised IORP Directive.

The selection of the elements of Article 31 that could be adopted should be such that the variety of IORP entities and pension systems is accommodated. The precise details of the adopted elements would depend on revisions to other parts of the IORP Directive.

#### **14.4. Impact assessment**

##### I ARTICLE 29 (RISK BASED SUPERVISION)

Option 1: Leave the IORP Directive unchanged

Option 2: Adopt Article 29 into the revised IORP Directive.

##### Positive impacts

Option 1: Leave the IORP Directive unchanged

No impact.

Option 2: Adopt Article 29 into the revised IORP Directive

- IORP members and beneficiaries
- IORPs and sponsoring employers
  - consistency with existing regulation in Solvency II
- Supervisory authorities
  - changes would make explicit what can only be found implicitly in the current Directive.
  - increased consistency of supervisory approaches,

##### Negative impacts

Option 1: Leave the IORP Directive unchanged

No impact.

Option 2: Adopt Article 29 into the revised IORP Directive

- IORP members and beneficiaries
  - (small) incremental compliance costs to IORP might be ultimately passed on to members and beneficiaries
- IORPs and sponsoring employers
  - Some degree of burden on IORPs in relation to the provision of additional data;
- Supervisory authorities
  - Some degree of burden on supervisors, specifically, in terms of possible modification of existing practices to conform with the revised Directive;

## II ARTICLE 31 (TRANSPARENCY AND ACCOUNTABILITY OF THE SUPERVISOR)

Option 1: Leave the IORP Directive unchanged

Option2: Adopt the main elements of Article 31 into the revised IORP Directive.

### Positive impacts

Option 1: Leave the IORP Directive unchanged

No impact.

Option 2: Adopt the main elements of Article 31 into the revised IORP Directive

- IORP members and beneficiaries
- IORPs and sponsoring employers
  - better comparability of objectives and methods employed by supervisors,
  - consistency with existing regulation in Solvency II
- Supervisory authorities
  - changes would make explicit what can only be found implicitly in the current Directive.

### Negative impacts

Option 1: Leave the IORP Directive unchanged

No impact.

## Option 2: Adopt the main elements of Article 31 into the revised IORP Directive

- IORP members and beneficiaries
  - (small) incremental compliance costs to IORP might be ultimately passed on to members and beneficiaries
- IORPs and sponsoring employers
  - Some degree of burden on IORPs in relation to the provision of additional data;
- Supervisory authorities
  - Some degree of burden on supervisors, specifically, in terms of possible modification of existing practices to conform with the revised Directive;

### Conclusion / Concluding remark

- 14.4.1 EIOPA is of the opinion that article 29 (risk based supervision) and the main elements of article 31 (supervisory disclosure) would benefit convergence among the EU. Therefore, for both articles EIOPA favours option 2, and advises to include article 29 and these main elements of article 31 into the revised IORP Directive.

## 14.5. EIOPA advice

*The EIOPA advice should address at least the following subjects:*

- *The material elements of Article 29 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the **general principles of supervision**;*
  - *The material elements of Article 31 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to **transparency and accountability**;*
  - *Other rules for IORPs, if any.*
1. EIOPA's view is that although many of the issues addressed in the context of SII by Articles 29 & 31 are in fact already in place either implicitly in the current IORP Directive (supervisory principles) or are being progressed by supervisors via EIOPA (transparency and accountability issues), adoption of the substance of Articles 29 & 31, at least in part, and to the extent feasible, would be of great benefit to convergence of supervisory approaches and to the transparency and accountability.
  2. In relation to the general principles of supervision (article 29), EIOPA considers that several Member States currently function under a (primarily) rules based system. These member States should have the possibility to gradually move to a risk based system.
  3. The issue of different pension supervisory systems also applies to transparency and accountability (article 31). There is variety in the information, both statistical and qualitative, that is available in member States. Harmonisation of disclosure requirements may therefore require some time.
  4. It is EIOPA's view that a common format for disclosures is not useful currently as there is no common approach to supervision, but a common format would probably be useful in a revised IORP Directive. Such a common approach would not prevent the supervisory authorities seeking additional information.
  5. The adoption of each specific item, if decided desirable, needs to be carefully considered to ensure that:
    - a) adoption will be appropriate in terms of security of member and beneficiary benefits and the costs attached to it;
    - b) the differences between insurance entities and IORPs are recognised;
    - c) the differences between the supervision of insurance entities and the supervision of IORPs are recognised; and
    - d) revisions to the IORP Directive are drafted to allow for the diversity of IORPs across the Member States.

## 15. CfA 10: General supervisory powers

### 15.1. Extract from the call for advice

The Commission Services would like EIOPA to advise on detailed rules by which supervisors can ensure that IORPs have proper stress test systems in place. EIOPA should also reflect on the possibility for national supervisors to impose administrative sanctions on IORPs which are sufficiently high to have a deterrent effect.

The EIOPA advice should address at least the following subjects:

- The material elements of Article 34(4) of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to **stress test**;
- The material elements of Article 36 of Regulation No 1060/2009 on credit rating agencies that should be amended or removed to adequately address the specificities of IORPs in relation to **administrative sanctions**;
- The effectiveness of Article 20(10) of the IORP Directive in practice;
- Other general supervisory powers for IORPs, if any.

### 15.2. Background

Current legal requirements (IORP Directive)

- 15.2.1. The IORP Directive already contains, within articles 13, 14 and 20, some provisions on the general supervisory powers of pension fund supervisory authorities.
- 15.2.2. Article 13(a) and (c) provide access to information, and article 13(d) enables supervisors to carry-out on-site inspections. Article 14(2) first paragraph enables supervisors to take measures against the IORP or its management. And articles 14(2) second paragraph and 14(4) of the IORP Directive contain provisions concerning preventive and corrective measures. As regards cross-border activity, Article 20(10) of the IORP Directive provides that the host Member State may take action against an IORP in another Member State if its social and labour law is not respected.
- 15.2.3. The IORP Directive does however not contain explicit provisions for supervisors to require stress tests nor specific requirements regarding administrative sanctions on IORPs, but it does contain provisions for supervisors to have powers to take any measures, administrative or financial.

Article 13: Information to be provided to the competent authorities

*Each Member State shall ensure that the competent authorities, in respect of any institution located in its territory, have the necessary powers and means:*

- (a) *to require the institution, the members of its board of directors and other managers or directors or persons controlling the institution to supply information about all business matters or forward all business documents;*
- (b) *..*
- (c) *to obtain regularly the statement of investment-policy principles, the annual accounts and the annual reports, and all the documents necessary for the purposes of supervision. These may include documents such as:*
  - (i) *internal interim reports;*
  - (ii) *actuarial valuations and detailed assumptions;*
  - (iii) *asset-liability studies;*
  - (iv) *evidence of consistency with the investment-policy principles;*
  - (v) *evidence that contributions have been paid in as planned;*
  - (vi) *reports by the persons responsible for auditing the annual accounts referred to in Article 10*
- (d) *to carry out on-site inspections at the institution's premises and, where appropriate, on outsourced functions to check if activities are carried out in accordance with the supervisory rules.*

#### Article 14: Powers of intervention and duties of the competent Authorities

2. *The competent authorities shall have the power to take any measures including, where appropriate, those of an administrative or financial nature, either with regard to any institution located in their territories or against the persons running the institution, which are appropriate and necessary to prevent or remedy any irregularities prejudicial to the interests of the members and beneficiaries.*

*They may also restrict or prohibit the free disposal of the institution's assets when, in particular:*

- (a) *the institution has failed to establish sufficient technical provisions in respect of the entire business or has insufficient assets to cover the technical provisions;*
  - (b) *the institution has failed to hold the regulatory own funds.*
3. *..*
  4. *The competent authorities may prohibit or restrict the activities of an institution located in their territories in particular if:*
    - (a) *the institution fails to protect adequately the interests of members and beneficiaries;*
    - (b) *the institution no longer fulfils the conditions of operation;*

- (c) *the institution fails seriously in its obligations under the rules to which it is subject;*
- (d) *in the case of cross-border activity, the institution does not respect the requirements of social and labour law of the host Member State relevant to the field of occupational pensions.*

*Any decision to prohibit the activities of an institution shall be supported by precise reasons and notified to the institution in question.*

#### Article 20: Cross-border activity

10. *If, despite the measures taken by the competent authorities of the home Member State or because appropriate measures are lacking in the home Member State, the institution persists in breaching the applicable provisions of the host Member State's requirements of social and labour law relevant to the field of occupational pension schemes, the competent authorities of the host Member State may, after informing the competent authorities of the home Member State, take appropriate measures to prevent or penalise further irregularities, including, insofar as is strictly necessary, preventing the institution from operating in the host Member State for the sponsoring undertaking.*

#### EIOPA Regulation

#### Article 23 - Identification and measurement of systemic risk

1. *The Authority shall, in consultation with the ESRB, develop criteria for the identification and measurement of systemic risk and an adequate stress testing regime which includes an evaluation of the potential for systemic risk that may be posed by financial institutions to increase in situations of stress.*

*The Authority shall develop an adequate stress testing regime to help identify those financial institutions that may pose a systemic risk. These institutions shall be subject to strengthened supervision, and where necessary, to the recovery and resolution procedures referred to in Article 25.*

2. *The Authority shall take fully into account the relevant international approaches when developing the criteria for the identification and measurement of systemic risk that may be posed by insurance, re-insurance and occupational pensions institutions, including those established by the Financial Stability Board, the International Monetary Fund, the International Association of Insurance Supervisors and the Bank for International Settlements.*

#### Article 32 - Assessment of market developments

2. *The Authority shall, in cooperation with the ESRB, initiate and coordinate Union-wide assessments of the resilience of financial institutions to adverse market developments. To that end, it shall develop the following, for application by the competent authorities:*

*(a) common methodologies for assessing the effect of economic scenarios on an institution's financial position;*

Core Principle 7: Supervision

*Effective supervision of pension funds and plans must be set up and focus on legal compliance, financial control, actuarial examination and supervision of managers. Appropriate supervisory bodies, properly staffed and funded, should be established in order to conduct when relevant off and on site supervision, at least for some categories of funds and in particular when problems are reported. Supervisory bodies should be endowed with appropriate regulatory and supervisory powers over individual plans, in order to prevent mis-selling cases arising from irregularities in the distribution and expenses methods.*

IOPS Principles of Private Pension Supervision

*Principle 4: Adequate Powers*

*Pension supervisory authorities should be endowed with the necessary investigatory and enforcement powers to fulfil their functions and achieve their objectives*

- 1. Pension supervisory authorities should be legally empowered to undertake supervision and should be granted adequate powers and the capacity to exercise these powers.*
- 2. The pension supervisory authority should have the power to conduct necessary supervisory functions, according to the nature of the pension system being supervised. Effective supervision of pension funds or plans should focus on legal compliance, financial soundness and control, minimum capital requirements, investment activity, good governance and integrity, actuarial examination, the supervision of pension plan or fund managers, and the provision for adequate disclosure of information to members. Powers should allow for relevant off-site and on-site inspection.*
- 3. Pension supervisory authorities should have comprehensive investigatory and enforcement powers. The legal framework that defines conditions and circumstances under which the pension fund supervisor must intervene should be flexible enough to enable the pension supervisor to undertake preventative, protective or punitive actions.*
- 4. The pension supervisory authority should have the power to conduct a full investigation when a problem is suspected or observed, obliging funds and other relevant parties (such as asset managers, custodians, auditors) to make documents and information available. Necessary powers include the ability to impose corrective measures and remedial actions if the authority's orders are not carried out. The scope of the powers may extend to the power to impose administrative sanctions such as fines, to direct management, to revoke licences and to refer matters for criminal prosecution. In some cases, powers may include the ability to issue binding regulation.*
- 5. The pension supervisory authority should have clear and well-defined strategic supervisory goals for the use of intervention, enforcement and sanction powers, clearly establishing whether the goal of their action is preventative, protective or punitive and use the appropriate tools and powers accordingly. The supervisory*

*authority should have a coherent, well thought-out policy for deciding on the mix of supervisory tools adopted and the ability to adapt this approach to changing circumstances.*

- 6. A sufficient gradation of powers is required to enable the supervisory authority to tailor its response accordingly and sufficiently punitive powers are needed to enforce action.*
- 7. Though not all powers may be used 'actively', the supervisory authority should still have certain powers either to use in exceptional circumstances – thereby avoiding what could be time consuming delays in dealing with other supervisory authorities – or, by acting as a deterrent, serving to modify the behaviour of supervised entities.*
- 8. Pension supervisory authorities should have the power to take exceptional measures, if needed, in times of acute financial and economic difficulty and /or volatility (for example increasing reporting requirements, strengthening stress tests, or temporarily suspending certain regulatory or supervisory requirements which may have a pro-cyclical, adverse impact on financial markets in the short-term).*

### *Solvency II Directive*

#### *Article 34 – General supervisory powers*

- 1. Member States shall ensure that the supervisory authorities have the power to take preventive and corrective measures to ensure that insurance and reinsurance undertakings comply with the laws, regulations and administrative provisions with which they have to comply in each Member State.*
- 2. The supervisory authorities shall have the power to take any necessary measures, including where appropriate, those of an administrative or financial nature, with regard to insurance or reinsurance undertakings, and the members of their administrative, management or supervisory body.*
- 3. Member States shall ensure that supervisory authorities have the power to require all information necessary to conduct supervision in accordance with Article 35.*
- 4. Member States shall ensure that supervisory authorities have the power to develop, in addition to the calculation of the Solvency Capital Requirement and where appropriate, necessary quantitative tools under the supervisory review process to assess the ability of the insurance or reinsurance undertakings to cope with possible events or future changes in economic conditions that could have unfavourable effects on their overall financial standing. The supervisory authorities shall have the power to require that corresponding tests are performed by the undertakings.*
- 5. The supervisory authorities shall have the power to carry out on-site investigations at the premises of the insurance and reinsurance undertakings.*
- 6. Supervisory powers shall be applied in a timely and proportionate manner.*

7. *The powers with regard to insurance and reinsurance undertakings referred to in paragraphs 1 to 5 shall also be available with regard to outsourced activities of insurance and reinsurance undertakings.*
8. *The powers referred to in paragraphs 1 to 5 and 7 shall be exercised, if need be by enforcement and, where appropriate, through judicial channels.*

#### Regulation No 1060/2009

With regard to administrative sanctions the CfA refers to Art. 36 of Regulation No 1060/2009 on credit rating agencies. This article has been changed recently by Regulation 513/2011 of 11 May 2011. The following text includes these changes:

#### *Article 36 - Penalties*

*Member States shall lay down the rules on penalties applicable to infringements of ~~the provisions of this Regulation Article 4(1)~~ and shall take all measures necessary to ensure that they are implemented. The penalties provided for shall be effective, proportionate and dissuasive.*

*Member States shall ensure that the sectoral competent authority disclose to the public every penalty that has been imposed for infringement of ~~this Regulation Article 4(1)~~, unless such disclosure would seriously jeopardise the financial markets or cause disproportionate damage to the parties involved.*

*By 7 December 2010 the Member States shall notify the rules referred to in the first subparagraph to the Commission. They shall notify the Commission without delay of any subsequent amendment thereto.*

- 15.2.4. The reasons for the change are the transfer of competence of the supervision of credit rating agencies from the national supervisory authorities to ESMA. National supervisory authorities remain, however, competent for the supervision of the use of credit ratings by financial institutions. See recital 9 and 21 of Regulation 513/2011 and Article 4(1) of Regulation 1060/2009:

*(9) ESMA should be responsible for the registration and ongoing supervision of credit rating agencies, but not for the oversight of the users of credit ratings. Competent authorities designated under the relevant sectoral legislation for the supervision of credit institutions, investment firms, insurance undertakings, assurance undertakings, reinsurance undertakings, undertakings for collective investment in transferable securities (UCITS), institutions for occupational retirement provision and alternative investment funds should therefore remain responsible for the supervision of the use of credit ratings by those financial institutions and entities which are supervised at national level in the context and for the purpose of the application of other financial services directives, and of the use of credit ratings in prospectuses.*

*(21) Member States should remain competent to lay down and implement the rules on penalties applicable to the infringement of the obligation on financial institutions and other entities to use, for regulatory purposes, only credit ratings issued by credit rating agencies registered in accordance with Regulation (EC) No 1060/2009.*

#### *Article 4(1) - Use of credit ratings*

*Credit institutions as defined in Directive 2006/48/EC, investment firms as defined in Directive 2004/39/EC, insurance undertakings subject to the First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance, assurance undertakings as defined in Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance, reinsurance undertakings as defined in Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance, UCITS as defined in Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), institutions for occupational retirement provision as defined in Directive 2003/41/EC and alternative investment funds may use credit ratings for regulatory purposes only if they are issued by credit rating agencies established in the Union and registered in accordance with this Regulation.*

15.2.5. On 8 December 2010, the European Commission published a consultation document<sup>57</sup> on sanctioning regimes in the financial sector. The contributions received were summarised in a feedback statement<sup>58</sup>. Below is a brief overview of some of the conclusions relevant to the CfA:

*(1) Appropriate types of administrative sanctions*

*There is a consensual view among different stakeholders that, to have a level playing field in the EU, a common set of core administrative tools should be available to all national competent authorities to address key violations of the EU financial services legislation.*

*(2) Publication of sanctions*

*This is because the publication of sanctions creates more transparency in the decisional practice, reinforces deterrence of sanctions and helps customers of the companies concerned and investors to take informed decisions. Other respondents, in particular the industry representatives, believe that the publication should be decided on a case-by case basis in view of the high reputational damage this could create for an individual company.*

*(3) Level of administrative pecuniary sanctions*

*Respondents were in general favourable to harmonising certain aspects related to the level of administrative fines in order to have more deterrent and effective sanctioning regimes in the EU.*

*However, most of the respondents rejected this idea mainly because of the difficulty to establish an appropriate minimum figure in the EU 27. There is however a broad agreement among the stakeholders that the EU law could provide for a sufficiently high maximum levels to be applied across the EU to allow competent authorities to apply deterrent sanctions to the most serious violations.*

*(5) Appropriate criteria for sanctions*

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<sup>57</sup> CEIOPS, parallel with CEBS and CESR, provided input to the Commission on this issue: CEIOPS' Report to the European Commission on EU Supervisory Powers, Objectives, Sanctioning Powers and Regimes, CEIOPS-SEC-21/09, 29 May 2009

<sup>58</sup> [http://ec.europa.eu/internal\\_market/consultations/docs/2010/sanctions/feedback\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2010/sanctions/feedback_en.pdf)  
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*There is a consensual view among different stakeholders that all the national competent authorities from the EU have to use a common set of appropriate criteria when applying sanctions. As for the types of sanctions, respondents underlined that this set of appropriate criteria should be non-exhaustive in the sense that the Member States may provide any additional criterion to be taken into account by their authorities.*

#### *Next steps:*

*The Commission envisages establishing minimum common standards that Member States should respect in designing and using their administrative sanctioning regimes for the EU financial services legislation. At this stage, the Commission decided to introduce those minimum standards as appropriate in each specific piece of EU legislation when that legislation will be reviewed.*

#### *OPC reports*

- 15.2.6. EIOPA has conducted a mapping exercise of supervisory approaches to stress testing for European IORPs<sup>59</sup>, parallel to a similar exercise for the insurance sector.
- 15.2.7. The results of this exercise are confidential and only available for EIOPA members. However, these are the general conclusions of this exercise:

*The mapping exercise shows that only approximately half of CEIOPS Members and Observers have conducted a stress test or modelling exercise for IORPs with one-third of these being a result of the financial crisis. The modelling exercises that were mentioned by four Member States varied in approach from a general exercise to measure the impact of the crisis on IORPs and inform the supervisory approach, to a more in depth analysis of projections at the individual IORP level. In general, stress tests are adapted to national circumstances and the main risks relevant to a stress test seem to be covered.*

*The lack of reported stress testing across many Member States can be explained by a number of reasons. Stress testing is mainly associated with DB arrangements, but some Member States run stress tests also for DC schemes, especially if they offer a guaranteed return. Stress tests would not play a role in Member States that have not yet established IORPs. Also, stress testing is often not seen as relevant by some Member States where the risk is borne by the sponsor and/or members rather than the IORP itself.*

*The uses of the stress testing and modelling work varied across respondents. However, the majority of Member States uses the results at an individual IORP level and additionally also in order to assess the systemic robustness of the IORP sector. Some Member States explicitly mentioned that they used the exercise to inform their supervisory and policy decisions.*

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<sup>59</sup> CEIOPS-OP-45-09 (final), 30 October 2009

### 15.3. Explanatory text

#### EIOPA view on issues in the CfA

##### Stress testing

- 15.3.1. The insurance sector, as a result of Solvency II, will be subject to stress testing at different levels:
- insurance companies' own stress test as part of the internal model validation (Article 124 SII, Article 230 TSIM19 IM);
  - stress test developed by national supervisory authority (to be run by authority and/or by the undertaking) (Article 34(4) SII);
  - EU-wide stress test developed by EIOPA (Article 23 EIOPA Regulation).
- 15.3.2. EIOPA has already conducted several EU-wide stress tests for the large European insurance companies. Up till now it was decided not to develop a similar exercise for IORPs. One of the reasons being the underlying divergence in calculation of liabilities which would make it impossible to conduct the same stress test to IORPs from different countries.
- 15.3.3. However, EIOPA, within its Regulation (Article 23), now has the obligation to develop such EU-wide stress tests for IORPs as well.
- 15.3.4. With regard to the stress testing requirements for the insurance sector EIOPA has conducted its latest stress test on a limited scope in view of the proportionality principle. The scope was defined as the 30 largest insurance companies, supplemented by smaller companies to reach at least 50% of the insurance market of each country as measured by gross premium income. The approach is also to avoid duplication. As such, supervisory authorities are not required to develop stress tests on top of the EU-wide stress test. Nonetheless, they can still develop national stress tests if they wish to. It is suggested that when transposing this to the pensions sector, the proportionality principle should equally be considered when setting the scope of any EU-wide stress tests and that any duplication should also be avoided.
- 15.3.5. EIOPA considers that Article 34(4) of the Solvency II Directive is a good basis for providing the supervisory authorities the powers to develop necessary tools to test the financial situation of IORPs. However, given the wide diversity in size, type of pension benefits managed, and the level of risk taking, the principle of proportionality must be applied EU-wide and within Member States. This principle is not clearly set out in Article 34(4) itself but can be found in Article 36(6)2nd paragraph: "The supervisory authorities shall establish the minimum frequency and the scope of those reviews, evaluations and assessments having regard to the nature, scale and complexity of the activities of the insurance or reinsurance undertaking concerned."
- 15.3.6. National supervisory authorities must assess the feasibility and usefulness of developing stress tests taking into account the type of IORPs under supervision. Attempting to develop a common stress test to be conducted on all IORPs might be counterproductive. Some segments of the market (the

large and/or complex IORPs) might benefit from a more in depth stress test, whereas running a simplified stress test on smaller and/or less complex IORPs might be more cost and time effective.

- 15.3.7. Article 34(4) provides the power to supervisory authorities to have such stress tests run by the undertaking itself, however, when transposing this to IORPs, supervisory authorities must assess the capacity of IORPs to run such stress tests. The same reasoning as in the above paragraph applies: larger IORPs should be able to run themselves stress tests developed by the supervisory authority whereas smaller IORPs would not. It depends, of course, on the depth and complexity of the stress test to be run.

#### Administrative Sanctions

- 15.3.8. The sanctioning regime in Solvency II (Article 34(2)) is similar to the dispositions in the IORP Directive (Article 14(2)) in that it is very vague and gives a lot of latitude in how to use sanctioning powers. Regulation 1060/2009 has a more developed sanctioning regime. This is probably the result of the findings of the financial crisis and the observation of shortcomings in existing national sanctioning regimes in the financial sector in terms of lack of sufficient deterrence and divergences in the application of sanctions.
- 15.3.9. The novelties of the sanctioning regime in Regulation 1060/2009 –abstraction made of the sanctioning regime applicable to the credit rating agencies itself which is now the competence of ESMA – are the obligation of Member States to lay down rules on penalties, and foremost to publicly disclose every penalty that has been imposed, unless such disclosure would seriously jeopardise the financial markets or cause disproportionate damage to the parties involved.
- 15.3.10. EIOPA considers that the obligation to establish rules on penalties is part of the good governance of the supervisory authority. This is supported by the IOPS principle nr. 4 on adequate powers, paragraph 5 (see above).
- 15.3.11. The case for obliging every penalty imposed to be published is less obvious. As the conclusions of the Commission's consultation on sanctioning regimes points out, "the publication of sanctions creates more transparency in the decisional practice, reinforces deterrence of sanctions and helps customers of the companies concerned and investors to take informed decisions." This is true in the field of financial services where customers have the free choice of financial service provider and companies should be transparent towards customers and shareholders. However, in the case of occupational pension funds there is, in general, no free choice of pension provider for the members, nor are there shareholders to be informed.
- 15.3.12. Due to a lack of information on if and how supervisory authorities make penalties public, it is not possible for EIOPA to fully assess the possibilities of publication and the consequential impacts this may have. Therefore EIOPA considers that, for the moment, it cannot advise on making penalties public.
- 15.3.13. In case of a cross-border activity the Host Member State Competent Authority should always be informed if a penalty has been imposed. For

statistical reasons it is also proposed that EIOPA be informed on an anonymous basis.

#### Competence of Host Supervisor to take measures

- 15.3.14. Research conducted by the EIOPA Review Panel on the compliance by EIOPA Members of the provisions of the Budapest Protocol<sup>60</sup> has revealed that during the period under analysis there were no cases where a Host Member State had to take measures against a cross-border IORP. This makes it difficult to assess the effectiveness of Article 20(10) of the Directive in practice.
- 15.3.15. Art. 20(10) of the IORP Directive is similar to Article 155(3)<sup>61</sup> of the Solvency II Directive, however according to Article 155(1) the Host supervisor can immediately and directly (i.e. without passing through the Home supervisor) request an insurance undertaking to put a stop on breaching its legal provisions whereas this is not foreseen in the IORP Directive.
- 15.3.16. EIOPA's General Protocol<sup>62</sup> added the obligation for the Host supervisor to already inform the Home supervisor when it requests the insurance undertaking concerned to remedy such irregularity. This may be done parallel to the communication to the undertaking, i.e. there is no obligation to inform the Home supervisor a priori.
- 15.3.17. Solvency II, through Article 155(4), also contains additional powers for the Host supervisor to intervene immediately in case of emergency, prior to informing the Home supervisor, and Article 155(8) gives the power to the Host supervisor to request any documents from insurance undertakings operating in their country, only if the same requirements apply to undertakings for which they are Home supervisor.
- 15.3.18. A measure of effectiveness of Article 20(10) can be distilled from the effectiveness of the similar requirement in the insurance sector.
- 15.3.19. Research conducted by the EIOPA Review Panel on the compliance by EIOPA Members with the provisions of the General Protocol<sup>63</sup> has revealed that during the period under analysis only 2 Host supervisors had to intervene despite measures taken by the Home supervisor. This low number of cases, coupled with little information on these cases, makes it, again, difficult to assess the effectiveness of the provision in question.

#### Policy options

##### Stress testing

Option 1: Leave the IORP Directive unchanged

Option 2: include Article 34(4) of SII into the revised IORP Directive

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<sup>60</sup> Final Report of CEIOPS' Peer Review of the Exchange of Information and Cooperation Provisions of the Budapest Protocol, CEIOPS-RP-78-10 final, 23 December 2010

<sup>61</sup> The requirements in Article 155 already exist in the current insurance directives.

<sup>62</sup> General Protocol relating to the Collaboration of the Insurance Supervisory Authorities of the Member States of the European Union (revised Siena Protocol)

<sup>63</sup> Peer Review about the Exchange of Information and Cooperation Provisions of the General Protocol, CEIOPS-RP-150-10 final rev1, 30 December 2010

Under this option, it should be clear that the current diversity in pension systems across Europe probably does not allow for a single stress test to be used by all IORPs. Therefore, the introduction of stress tests into the IORP framework should be accompanied by the proportionality principle, allowing Member States and supervisors to perform stress tests that are fit-for-purpose under their specific jurisdiction.

#### Administrative Sanctions

Option 1: Leave the IORP Directive unchanged

Option 2: include Article 36 of the CRA Regulation into the revised IORP Directive

#### Competence of Host Supervisor to take measures

Option 1: Leave the IORP Directive unchanged

Option 2: include Articles 155(1), 155(4) and 155(8) of SII into the revised IORP Directive

### **15.4. Impact assessment**

#### I. STRESS TESTING

Option 1: Leave the IORP Directive unchanged

Option 2: Include article 34(4) of SII into the revised IORP Directive

#### Positive impacts

Option 1: Leave the IORP Directive unchanged

No impact.

Option 2: include Article 34(4) of SII into the revised IORP Directive

- IORP members and beneficiaries
  - higher level of members and beneficiaries protection
- IORPs and sponsoring employers
  - improved knowledge of the risks
  - allows for IORPs to take proactive measures
- Supervisory authorities

- identification of risks being built up in the system
- proactive tool for supervisors
- improved knowledge of the risks
- allows for supervisors and IORPs to take proactive measures

### Negative impacts

Option 1: Leave the IORP Directive unchanged

No impact.

Option 2: include Article 34(4) of SII into the revised IORP Directive

- IORP members and beneficiaries
  - Incremental compliance costs to IORP will be ultimately passed on to members and beneficiaries
- IORPs and sponsoring employers
  - burdensome calculations
- Supervisory authorities
  - lack of timely data
  - limited scope
  - a single stress test for all different pension systems might not be possible

## II. ADMINISTRATIVE SANCTIONS

Option 1: Leave the IORP Directive unchanged

Option 2: Include article 36 of the CRA Regulation into the revised IORP Directive

### Positive impacts

Option 1: Leave the IORP Directive unchanged

No impact

Option 2: Include article 36 of the CRA Regulation into the revised IORP Directive

- IORP members and beneficiaries
  - Increased transparency

- IORPs and sponsoring employers
  - transparency on rules to impose penalties (legal certainty)
- Supervisory authorities
  - allows for transparency of sanctioning regime
  - allows cross-sectoral supervisors to harmonise sanctioning regimes to the extent appropriate

#### Negative impacts

Option 1: Leave the IORP Directive unchanged  
No impact

Option 2: Include Article 36 of the CRA Regulation into the revised IORP Directive

- IORP members and beneficiaries
  - no negative impacts
- IORPs and sponsoring employers
  - no negative impacts
- Supervisory authorities
  - no negative impacts

### III. COMPETENCE OF HOST SUPERVISOR TO TAKE MEASURES

Option 1: Leave the IORP Directive unchanged

Option 2: Include articles 155(1), 155(4) and 155(8) of SII into the revised IORP Directive

#### Positive impacts

Option 1: Leave the IORP Directive unchanged

No impact

Option 2: Include articles 155(1), 155(4) and 155(8) of SII into the revised IORP Directive

- IORP members and beneficiaries
  - Faster and more effective protection of members and beneficiaries in host state
- IORPs and sponsoring employers

- N/A

➤ Supervisory authorities

- no loss of valuable time in case of emergency
- quick settlement of breaches
- host supervisor can fully exercise its supervision of applicable law

Negative impacts

Option 1: Leave the IORP Directive unchanged

No impact

Option 2: Include articles 155(1), 155(4) and 155(8) of SII into the revised IORP Directive

➤ IORP members and beneficiaries

- Small probability that the measure will hinder cross-border provision of occupational pensions

➤ IORPs and sponsoring employers

- IORP can be subject to actions from different supervisors

➤ Supervisory authorities

- there could be contradictions in actions from Home and Host supervisors

Conclusions

- i. EIOPA considers that article 34(4) of the Solvency II Directive is suitable for the revised IORP Directive, provided that the principle of proportionality is secured in the article itself.
- ii. EIOPA considers that the requirement to explicitly lay down sanctioning regimes, as prescribed by article 36 of the CRA Regulation, is a good basis for providing evidence of the consistent and transparent use of sanctioning regimes in the Member States. EIOPA can however not yet advise on publication of sanctions.
- iii. With regard to the power for Host State Supervisory authorities to take necessary measures in case of cross-border activities, EIOPA considers that the revised IORP Directive should allow for these powers. Therefore, the current provisions of the IORP Directive should be extended with the provisions of articles 155(1), 155(4) and 155(8) of the Solvency II Directive.

## 15.5. EIOPA advice

*The Commission Services would like EIOPA to advise on detailed rules by which supervisors can ensure that IORPs have proper stress test systems in place. EIOPA should also reflect on the possibility for national supervisors to impose administrative sanctions on IORPs which are sufficiently high to have a deterrent effect.*

*The EIOPA advice should address at least the following subjects:*

- *The material elements of Article 34(4) of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to stress test;*

1. EIOPA considers that Article 34(4) of the Solvency II Directive is a good basis for providing the supervisory authorities with the powers to develop necessary tools to test the financial situation of IORPs. However, given the wide diversity in size, type of pension benefits managed and the level of risk taking, the principle of proportionality must be applied EU-wide and within Member States so that supervisors retain flexibility for the use of the stress test tool.

2. Although the principle of proportionality is included in Article 36(6)2nd para. EIOPA suggests that this principle is secured in Article 34(4) itself.

- *The material elements of Article 36 of Regulation No 1060/2009 on credit rating agencies that should be amended or removed to adequately address the specificities of IORPs in relation to administrative sanctions;*

3. Under the current IORP Directive, Member States already have the powers to impose sanctions. These powers should be exercised consistently and transparently within Member States. EIOPA considers that there is currently no need for further harmonisation of sanctioning regimes at the European level.

4. EIOPA considers that Article 36 of the Regulation 1060/2009, which requires Member States to explicitly lay down their sanctioning regime, is a good basis for providing evidence of the consistent and transparent use of the sanctioning regimes in Member States. However, given the special status of IORPs, in general not being commercial financial institutions, and a lack of research in this matter, EIOPA advises not to include an obligation to make penalties public. EIOPA proposes that further analysis is conducted to identify if there is a case for harmonisation.

*The effectiveness of Article 20(10) of the IORP Directive in practice:*

5. Article 20(10) of the IORP Directive allows the Host supervisor to directly approach the IORP to request stopping a breach to its legislation. Due to a lack of actual cases where this provision had to be applied, both in the pensions as in the insurance field, EIOPA is not able to assess the effectiveness of Article 20(10) in practice. This lack of actual cases may be due to the fact that this power is only available to the Host supervisor under extreme circumstances and after interventions from the Home supervisor have failed to stop the breach.

6. EIOPA is of the opinion that the provisions in the IORP Directive should be extended with the provisions of Article 155(1) of Solvency II, in order to clarify the situations in which the Host supervisor is allowed to immediately and directly approach the IORP to request stopping a breach to its legislation. This could shorten the time needed to remedy the irregular situation. However, the requirement to immediately inform the Home supervisor of this communication, as is currently foreseen in the General Protocol, should be included in the Directive itself.

7. The provisions in Article 155(4), giving additional powers to the Host supervisor to intervene immediately in case of emergency, prior to informing the Home supervisor, and in Article 155(8), giving the power to the Host supervisor to request any documents from insurance undertakings operating in their country if the same requirements apply to undertakings for which they are Home supervisor, should also be inserted in the IORP Directive to give all the powers necessary to the Host supervisor to conduct its supervision.

*Other general supervisory powers for IORPs, if any.*

None, except for the above in relation to Article 20(10).

## **16. CfA 11: Supervisory review process and capital add-ons**

### **16.1. Extract from the call for advice**

The EIOPA advice should address at least the following subjects:

- The material elements of Article 36 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs;
- The material elements of Article 37 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs (where they are subject to own fund requirements); the advice should also consider whether similar requirements should be applied to the level of funding of technical provisions.
- Other rules for IORPs, if any.

### **16.2. Background**

Current legal requirements (IORP Directive)

16.2.1. The IORP Directive does not contain provisions regarding the supervisory review process, as such, or the possibility to impose capital add-ons, although it does have provisions relating to powers (Article 14) and to Information to competent authorities (Article 13).

International standards (OECD/IOPS, etc...)

#### **OECD/IOPS Good Practices for Pension Funds' Risk Management Systems**

##### ***Good Practice 8: Supervisory Oversight of Pension Funds' Risk Management Systems***

16.2.2. The pension regulatory or supervisory authority should have the power to evaluate the directors and governing boards of pension funds or plans, and to determine that appropriate corporate governance, risk management and internal controls and a code of conduct will be in place (appropriate meaning reflecting the scope and degree of sophistication of the proposed activities of the applicant).

16.2.3. An evaluation of a pension fund or plan's risk management system should be central to on-going supervisory assessment as well as part of any licensing or registration criteria. The supervision of risk management systems should be proportional to the nature, scale and complexity of the pension fund.

16.2.4. In those instances where supervisors determine that the risk management system is not adequate or effective for the organisation's specific risk profile, they should take appropriate action. This would involve communicating their concerns to the governing board and monitoring what action is taken to improve risk management.

16.2.5. Supervisory reviews should where possible include the right to directly address to and request information from a pension fund's service providers (via

prescribed conditions in the contract between the pension fund and the service provider). Alternatively, the pension supervisory authority should have mechanisms in place for liaising with other financial service authorities in order to do so.

- 16.2.6. When assessing a pension fund which already has outsourcing agreements in place, the pension supervisory authority should consider whether the governing board is aware of any shortfall in existing arrangements vs. good practices or supervisory guidance, what steps the pension fund has taken to ensure that arrangements meet such standards, and whether the risks arising as a result of entering into an outsourcing agreement are appropriately covered in the fund's risk management strategy.

#### Solvency II Directive

##### Article 36 –Supervisory review process

1. *Member States shall ensure that the supervisory authorities review and evaluate the strategies, processes and reporting procedures which are established by the insurance and reinsurance undertakings to comply with the laws, regulations and administrative provisions adopted pursuant to this Directive.*

*That review and evaluation shall comprise the assessment of the qualitative requirements relating to the system of governance, the assessment of the risks which the undertakings concerned face or may face and the assessment of the ability of those undertakings to assess those risks taking into account the environment in which the undertakings are operating.*

2. *The supervisory authorities shall in particular review and evaluate compliance with the following:*
  - a. *the system of governance, including the own-risk and solvency assessment, as set out in Chapter IV, Section 2;*
  - b. *the technical provisions as set out in Chapter VI, Section 2;*
  - c. *the capital requirements as set out in Chapter VI, Sections 4 and 5;*
  - d. *the investment rules as set out in Chapter VI, Section 6;*
  - e. *the quality and quantity of own funds as set out in Chapter VI, Section 3;*
  - f. *where the insurance or reinsurance undertaking uses a full or partial internal model, on-going compliance with the requirements for full and partial internal models set out in Chapter VI, Section 4, Subsection 3.*
3. *The supervisory authorities shall have in place appropriate monitoring tools that enable them to identify deteriorating financial conditions in an insurance or reinsurance undertaking and to monitor how that deterioration is remedied.*
4. *The supervisory authorities shall assess the adequacy of the methods and practices of the insurance and reinsurance undertakings designed to identify possible events or future changes in economic conditions that could have adverse effects on the overall financial standing of the undertaking concerned.*

*The supervisory authorities shall assess the ability of the undertakings to withstand those possible events or future changes in economic conditions.*

- 5. The supervisory authorities shall have the necessary powers to require insurance and reinsurance undertakings to remedy weaknesses or deficiencies identified in the supervisory review process.*
- 6. The reviews, evaluations and assessments referred to in paragraphs 1, 2 and 4 shall be conducted regularly.*
- 7. The supervisory authorities shall establish the minimum frequency and the scope of those reviews, evaluations and assessments having regard to the nature, scale and complexity of the activities of the insurance or reinsurance undertaking concerned.*

#### *Article 37 –Capital add-ons*

- 1. Following the supervisory review process supervisory authorities may in exceptional circumstances set a capital add-on for an insurance or reinsurance undertaking by a decision stating the reasons. That possibility shall exist only in the following cases:*
  - (a) the supervisory authority concludes that the risk profile of the insurance or reinsurance undertaking deviates significantly from the assumptions underlying the Solvency Capital Requirement, as calculated using the standard formula in accordance with Chapter VI, Section 4, Subsection 2 and:*
    - (i) the requirement to use an internal model under Article 119 is inappropriate or has been ineffective; or*
    - (ii) while a partial or full internal model is being developed in accordance with Article 119;*
  - (b) the supervisory authority concludes that the risk profile of the insurance or reinsurance undertaking deviates significantly from the assumptions underlying the Solvency Capital Requirement, as calculated using an internal model or partial internal model in accordance with Chapter VI, Section 4, Subsection 3, because certain quantifiable risks are captured insufficiently and the adaptation of the model to better reflect the given risk profile has failed within an appropriate timeframe; or*
  - (c) the supervisory authority concludes that the system of governance of an insurance or reinsurance undertaking deviates significantly from the standards laid down in Chapter IV, Section 2, that those deviations prevent it from being able to properly identify, measure, monitor, manage and report the risks that it is or could be exposed to and that the application of other measures is in itself unlikely to improve the deficiencies sufficiently within an appropriate timeframe.*
- 2. In the circumstances set out in points (a) and (b) of paragraph 1 the capital add-on shall be calculated in such a way as to ensure that the undertaking complies with Article 101(3).*

*In the circumstances set out in point (c) of paragraph 1 the capital add-on shall be proportionate to the material risks arising from the deficiencies which gave rise to the decision of the supervisory authority to set the add-on.*

3. *In the cases set out in points (b) and (c) of paragraph 1 the supervisory authority shall ensure that the insurance or reinsurance undertaking makes every effort to remedy the deficiencies that led to the imposition of the capital add-on.*
4. *The capital add-on referred to in paragraph 1 shall be reviewed at least once a year by the supervisory authority and be removed when the undertaking has remedied the deficiencies which led to its imposition.*
5. *The Solvency Capital Requirement including the capital add-on imposed shall replace the inadequate Solvency Capital Requirement.*

*Notwithstanding subparagraph 1 the Solvency Capital Requirement shall not include the capital add-on imposed in accordance with point (c) of paragraph 1 for the purposes of the calculation of the risk margin referred to in Article 77(5).*

6. *The Commission shall adopt implementing measures laying down further specifications for the circumstances under which a capital add-on may be imposed and the methodologies for the calculation thereof.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

#### OPC reports

CEIOPS Report on Risk Management Rules applicable to IORPs, November 2009; Section II.4 and Conclusion.

CEIOPS Report on Management Oversight and Internal Controls applicable to IORPs, November 2010; Section II.5 and Conclusion.

### **16.3. Explanatory text**

#### EIOPA view on issues in the CfA

##### Supervisory review process

- 16.3.1. EIOPA fully agrees with the Solvency II Directive that a supervisory review process needs to be in place, in order to check the compliance of IORPs with the regulations of the revised IORP Directive.
- 16.3.2. The current IORP Directive does not contain a specific requirement to supervise the activities of IORPs, but the fact that these activities are supervised in practice is a presumption of the Directive. See for example recital 19 (differences in supervision to reflect powers against different agencies that combine to bring about member protection), recital 25 (competent authorities must have rights to information and powers of

intervention against IORPs and those who run them), recital 32 (Supervisory methods and practices differ from Member State to Member State), Article 13 (Information to be sent to competent authorities) and Article 14 (Powers of intervention and duties of competent authorities).

- 16.3.3. One position is that adding a specific article on the supervisory review process along the lines of Article 36 of the Solvency II Directive is proper for the IORP Directive, as it clarifies what supervision is about. Article 36 can be used as a starting point for IORPs as well, with only minor changes to be made.
- 16.3.4. The changes that need to be made have their origin in the specificities of pensions in relation to insurance business. One addition to the text of Article 36 needs to be that supervisors need to look at the value and strength of the security mechanisms of IORPs (please refer to CfA 6). Other additions may be necessary, dependent on the final EIOPA advice, for instance with regard to the prohibition of borrowing and investment restrictions.
- 16.3.5. Another position is that the duties and powers in the IORP Directive could be retained, so that Member States can determine the most appropriate supervisory powers for their population of IORPs. This would, according to this view, enable a diversity of approach that better reflects the diversity of the type, size, complexity and legal form of IORPs across Member States.

#### Capital add-ons

- 16.3.6. Article 37 of the Solvency II Directive provides supervisors with the possibility of imposing additional capital requirements (capital add-ons) on top of the regular Solvency Capital Requirement (SCR) in specific, extraordinary circumstances. Essentially, capital add-ons are possible if there are serious deviations between an undertaking's investment policy and its actual investments, leading to a significantly higher risk profile than assumed for the SCR calculations, or if the governance of the institution is seriously lacking.
- 16.3.7. If the actual risk profile is higher than it should be under the undertaking's investment policy, the intention of the capital add-ons is to raise the SCR requirements (based on the investment policy) to the SCR that would have been required if it was calculated using the actual risk profile. If the governance is lacking, the capital add-on should be proportionate to the risks arising from the deficiencies.
- 16.3.8. Assuming that the capital requirements of the future IORP Directive will resemble those of the Solvency II Directive, it must be noted that the circumstances under which the Solvency II Directive allows supervisors to impose capital add-ons could also arise within IORPs. Thus one position is that the possibility of imposing capital add-ons should also be given to supervisors in the context of the IORP Directive.
- 16.3.9. EIOPA notes that a capital add-on does not necessarily imply that additional (hard) capital needs to be added to the scheme. Such a need does not exist for instance if the scheme's assets are sufficient to cover the technical provision, the SCR and the capital add-on. It is also possible to cover the capital add-on with sponsor support.

16.3.10. EIOPA also notes that currently no (or very few) pension supervisors actually have the legal possibility of imposing capital add-ons. Even though the use of such a power would be highly restricted, the introduction of this power would impact almost all Member States.

16.3.11. A specific element in this discussion is how to deal with schemes where members bear all the risks, since they are not exposed to capital requirements, other than on operational risk. This subject needs further consideration, not only because the lack of capital requirements leads to a capital add-on of zero, but also because any additional capital requirements would, at least initially, by definition<sup>64</sup> be borne by the members of the scheme.

#### Policy options

Option 1: Leave the IORP Directive unchanged (Retain the powers of intervention part of the IORP directive which enables Member States to determine those powers it sees necessary to prevent or remedy any potential prejudice to the interest of members.)

Option 2: Introduce both the supervisory review process and the possibility to impose capital add-ons into the IORP Directive, by amending Articles 36 and 37 of the Solvency II Directive to include specific pension characteristics.

Option 3: Introduce the supervisory review process into the IORP Directive, by amending Article 36 of the Solvency II Directive to include pension characteristics, but leave out the possibility to impose capital add-ons.

### **16.4. Impact assessment**

#### Positive impacts

Option 1: Leave the IORP Directive unchanged

No impact

Option 2: Introduce both the supervisory review process and the possibility to impose capital add-ons into the IORP Directive, by amending Articles 36 and 37 of the Solvency II Directive to include specific pension characteristics

➤ IORP members and beneficiaries

- The same level of protection as in the insurance sector

➤ IORPs and sponsoring employers

- Cross-sectoral consistency

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<sup>64</sup> There is a possibility in virtually all pension schemes that additional capital requirements are borne by the members and beneficiaries. Such requirements may for instance lead the IORP to withhold indexation in order to acquire the required capital. The issue in pure DC schemes is that there is no-one else but the members and beneficiaries to pay for the additional capital requirements.

- Improved legal certainty
- Supervisory authorities
  - Additional powers for supervisors that they can use in extreme circumstances.

Option 3: Introduce the supervisory review process into the IORP Directive, by amending Article 36 of the Solvency II Directive to include pension characteristics, but leave out the possibility to impose capital add-ons.

- IORP members and beneficiaries
  - Improved level of protection
- IORPs and sponsoring employers
  - Partial cross-sectoral consistency
- Supervisory authorities
  - In line with the existing powers of EU pensions supervisors.

### Negative impacts

Option 1: Leave the IORP Directive unchanged

No impact

Option 2: Introduce both the supervisory review process and the possibility to impose capital add-ons into the IORP Directive, by amending Articles 36 and 37 of the Solvency II Directive to include specific pension characteristics

- IORP members and beneficiaries
- IORPs and sponsoring employers
  - A harmonised approach to supervision ignores the different ways in which pensions are successfully delivered in the EU
  - Incremental costs
- Supervisory authorities
  - incremental costs
  - Discussion needed about the way to deal with pure DC schemes.

Option 3: Introduce the supervisory review process into the IORP Directive, by amending Article 36 of the Solvency II Directive to include pension characteristics, but leave out the possibility to impose capital add-ons.

- IORP members and beneficiaries
  - Potentially lower level of protection compared to policyholders in the insurance sector
- IORPs and sponsoring employers
  - incremental costs
- Supervisory authorities
  - Difference in supervisory powers between pension and insurance sectors, even though the circumstances in which these powers are needed can exist in both sectors. This is even more a problem for integrated supervisors.

#### Conclusion / Concluding remark

- 16.4.1. Introducing both the supervisory review process and the possibility to impose capital add-ons into the IORP Directive would be consistent with the overall goal of the European Commission to harmonise the prudential regulation of occupational pensions and with the holistic balance sheet approach introduced in chapter 8 of this advice.
- 16.4.2. However, if the revised IORP Directive does not provide for harmonisation, the current and remaining diversity in the European IORP landscape would be better reflected if the supervisor's powers and duties in the IORP Directive were retained.

## 16.5. EIOPA advice

*The EIOPA advice should address at least the following subjects:*

- The material elements of Article 36 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs;*
1. EIOPA considers that a revised IORP Directive should contain an article regarding the supervisory review process. For this article, both Article 36 of the Solvency II Directive and, given the current diversity in the European IORP landscape, Article 13 and 14 of the IORP Directive can be used for inspiration.
- The material elements of Article 37 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs (where they are subject to own fund requirements); the advice should also consider whether similar requirements should be applied to the level of funding of technical provisions.*
2. EIOPA considers that it is important that supervision should look at the way in which IORPs implement their investment policy, as contained in their Statement of Investment Policy Principles (Article 12 of the IORP Directive), into the actual investments. Where the risk profile of the actual investments significantly differs from the risk profile of the investment policy, this might not be in the best interest of members and beneficiaries. Such situations should be addressed to the IORP and amended or explained by the IORP. The possibility to impose capital add-ons would then provide the supervisor with a final mechanism to resolve the situation, only to be used if other supervisory measures fail.
  3. If the revised IORP Directive includes the possibility for supervisors to impose capital add-ons, EIOPA advises to specifically look at pension schemes where members bear all the risks, as imposing a capital add-on may then directly affect the pensions of the members.
- Other rules for IORPs, if any.*

## **17. CfA 12: Supervision of outsourced functions and activities**

### **17.1. Extract from the call for advice**

*The EIOPA advice should address at least the following subjects:*

- *The way in which Article 13(b) of Directive 2003/41/EC should be clarified. Particular attention should be paid to determine whether the material elements of Article 38(1) of Directive 2009/138/EC could be used for this purpose;*
- *The way in which Article 13(d) of Directive 2003/41/EC should be clarified. Particular attention should be paid to determine whether the material elements of Article 38(2) of Directive 2009/138/EC could be used for this purpose;*
- *Other rules to supervise outsourced functions and activities, if any: e.g. location of main administration, sub-contracting of the transferred activity by the third-party service provider (chain outsourcing).*

### **17.2. Background**

#### Current legal requirements (IORP Directive)

- 17.2.1. The IORP Directive in its current wording requires the Member States to give their Supervisory Authorities necessary powers for effective supervision in cases of outsourcing. The various references included in the Directive in this regard are as follows:

*Recital 25: "Where an institution for occupational retirement provision has transferred functions of material importance such as investment management, information technology or accounting to other companies (outsourcing), it should be possible for the rights to information and powers of intervention to be enlarged so as to cover these outsourced functions in order to check whether those activities are carried out in accordance with the supervisory rules."*

*Article 13: "Each Member State shall ensure that the competent authorities, in respect of any institution located in its territory, have the necessary powers and means:*

*...*

*(b) to supervise relationships between the institution and other companies or between institutions, when institutions transfer functions to those other companies or institutions (outsourcing), influencing the financial situation of the institution or being in a material way relevant for effective supervision;"*

*...*

*(d) to carry out on-site inspections at the institution's premises and, where appropriate, on outsourced functions to check if activities are carried out in accordance with the supervisory rules."*

#### International standards, guidelines and good practices

17.2.2. With regard to the supervision of outsourcing the applicable international standard (OECD/IOPS good practices for pension funds' risk management systems) requires that the service provider must commit itself to enable monitoring of its activities by the supervisory authority of the pension institution on an on-going basis. This should include access to the information and the premises of the service provider (where appropriate), including right of the supervisory authority to perform or require an audit of the service provider. The service providers may not charge a fee for providing information or access to the supervisory authority of the pension institution.

#### Results of the public consultation on Green Paper on pensions

17.2.3. As mentioned in section 2.3 of the CfA 13, the summary of consultation responses to question 10 of the Green paper on pensions concludes that many respondents considered the qualitative requirements of Solvency II (pillar 2 and 3) suitable for pension funds.

#### Solvency II Framework Directive

17.2.4. Directive 2009/138/EC (Solvency II Framework Directive) in Article 38 provides for the following rules on supervision of outsourced functions and activities of insurance and reinsurance undertakings

##### *Article 38*

##### *Supervision of outsourced functions and activities*

*1. Without prejudice to Article 49, Member States shall ensure that insurance and reinsurance undertakings which outsource a function or an insurance or reinsurance activity take the necessary steps to ensure that the following conditions are satisfied:*

*(a) the service provider must cooperate with the supervisory authorities of the insurance and reinsurance undertaking in connection with the outsourced function or activity;*

*(b) the insurance and reinsurance undertakings, their auditors and the supervisory authorities must have effective access to data related to the outsourced functions or activities;*

*(c) the supervisory authorities must have effective access to the business premises of the service provider and must be able to exercise those rights of access.*

*2. The Member State where the service provider is located shall permit the supervisory authorities of the insurance or reinsurance undertaking to carry out themselves, or through the intermediary of persons they appoint for that purpose, on-site inspections at the premises of the service provider. The supervisory authority of the insurance or reinsurance undertaking shall inform the appropriate authority of the*

*Member State of the service provider prior to conducting the on-site inspection. In the case of a non-supervised entity the appropriate authority shall be the supervisory authority.*

*The supervisory authorities of the Member State of the insurance or reinsurance undertaking may delegate such on-site inspections to the supervisory authorities of the Member State where the service provider is located.*

#### OPC reports

- 17.2.5. In 2007 – 2008 CEIOPS OPC carried out a survey regarding applicable outsourcing principles for the IORPs among the EEA Member States. This survey obtained information on how Member States regulate outsourcing of IORPs' functions and activities and how the supervision of the outsourced functions and activities is done. The results were summarised in the Report on outsourcing by IORPs (CEIOPS-OP-12-08M final), OPC, 30 October 2008. The explanatory text below builds on the most important finding of the survey.

### **17.3. Explanatory text**

#### EIOPA view on issues in the CfA

##### Outsourcing conditions

- 17.3.1. Currently there are no details provided in the IORP Directive on what are the "necessary powers and means" the Member states are required to give to their supervisory authorities to supervise the relationship between IORP and service provider. This wording therefore enables different interpretations by EIOPA members.
- 17.3.2. Indeed, the findings of the OPC report on outsourcing show differences in what powers of supervisory authority vis-à-vis service provider exist among the Member States. A large majority of respondents (24) indicated that the IORP's supervisory authority in their country is able to obtain any data and/or reports necessary to fulfil supervisory functions from the service provider via the IORP. This is catered for in the national legislation and/or in the outsourcing agreements concluded between IORPs and service providers. Most of the supervisory authorities (19) also have the power to require the service provider itself to supply data and/or reports. Supervisory authorities in most of the cases are empowered to carry-out on-site inspections at the premises of the service provider (21).
- 17.3.3. As mentioned above, the survey on outsourcing revealed that there are differences in the scope of powers exercised by IORPs' supervisory authorities with respect to outsourced functions. Nevertheless, the ultimate responsibility for outsourced functions is borne by the IORPs in all Member States. Consequently, IORPs have to manage all possible problems arising from outsourced functions and provide all the requested information to their supervisory authorities.
- 17.3.4. The survey also examined possible geographic limitations of outsourcing. It revealed that more than one third of the respondents require the custodian to be located in the EU/EEA. Furthermore, three countries indicated that asset management can be outsourced only to an EEA based investment manager. None of the respondents have in place any specific rules with

regard to cross-border outsourcing other than discussed above. One country noted that the supervisory authority is allowed to conclude collaboration agreements with other authorities with respect to implementing the rules applicable to IORPs.

- 17.3.5. Article 38 (1) of the Solvency II Framework Directive contains more details with respect to supervision of outsourcing. In general EIOPA supports the idea of using elements of this article to clarify the IORP directive in the area of supervision of outsourcing. In addition EIOPA proposes that also elements of the Article 34(7) of the Solvency II Framework Directive providing that „the powers with regard to insurance and reinsurance undertakings shall also be available with regard to outsourced activities of insurance and reinsurance undertakings” should be incorporated to ensure consistency of the supervisory powers in case of outsourcing.
- 17.3.6. Finally, EIOPA considers the written outsourcing agreement an effective tool facilitating the exercise of supervision in case of domestic and cross-border outsourcing. Thus, the revised IORP Directive should require IORPs to conclude written outsourcing agreement. More details on this issue are provided in response to CfA 20.

#### Cross-border supervision of outsourcing

- 17.3.7. Article 38 (2) of the Solvency II Framework Directive contains more details with respect to cross-border supervision of outsourcing. In general EIOPA supports the idea of using elements of this article to clarify the IORP directive in the area of supervision of outsourcing. The relevant provision of the IORP II Directive could provide that the Member State where the service provider is located shall permit the supervisory authorities of the IORP to carry out themselves, or through the intermediary of persons they appoint for that purpose, on-site inspections at the premises of the service provider. The supervisory authority of the IORP shall inform the appropriate authority of the Member State of the service provider prior to conducting the on-site inspection. In the case of a non-supervised entity the appropriate authority shall be the supervisory authority. The supervisory authorities of the Member State of the IORP may delegate such on-site inspections to the supervisory authorities of the Member State where the service provider is located.
- 17.3.8. EIOPA in general supports the idea to use material elements of the Article 38 (2) of the Solvency II Framework Directive to clarify Article 13(d) of IORP directive in particular when the service provider is located in another Member State. This could provide specific rules how to proceed with on-site inspection when the service provider is located in another member state and ensure a common approach among the Member States.
- 17.3.9. In addition EIOPA is of the view that further amendments should be introduced primarily providing that Member States must ensure the supervisory authority has the powers to intervene on outsourced functions or activities, if necessary.
- 17.3.10. At the same time Article 38 (2) of the Solvency II Framework Directive does not cater for the cases when a service provider is located in a non-EEA country. In this case cooperation between supervisory authorities would not work in the same way.

- 17.3.11. One position is to provide additional amendments to article 13(d) of the current IORP Directive stating that when the service provider is located in a non-EEA country it is an obligation of the IORP to ensure that the supervisory authority or their appointed persons are able to carry out on-site inspections at the premises of the service provider. This obligation would be regulated as a requirement to be included in the written outsourcing agreement concluded between the IORP and the service provider. In order to ensure these requirements are fulfilled by an IORP, the supervisory authority might ask for prior notification of the contract with the service provider located in the non-EEA country.
- 17.3.12. However, another position is that there is no place for such a notification requirement. Moreover, the survey on outsourcing shows that there are different approaches among the Member States as regard notifications by the supervisory authority. The respondents are nearly evenly split in their approach to the procedure that must be undertaken by the IORP before the actual transfer of functions occurs.
- 17.3.13. In the majority (14) of cases, the outsourcing of IORP's functions is subject to approval by the supervisory authority or notification (a priori or ex-post) to it and more than half of these countries (8 out of 14) require IORP to get a prior approval before the actual transfer of function although some of them indicated that this refers to certain functions only while other functions are subject to ex-post notification.
- 17.3.14. In nine cases, no approval by the supervisory authority is required regarding the transfer of an IORP's function. However, some of these respondents pointed out that there are certain other requirements with a similar effect.
- 17.3.15. To ensure supervisory authority or their appointed persons are able to carry out on-site inspections at the premises of the service provider located in a non-EEA country, development of the respective procedure could be considered in level 2 implementing measures.

#### Chain outsourcing

- 17.3.16. Currently the IORP directive is silent on chain outsourcing and does not state any requirements on this subject. A survey carried out by the OPC on outsourcing requirements implemented by member states also shows that area in most of the member states is not regulated and consequently could cause obstacles for the supervisory authority to fulfil its functions as regards the actual service provider.
- 17.3.17. According to the findings of the survey, subcontracting of the transferred activity by the service provider (chain outsourcing) is allowed in slightly less than a half of the cases (12). Moreover, there are several cases (9) where the national primary law is silent on this issue and the chain outsourcing is allowed in practice subject to certain conditions, such as ensuring that the supervisory authority shall have the right to obtain information it might need from the subcontractee or that the IORP still has the necessary powers to issue instructions and obtain information from the subcontractee. Four respondents indicated that chain outsourcing is not allowed under their national legislation. In a further two cases this issue is not expressly regulated by law. In these cases, respective supervisory authorities do not

allow IORPs' service providers to enter into subcontracting agreements. One of these cases indicated that this approach is justified by other provisions of its prudential law regulating the overall design of the IORPs. Only five countries allowing subcontracting of the transferred activity indicated that this arrangement is subject to a priori or an ex-post notification. In one case prior approval is required. In all other cases no formal approval by supervisory authority or notification to it is required.

- 17.3.18. To avoid such situations additional rules could be introduced in the IORP directive to ensure that, in the case of chain outsourcing, IORPs and supervisory authorities have the same controlling powers vis-à-vis a subcontractee as they have vis-à-vis the service provider. In case when subcontractee is a supervised entity there should be same level of cooperation between supervisory authorities as stated for supervision of service providers to avoid potential overlapping of supervision. The specific clarification on how the supervisors cooperate could be addressed in Level 2 implementing measures if needed.
- 17.3.19. In addition it would be advisable to clarify to which extent delegated services would be considered as outsourced activity. This would be especially relevant for delegated investment services since outsourcing of investment management activity is very common or even mandatory in many Member States. This issue could be addressed in Level 2 implementing measures.

#### Location of the main administration

- 17.3.20. Another non-regulated area in the IORP directive is location of the main administration of the IORP and how this influences duties of the supervisory authority. Article 6 of the IORP Directive states that the Home State is the EU country where the IORP has its main administration. At the same time there is no definition of "main administration". The survey on outsourcing shows that different countries treated this in different way. The majority of EIOPA members stated that main administration means the registered office while some others refer to the location of a headquarters or central office, and there are even countries who interpret it as the location of administration or asset management.
- 17.3.21. Since location of the main administration is important to determine what is the home country of the IORP which is then crucial for supervision of cross border activities it might be advisable to provide details on what is to be understood by the "main administration".
- 17.3.22. EIOPA considers that it might be possible to amend the definition of the "home state" and make it consistent with the definitions used for other sectors.
- 17.3.23. Relevant directives in other financial sectors provide for the following definitions of home state:
- a) UCITS IV Directive - "management company's home Member State" means the Member State in which the management company has its registered office;

- b) CRD - "home Member State" means the Member State in which a credit institution has been authorised in accordance with Articles 6 to 9 and 11 to 14;
- c) Solvency II - "home Member State" means any of the following:
- for non-life insurance, the Member State in which the head office of the insurance undertaking covering the risk is situated;
  - for life insurance, the Member State in which the head office of the insurance undertaking covering the commitment is situated; or
  - for reinsurance, the Member State in which the head office of the reinsurance undertaking is situated.

17.3.24. Based on the above examples and taking into account the specificities of IORPs, it seems to be most appropriate that the home state is defined as the state where the IORP was authorised or registered. Furthermore, for the reasons of regulatory cross-sectoral consistency and accessibility of IORPs by its supervisor the revised IORP Directive should include the requirement that main administration of IORP is always located in the home member state. It could be also made clear that the term "place of main administration" refers to a place where the main strategic decisions of the IORP's executive body are made.

17.3.25. In any case, however, the supervisory authority must be able to effectively supervise the IORP.

#### Policy options

17.3.26. The following policy options can be derived for supervision of outsourced functions.

- Option 1: Leave the IORP directive unchanged
- Option 2: Introduce into the IORP Directive the same principles for the supervision of outsourced activities as in Articles 38 (1) and 38 (2) of the Solvency II Framework Directive. In addition, the revised IORP Directive should contain following principles:
  - Member States must ensure the supervisory authority has the necessary powers to intervene on outsourced functions or activities.
  - In case of sub-contracting of the outsourced activity Member States must ensure that IORP and its supervisory authorities have the same powers vis-à-vis the subcontractee as vis-a-vis the service provider,
  - the "home state" should be defined as state where the IORP has been authorised or registered,
  - the main administration (a place where the main strategic decisions of the IORP's decision making body are made) of IORP must be always located in the home member state. It could be also made clear that the term "place of main administration" refers to.

## **17.4. Impact assessment**

### Positive impacts

Option 1:

No impact.

Option 2:

- The proposed changes would introduce the common principles for the supervision of outsourcing that would lead to higher standard of supervision among Member States and increase security of the members benefits.
- It would be ensured that supervisory authorities' powers would be the same regardless of whether the IORP's functions and activities are performed by the IORP itself or outsourced to domestic or cross-border providers. That would help to ensure the same protection level for members.
- Introduction of additional rules (regarding chain outsourcing and location of main administration) would eliminate possible grey areas and ensure consistency of the supervisory process
- Standardised approach of supervision of the outsourced functions and activities will provide harmonisation of the regulation within the EU that could facilitate cross border activities

#### Negative impacts

Option 1:

No impact.

Option 2:

- Introduction of the proposed regulation would increase administrative burdens faced by IORPs and supervisors in those Member States where the level of supervisory powers is currently below the proposed level. This could result in increasing costs faced by members in those Member States. On the other hand this would be limited only to those countries where currently supervisors have limited powers vis-a-vis service providers

#### Conclusion

17.3.27. EIOPA prefers option 2 which was also supported by the majority of respondents in first round of consultations on this topic. There was a general agreement among respondents that the role of supervisory authority should be clarified in the revised directive.

17.3.28. EIOPA notes that the above assessment of impact is only an estimation and does not in principle replace the need for an impact study to assess the real impact of the new requirements. Furthermore EIOPA stresses that the impact could significantly increase if the principle of proportionality were not appropriately applied.

## 17.5. EIOPA advice

***The EIOPA advice should address at least the following subjects:***

***The way in which Article 13(b) of Directive 2003/41/EC should be clarified. Particular attention should be paid to determine whether the material elements of Article 38(1) of Directive 2009/138/EC could be used for this purpose;***

1. EIOPA holds the view that the material elements of article 38(1) of the Solvency II Framework Directive are applicable to IORPs.
2. The revised IORP Directive could provide that:
  - the service provider must cooperate with the supervisory authorities of the IORP in connection with the outsourced function or activity;
  - the IORPs, their auditors and the supervisory authorities must have effective access to data related to outsourced functions or activities;
  - the supervisory authorities must have effective access to the business premises of the service provider and must be able to exercise those rights of access.

***The way in which Article 13(d) of Directive 2003/41/EC should be clarified. Particular attention should be paid to determine whether the material elements of Article 38(2) of Directive 2009/138/EC could be used for this purpose***

3. EIOPA recommends introducing the requirements for IORPs as they were introduced for insurance and reinsurance undertakings in article 38(2) of the Solvency II Framework Directive, with the following addition: Member States must ensure the supervisory authority has the necessary powers to intervene on outsourced functions or activities. To ensure consistency of supervisory powers also elements of the article 34(7) of the Solvency II Framework Directive should be considered.
4. Further details on the case where the service provider is located in a non-EEA country could be considered in level 2 implementing measures in order to ensure access of the supervisory authority to the information and premises of the service provider. These measures could include provisions that when the service provider is located in a non EEA country, it is the responsibility of the IORP to ensure access of the supervisory authority to the information and premises of the service provider. Member States might require the IORPs to include this obligation in the contract concluded between the IORP and service provider. Member States might also require prior notification by the IORP of the contract with a service provider located in a non-EEA country.

***Other rules to supervise outsourced functions and activities, if any: e.g. location of main administration, sub-contracting of the transferred activity by the third-party service provider (chain outsourcing).***

5. EIOPA recommends introducing additional rules on chain outsourcing stating that Member States must ensure that in the case of sub-contracting of the outsourced activity (chain outsourcing) IORPs and supervisory authorities have the same powers vis-à-vis the subcontractee as vis-a-vis the service provider. In case when subcontractee is a supervised entity itself the overlapping of supervision should be avoided. Further details on supervisory cooperation could be addressed in Level 2.
6. EIOPA recommends changing the definition of the home state to the state where the IORP has been authorised or registered. Furthermore, the revised IORP

Directive should include a requirement that the main administration is always located in the home member state. It could be also made clear that the term “place of main administration” refers to a place where the main strategic decisions of the IORP’s decision making body are made.

## 18. CfA 13: General governance requirements

### 18.1. Extract from the call for advice

*The Commission Services would like EIOPA to advise on how to include rules concerning governance requirements*

- *The EIOPA advice should address at least the following subjects:*
- *The material elements of Article 41 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to general governance requirements;*
- *Provisions to ensure a sound remuneration policy, possibly based on the Level 2 implementing measures currently being developed for Article 41 of Directive 2009/138/EC;*
- *Other requirements for IORPs, if any.*

### 18.2. Background

#### Current legal requirements (IORP Directive)

- i. Currently the IORP Directive does not contain rules concerning the clear allocation of responsibilities, written documentation of key governance functions or contingency plans. The only references in the IORP directive to the governance requirements are as follows:

#### *Article 9*

##### *Conditions of operation*

*1. Each Member State shall, in respect of every institution located in its territory, ensure that:*

*[...]*

*(c) properly constituted rules regarding the functioning of any pension scheme operated by the institution have been implemented and members have been adequately informed of these rules;*

*[...]*

*4. A Member State may permit or require institutions located in its territory to entrust management of these institutions, in whole or in part, to other entities operating on behalf of those institutions.*

*[...]*

#### *Article 14*

##### *Powers of intervention and duties of the competent authorities*

*1. The competent authorities shall require every institution located in their territories to have sound administrative and accounting procedures and adequate internal control mechanisms.*

*2. The competent authorities shall have the power to take any measures including, where appropriate, those of an administrative or financial nature, either with regard to any institution located in their territories or against the persons running the institution, which are*

*appropriate and necessary to prevent or remedy any irregularities prejudicial to the interests of the members and beneficiaries.*  
[...]

- ii. Furthermore, article 8 of the IORP Directive stipulates that there shall be a legal separation of the sponsoring undertaking and the institution for occupational retirement provision. This is in line with principle 2 of the OECD Recommendation on the Core Principles of Occupational Pension Regulation (OECD Core Principles) mentioned below.
- iii. Finally, Article 12 of the IORP Directive states that every IORP shall at least review its written investment policy every three years or without delay whenever a significant change has occurred.

#### International standards, guidelines and good practices

- iv. In principle 2 of the OECD Core Principles it is recommended that within pension institutions there should be a functional system in place comprising the adequate legal, accounting, technical, financial and managerial criteria, without excessive administrative burden. The pension fund and sponsor must be legally separated or such separation must be guaranteed through appropriate mechanisms. Additionally, principle 6 of the OECD Core Principles states that the governance structure should ensure an appropriate division of operational and oversight responsibilities, and the accountability and suitability of those with such responsibilities. To encourage good decision making, proper and timely execution, transparency and regular review and assessment, appropriate control, communication and incentive mechanisms should be in place.
- v. The OECD Guidelines for Pension Fund Governance, June 2009, identify as part of a governance structure a clear identification of responsibilities, the existence of a governing body, the accountability of the governing body, the suitability of the members of the governing body, the possibility to delegate functions and to get expert advice from external sources, the appointment and performance of an auditor, an actuary for defined benefit plans and a custodian. Furthermore, there should be a risk based internal control system and appropriate reporting and disclosure mechanisms.
- vi. According to Good practice 2 in the OECD/IOPS Report on Good Practices for Pension Funds' Risk Management Systems, January 2011, the governing board is responsible for defining, implementing and improving the risk management system as well as determining and regularly reviewing the risk management strategy. Responsibilities should be clear and reflect the nature and extent of risks, and different people are to be assigned for decision making, execution and checking functions. There should be a strong internal control culture within the organisation including communication of information between levels of management. A policy for conflict of interests as well as a code of conduct policy for all staff should be in place. Policies and practices (including compensation) that may provide incentives for inappropriate activities should be avoided.

#### Results of the public consultation on Green Paper on pensions

- vii. The summary of consultation responses to question 10 of the Green Paper on pensions concludes that many respondents considered pillars 2 and 3 of

Solvency II as potentially offering some useful principles. According to respondents, these principles could be explored at EU level in areas around governance, risk management and information disclosure. While the degree of explicit support varied by type of organisation, there was no response suggesting that the qualitative requirements of Solvency II would be unsuitable for pension funds.

### Solvency II Framework Directive

- viii. Directive 2009/138/EC (Solvency II Framework Directive) in Article 41 provides for the following rules on general governance requirements for insurance and reinsurance undertakings:

#### *Article 41*

##### *General governance requirements*

*1. Member states shall require all insurance and reinsurance undertakings to have in place an effective system of governance which provides for sound and prudent management of the business.*

*That system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information. It shall include compliance with the requirements laid down in Articles 42 to 49.*

*The system of governance shall be subject to regular internal review.*

*2. The system of governance shall be proportionate to the nature, scale and complexity of the operations of the insurance or reinsurance undertaking.*

*3. Insurance and reinsurance undertakings shall have written policies in relation to at least risk management, internal control, internal audit and, where relevant, outsourcing. They shall ensure that those policies are implemented.*

*Those written policies shall be reviewed at least annually. They shall be subject to prior approval by the administrative, management or supervisory body and be adapted in view of any significant change in the system or area concerned.*

*4. Insurance and reinsurance undertakings shall take reasonable steps to ensure continuity and regularity in the performance of their activities, including the development of contingency plans. To that end, the undertaking shall employ appropriate and proportionate systems, resources and procedures.*

*5. The supervisory authorities shall have appropriate means, methods and powers for verifying the system of governance of the insurance and reinsurance undertakings and for evaluating emerging risks identified by those undertakings which may affect their financial soundness.*

*The Member States shall ensure that the supervisory authorities have the powers necessary to require that the system of governance be*

*improved and strengthened to ensure compliance with the requirements set out in Articles 42 to 49.*

#### OPC reports

- ix. CEIOPS OPC Report on Management Oversight and Internal Controls Rules Applicable to IORPs (CEIOPS-OP-37-10 Rev1), 9 June 2010, concludes in section II.2 that all EEA countries that took part in the survey have already implemented at least some of the general governance requirements laid down in article 41 of Solvency II Framework Directive.

### **18.3. Explanatory text**

#### EIOPA's view on issues in the CfA

- 18.3.1. As regards article 41 of the Solvency II Framework Directive, EIOPA is of the opinion that the equivalent standard of general governance requirements as provided for the insurance and reinsurance undertakings in the Solvency II Framework Directive should be applicable also to IORPs.

#### Obligation to have an effective system of governance

- 18.3.2. Similarly to the insurance undertaking the governance system of IORP should:

- ensure that its management is sound and prudent;
- secure a high standard of members' and beneficiaries' protection; and
- assist the management board in setting and, on an ongoing basis, adjusting the IORPs' overall risk profile to match their financial strength.

An adequate governance framework should facilitate appropriate decision-making and other actions by the IORP, thereby reducing the probability and impact of non-compliance. All these requirements are in line with the OECD Guidelines for Pension Fund Governance.

- 18.3.3. The difference between governance systems in IORPs in different member states (i.e. one tier boards and two tier boards) has been taken into account through using the reference 'management, administrative or supervisory body'. The role/tasks of the management, administrative and supervisory bodies and the relation between them differ between member states. EIOPA underlines that in each system adequate internal supervision (this could for example be non-executive board members or the supervisory body of the IORP) is needed in order to ensure an effective system of governance.

#### Separation of IORP from a sponsoring undertaking

- 18.3.4. EIOPA wants to stress that an IORP must be legally separated from a sponsor as it is currently stated in Article 8 of the IORP directive and also stipulated in the above mentioned principle 2 of the OECD core principles. The obligation to separate the IORP from its sponsoring undertaking should be carried over to a revised IORP directive.

#### General proportionality clause

- 18.3.5. There are vast differences in the nature, scale and complexity of IORPs among individual Member States as well as within the same Member State. Some of the governance requirements could be too burdensome for IORPs of a less complex nature, smaller scale and with less complex operations. A new supervisory system for IORPs should not undermine the supply or the cost efficiency of occupational retirement provision in the EU. EIOPA emphasises that it is very important that the revised IORP Directive contains a general proportionality clause applicable to all elements of governance in similar fashion to that in the Solvency II Framework Directive. Since the occupational pension landscape is very heterogeneous, there might be cases where the proportionality principle will need to be construed and applied more broadly than under the Solvency II regime.
- 18.3.6. The principle of proportionality should apply to the whole governance system and, as a consequence, to all future implementing measures.
- 18.3.7. In assessing what is proportionate, the focus must be on the combination of all three criteria: nature, scale and complexity in order to arrive at a solution that is adequate to the risks to which an IORP is exposed.
- 18.3.8. Proportionality does not mean the introduction of automatic and systematic simplifications for certain IORPs. The principle will be applied where it would be disproportionate to the nature, scale and complexity of an IORP's business to apply the general rules without relief. The individual risk profile should be the primary guide in assessing the need to apply the proportionality principle.
- 18.3.9. In this regard EIOPA for the purpose of this advice distinguishes between the following two categories of IORPs:
- a) Small IORPs are those mentioned in article 5 of the present IORP Directive, that can be exempted from (the whole or part of) the scope of the Directive. As a result, they cannot apply article 20 of the IORP Directive concerning cross-border activities.
  - b) IORPs with less complex natures, smaller scale and lower complexity of their operations are those that would fall within the scope of the revised Directive but, for reasons of proportionality, they could choose to implement alternative measures meeting the general objectives of the governance requirements.
- 18.3.10. A hypothetical example of an alternative measure could be that the compliance function is carried out by the administrative, management or supervisory body of the IORP, that for instance discusses the subject at least once a year with a special mention in the minutes.

#### Documentation of IORP policies and business continuity

- 18.3.11. EIOPA believes that written policies, not only for risk management but also for internal control, internal audit and, where relevant, outsourcing, should be applicable to IORPs in order to facilitate a control mechanism. The written policies should be reviewed regularly, and when significant changes have been made. However, EIOPA is of the opinion that imposing an obligation to perform at least annual review as stated in Article 41(3) of the Solvency II Framework Directive would be overly burdensome for some IORPs. Therefore

the revised IORP Directive should provide for enough flexibility in this respect, so these requirements can be applied in a proportionate manner.

- 18.3.12. EIOPA stresses that the obligation included in Article 12 of the IORP directive - that member states inter alia shall ensure that every IORP located in its territory prepares and, at least every three years, reviews a written statement of investment-policy principles – should be retained.
- 18.3.13. Consistently with the Solvency II Framework Directive, the written policies of IORP shall be subject to prior approval by its administrative, management or supervisory body. The wording of this requirement should be sufficiently clear so as to avoid the impression that these policies should be submitted to the supervisory authority of the IORP.
- 18.3.14. Additionally, EIOPA believes that the development of contingency plans as in Article 41(4) of the Solvency II Framework Directive should apply to IORPs since members and beneficiaries will benefit from long term planning.

#### Role of the supervisory authority

- 18.3.15. EIOPA is of the view that Member States should be required to equip supervisory authorities with the means, methods and powers necessary for verifying the system of governance and evaluating emerging risks identified by IORPs which may potentially impact on their financial soundness.
- 18.3.16. The implementation of governance requirements is the obligation and the responsibility of the IORP. This obligation and responsibility cannot be transferred to the supervisory authority.

#### Participation of members in the management of the IORP

- 18.3.17. In some Member States, the participation of members and/or beneficiaries is embedded in the governance structure of an IORP. For example, some Member States provide that employers and employees should be represented equally in the IORP bodies in certain situations.
- 18.3.18. In some other Member States the IORPs are professional, single purpose pension fund managers run by persons with appropriate education and proven experience of acting in the managerial capacity in the area of financial services. Thus participation of employees in the administrative, management or supervisory bodies of IORPs in these countries may not be necessary or appropriate.
- 18.3.19. EIOPA notes that the revised general governance system for IORPs should not prevent Member States from requiring or permitting IORPs to allow for the participation of members in their governance structure, if appropriate.

#### Remuneration policy

- 18.3.20. EIOPA believes that a sound remuneration policy should be part of a good governance system.
- 18.3.21. However, to develop the sound remuneration policy some special characteristics of IORPs must be considered such as:

- Some IORPs do not employ staff. They use staff from a sponsoring undertaking to fulfil their duties and the remuneration of these staff is linked to the employer's pay policy.
- Some IORPs use volunteer, unpaid staff. Therefore a remuneration policy for these individuals may be irrelevant.

18.3.22. EIOPA is in favour of adding a general principle requiring IORPs to have in place a sound remuneration policy, provided the special characteristics of the IORP do not make such a policy irrelevant. This principle should be provided for in the level 1 text of the revised IORP Directive. Further analysis might reveal the need to further elaborate the details on what constitutes a sound remuneration policy in level 2 implementing measures.

#### Differences between DB and DC pension provision

18.3.23. Regarding governance requirements EIOPA does not see any major differences between defined benefit and defined contribution schemes. Therefore the same requirements should be applied to both types of schemes.

#### Policy options

18.3.24. The following policy options can be derived for general governance requirements.

- Option 1: Leave the IORP directive unchanged
- Option 2: Introduction of general governance requirements as described above

18.3.25. EIOPA prefers option 2 in line with almost all respondents to the first consultation of this topic. There was a broad support for the introduction of general governance requirements.

### **18.4. Impact assessment**

#### Positive impacts

Option 1:  
No impact.

Option 2:

- Members and beneficiaries, IORPs, the sponsoring companies and also the Competent Authorities will benefit from the introduction of general governance requirements as this leads to more secure and sustainable pensions. The proposed general governance framework increases the standard of IORPs' prudential regulation and secures a high level of members' and beneficiaries' protection.
- Standardisation of general governance requirements will lead to more harmonisation across the EU. This will increase confidence of members

and beneficiaries in their pensions and may also alleviate cross border activity.

#### Negative impacts

Option 1:

No impact.

Option 2:

- Additional administrative burden for IORPs in those member states where no formal general governance requirements exists. This burden will lead to either an increase of contributions or a decrease of benefits. But in many member states general governance requirements are already in place on a national level. Therefore EIOPA is of the opinion that this additional effect is limited.

Conclusion / Concluding remark/

- 18.4.1. EIOPA prefers option 2 provided that the principle of proportionality is secured in the article itself.
- 18.4.2. EIOPA notes that the above assessment of impact is only an estimation and does not in principle replace the need for an impact study to assess the real impact of the new requirements. Furthermore EIOPA stresses that the impact could significantly increase if the principle of proportionality were not appropriately applied.

## 18.5. EIOPA advice

### **The material elements of Article 41 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to general governance requirements;**

1. EIOPA proposes to introduce the same general governance requirements for IORPs as for insurance and reinsurance undertakings in article 41 of the Solvency II Framework Directive with the following amendments:
  - an IORP must remain legally separated from the sponsoring undertaking as currently laid down in article 8 of the IORP directive,
  - if appropriate, the governance system should not prevent members' and beneficiaries' participation in the governance structure of the IORP,
  - written policies on certain governance areas that the IORPs will be required to have shall be reviewed regularly (instead of "at least annually" as in Solvency II Framework Directive); The clarification of what is meant by "regularly" will be provided in the level 2 text.
  - the policies shall be subject to prior approval by the administrative, management or supervisory body of the IORP and be adapted in light of any significant change in the system or area concerned.
2. Furthermore EIOPA wants to stress that given the large heterogeneity of IORPs throughout the EU, the principle of proportionality as laid down in article 41 (2) of the Solvency II Framework Directive needs to apply to all elements of the governance system of IORPs (e.g. internal control, internal audit, outsourcing).

### **Provisions to ensure a sound remuneration policy, possibly based on the Level 2 implementing measures currently being developed for Article 41 of Directive 2009/ 138/EC;**

3. EIOPA is in favour of adding the general principle requiring IORPs to have a sound remuneration policy providing the special characteristics of the IORP do not make such a policy irrelevant. Further analysis might reveal the need to further elaborate the details at level 2.

### **Other requirements for IORPs, if any.**

None

## 19. CfA 14: Fit and proper

### 19.1. Extract from the call for advice

*EIOPA is invited to provide advice on at least the following questions:*

- *Scope: to whom should the fit and proper criteria be applied? The current directive states that it applies to the persons that "effectively run" the IORP. Should it apply only to the management board members or also to other people such as those carrying out functions: risk management, internal control, internal audit, compliance, actuarial and outsourced.*
- *Timing: when should fit and proper requirements be applied?*
- *What procedures and ongoing controls should be set up by the supervisory authority to check the continued respect of fit and proper criteria?*
- *What powers should the supervisor exercise when fit and proper requirements are not fulfilled?*

### 19.2. Background

#### Current legal requirements (IORP Directive)

19.2.1. The IORP Directive contains in Article 9 a general requirement concerning the fitness and propriety of persons who effectively run the IORP. The relevant provisions are as follows:

#### *Article 9 Conditions of operation*

*1. Each Member State shall, in respect of every institution located in its territory, ensure that:*

*[...]*

*(b) the institution is effectively run by persons of good repute who must themselves have appropriate professional qualifications and experience or employ advisers with appropriate professional qualifications and experience;*

*[...]*

#### International standards, guidelines and good practices

19.2.2. Principle 2 of the OECD Recommendation on the Core Principles of Occupational Pension Regulation, June 2009, stipulates that members of the governing bodies of the pension entity should be subject to fit and proper requirements.

19.2.3. The OECD Guidelines for Pension Fund Governance, June 2009, identify as part of a governance structure inter alia the suitability of the members of the governing body.

## Results of the public consultation on Green paper on pensions

19.2.4. As mentioned in section 2.3 of the CfA 13, the summary of consultation responses to question 10 of the Green paper on pensions concludes that many respondents considered the qualitative requirements of Solvency II (pillar 2 and 3) suitable for pension funds.

## Solvency II Framework Directive

19.2.5. The Solvency II Framework Directive in Article 42 provides for the following rules on fitness and propriety for management and key functions of the insurance and reinsurance undertakings:

### *Article 42*

*Fit and proper requirements for persons who effectively run the undertaking or have other key functions*

*1. Insurance and reinsurance undertakings shall ensure that all persons who effectively run the undertaking or have other key functions at all times fulfil the following requirements:*

*(a) their professional qualifications, knowledge and experience are adequate to enable sound and prudent management (fit); and  
(b) they are of good repute and integrity (proper).*

*2. Insurance and reinsurance undertakings shall notify the supervisory authority of any changes to the identity of the persons who effectively run the undertaking or are responsible for other key functions, along with all information needed to assess whether any new persons appointed to manage the undertaking are fit and proper.*

*3. Insurance and reinsurance undertakings shall notify their supervisory authority if any of the persons referred to in paragraphs 1 and 2 have been replaced because they no longer fulfil the requirements referred to in paragraph 1.*

### *Article 43*

*Proof of good repute*

*1. Where a Member State requires of its own nationals proof of good repute, proof of no previous bankruptcy, or both, that Member State shall accept as sufficient evidence in respect of nationals of other Member States the production of an extract from the judicial record or, failing this, of an equivalent document issued by a competent judicial or administrative authority in the home Member State or the Member State from which the foreign national comes showing that those requirements have been met.*

*2. Where the home Member State or the Member State from which the foreign national concerned comes does not issue the document referred to in paragraph 1, it may be replaced by a declaration on oath – or in Member States where there is no provision for declaration on oath by a solemn declaration – made by the foreign national concerned before a competent judicial or administrative authority or, where*

*appropriate, a notary in the home Member State or the Member State from which that foreign national comes.*

*Such authority or notary shall issue a certificate attesting the authenticity of the declaration on oath or solemn declaration.*

*The declaration referred to in the first subparagraph in respect of no previous bankruptcy may also be made before a competent professional or trade body in the Member State concerned.*

*3. The documents and certificates referred to in paragraphs 1 and 2 shall not be presented more than three months after their date of issue.*

*4. Member States shall designate the authorities and bodies competent to issue the documents referred to in paragraphs 1 and 2 and shall forthwith inform the other Member States and the Commission thereof. Each Member State shall also inform the other Member States and the Commission of the authorities or bodies to which the documents referred to in paragraphs 1 and 2 are to be submitted in support of an application to pursue in the territory of that Member State the activities referred to in Article 2.*

#### *Article 50 Delegated acts*

*1. The Commission shall adopt delegated acts, in accordance with Article 301a[...], to further specify the following:*

*[...]*

*(c) the requirements set out in Article 42 and the functions subject thereto;*

#### OPC reports

19.2.6. With respect to fit and proper requirements the EIOPA OPC Report on Management Oversight and Internal Controls Rules Applicable to IORPs (CEIOPS-OP-37-10 Rev1), 9 June 2010, concludes that Member States' approach in this area differs quite a lot. In the large majority of responding EEA countries the fit and proper requirements apply to the management board members, actuaries and outsourced functions. These requirements apply very rarely to the compliance function, which, moreover, exists only in 12 jurisdictions.

### **19.3. Explanatory text**

#### EIOPA's view on issues in the CfA

19.3.1. In general, EIOPA agrees on the applicability of principles contained in Articles 42 and 43 of Solvency II Framework Directive to IORPs.

19.3.2. EIOPA notes that the fit and proper requirements in the revised IORP Directive will have to take into account the heterogeneous nature of occupational pensions among Member States.

#### Scope

19.3.3. EIOPA is of the view that the fit and proper criteria should apply in either case to persons that 'effectively run the IORP' or 'persons who have other key functions'.

19.3.4. It should be stressed that it is, in principle, the responsibility of the IORP to ensure that the persons who effectively run the IORP and have other key functions within the IORP are fit and proper. This responsibility cannot be transferred to the supervisory authority.

#### Fitness

19.3.5. IORPs should be required to ensure that persons who effectively run the IORP or carry out other key functions have to be fit to do so, i.e. their professional qualifications, knowledge and experience have to be adequate to enable sound and prudent management of the IORP or to properly perform their key function.

19.3.6. The level of professional qualification, knowledge and experience expected from persons who effectively run the IORP or have other key functions depends on the nature, scale and complexity of the activities of the IORP, as well as the responsibilities that go with the particular key/management function of the person and, in the case of persons who effectively run the IORP, the composition and functioning of the whole group of persons who effectively run the IORP.

#### Propriety

19.3.7. Persons who effectively run the IORP or have other key functions have in either case to be proper i.e. of a good reputation and integrity.

#### Key functions

19.3.8. In Recital 31 the Solvency II Framework Directive provides for the following definition of "function":

*"A function is an administrative capacity to undertake particular governance tasks. The identification of a particular function does not prevent the undertaking from freely deciding how to organise that function in practice save where otherwise specified in this Directive. This should not lead to unduly burdensome requirements because account should be taken of the nature, scale and complexity of the operations of the undertaking. It should therefore be possible for those functions to be staffed by own staff, to rely on advice from outside experts or to be outsourced to experts within the limits set by this Directive."*

19.3.9. The term 'function' is used to denote that the insurance and reinsurance undertaking must have the administrative capacity to perform a certain task. Given the principle of proportionality, the term does not imply that the particular person(s) may not perform any additional tasks, i.e. that insurance and reinsurance undertakings need a separate organisational unit. To what extent staff may perform in dual or multiple roles is a question of appropriate segregation of duties. The performance of some tasks is incompatible with

certain other responsibilities. In such cases, good practice dictates that these tasks be performed by different persons.

19.3.10. EIOPA finds the above definition and interpretation of 'function' suitable for IORPs.

19.3.11. Taking into account the heterogeneous nature of the IORP sector, the principles of good governance must be implemented in a reasonable and proportionate manner. It must be the responsibility of each IORP to define a consistent and adequate solution to the carrying out of a function (depending on the nature, scale and complexity of its activities and hence depending on its risk profile).

19.3.12. In order to be considered proportionate, the way in which a key function is carried out by an IORP has to be at least suitable and necessary to achieve its objective as well as appropriate. This could imply that IORPs outsource certain key functions, subject to the requirements included under 'outsourcing' (CfA 20).

19.3.13. In some IORPs full segregation of duties may be considered unreasonable and disproportionate. Therefore IORPs in these cases may make other arrangements to ensure that conflicts of interest are avoided or effectively managed. This must however not lead to a lower level of protection. Additional procedures should be implemented in order to ensure a level of control equivalent to that achieved through a full segregation of duties.

19.3.14. The IORPs' own responsibility for ensuring that persons who have key functions are fit and proper should be emphasised. Given the different ways in which key functions can be carried out (e.g. it could be dedicated persons/units within the IORP, tasks allocated to employees or tasks that have been outsourced to professional service providers), EIOPA considers that the IORP needs to assess whether the persons who have key functions meet the fit and proper criteria.

19.3.15. Proportionality works two ways: it justifies simpler and less burdensome ways of carrying out key functions for IORPs of simple nature, scale and complexity in their operations, but could also increase the extent of carrying out key functions for IORPs of a more complex nature, larger scale and higher complexity in their operations.

19.3.16. In line with Recital 33 of the Solvency II Framework Directive, EIOPA is of the view that functions included in the system of governance are considered to be key functions and consequently also important and critical functions.

#### Timing

19.3.17. The fit and proper requirements must be fulfilled by persons who effectively run the IORP, and those who have key functions, at all times.

#### Procedures and controls for checking compliance with fit and proper

19.3.18. With respect to the procedure and controls for checking compliance with the fit and proper requirements, EIOPA is of the view that the Level 1 text should contain a flexible principle on the assessment procedure and ongoing

controls, which will be interpreted at Level 2. The Level 1 principle should require Member States to ensure that the supervisory authority has effective powers to assess and monitor whether at least persons who effectively run the IORP are fit and proper. In the text below, EIOPA gives also some indications of what details may be included in the Level 2 text.

- 19.3.19. Given the differences in the pension landscapes among Member States, the role of the supervisory authority in the assessment of fitness and propriety could be different for authorised and non-authorised IORPs.
- 19.3.20. In the case of IORPs that are subject to authorisation, the supervisory authority could be required to assess fitness and propriety of candidates for persons who will effectively run the IORP prior to granting the authorisation. The IORP should be required to supply the supervisor with all information needed for the assessment. When a person effectively running the IORP is to be replaced by another individual, the supervisory authority could be required to assess fitness and propriety of the candidate prior to taking up his/her duty. The IORP should notify to the supervisory authority all changes in the composition of persons who effectively run the IORP and provide it with all information needed in order to carry out the assessment of fitness and propriety. Finally, the IORP should notify the supervisory authority when a person who effectively runs the IORP ceases to be fit or proper.
- 19.3.21. For persons who have key functions (in IORPs that are subject to authorisation) EIOPA does not necessarily foresee a need that the Supervisory Authority be involved in assessing the fitness and propriety of candidates. IORP could be required to supply all information needed to assess the fitness and propriety but only upon the request from its supervisory authority.
- 19.3.22. In the case of IORPs that are not subject to authorisation at the national level, EIOPA does not see a need for ex-ante assessment by supervisory authority of appointments of persons who effectively run the IORP or have a key function. However, in some Member States, there is an ex-ante assessment by the supervisory authority of appointments of persons who effectively run the IORP. This possibility should remain. Furthermore, IORPs could be required to supply information on fitness and propriety of persons mentioned above upon the request of its supervisory authority.
- 19.3.23. As to the ongoing responsibility, a supervisor should be able to reassess fitness and propriety of a person who effectively runs the IORP or has other key function if there are facts and/or circumstances that constitute reasonable grounds. This does not, however, involve the standard or periodical assessment of these requirements. Given the enormous differences between the different types of IORPs in the EU as well as the nature, scale and complexity of the operations of IORPs, proportionality in reassessing fitness and propriety is needed.

#### Powers of supervisory authorities

- 19.3.24. When fit and/or proper requirements are not fulfilled, the supervisory authority should, among other proceedings, be able to refuse that a person is appointed to run the IORP or be in a key function or to require the replacement of individuals that do not meet these criteria.

19.3.25. Given the level of detail and the fact that proportionality is needed, EIOPA recommends further elaborating the supervisory powers in the level 2 text. A more general principle should be included in the level 1 text.

#### Mutual recognition of proofs of good repute

19.3.26. EIOPA considers that rules for the proof of good repute contained in Article 43 of the Solvency II Framework Directive should be applied mutatis mutandis to IORPs. EIOPA is of the view that the establishment of what would be sufficient evidence for one Member State to assess the good repute of nationals from another Member State, and the acceptance of proofs provided by another Member State, are important aspects to facilitate cross border activities of IORPs.

#### Policy options

19.3.27. The following policy options can be derived for fit and proper requirements.

- Option 1: Leave the IORP directive unchanged
- Option 2: Introduction of fit and proper requirements as described in the blue box below.

### **19.4. Impact assessment**

#### Positive impacts

Option 1:  
No impact.

Option 2:

- Members and beneficiaries, IORPs, the sponsoring companies and also the Competent Authorities will benefit from the introduction of fit and proper requirements. Fit and proper requirements for those which effectively run an undertaking and for key functions will increase the security level of pensions and will make them more independent of future adverse market developments.
- Provided there is an adequate application of the principle of proportionality, the fit requirements will lead to a better match between the fitness of the persons who effectively run the IOPR or have other key functions and the scale, nature and complexity of the IORP.
- Standardisation of fit and proper requirements will lead to more harmonisation across the EU. This will increase confidence of members and beneficiaries in their pensions and may also accelerate cross border activity.

#### Negative impacts

Option 1:  
No impact.

## Option 2:

- Additional expenses for IORPs to hire fit and proper staff or to increase/keep up to date the staff's level of knowledge. New tasks for Competent Authorities which may increase the administrative burden needed to assess persons appointed or to assess other key functions. Finally, more stringent fitness and properness requirements may complicate wider participation in the scheme and the use of unpaid volunteers or salaried staff (e.g. lay trustees) in their management.

### Conclusion / Concluding remark/

- 19.4.1. EIOPA prefers option 2 in line with almost all respondents to the first consultation of this topic. There was a broad support for the introduction of the fit and proper requirements described above.
- 19.4.2. EIOPA notes that the above assessment of impact is only an estimation and does not in principle replace the need for an impact study to assess the real impact of the new requirements. Furthermore EIOPA stresses that the impact could significantly increase if the principle of proportionality were not appropriately applied.

## 19.5. EIOPA advice

1. EIOPA recommends the introduction of the same fit and proper requirements for IORPs as were introduced for insurance and reinsurance undertakings in article 42 (1) of the Solvency II Framework Directive. It is suggested that the requirement for persons who effectively run the IORP or have other key functions to be fit is amended as follows: “professional qualifications, knowledge and experience are adequate to enable sound and prudent management of the IORP or to properly perform their key function (fit)”

***Scope: to whom should the fit and proper criteria be applied? The current directive states that it applies to the persons that "effectively run" the IORP. Should it apply only to the management board members or also to other people such as those carrying out functions: risk management, internal control, internal audit, compliance, actuarial and outsourced.***

2. EIOPA recommends applying the fit and proper criteria to persons who effectively run the IORP and to persons who have other key functions.

3. The fit and proper requirements should not unduly prevent members' and beneficiaries' participation in the governance structure of the IORP.

***Timing: when should fit and proper requirements be applied?***

4. Fit and proper requirements should apply at all times.

***What procedures and ongoing controls should be set up by the supervisory authority to check the continued respect of fit and proper criteria?***

5. EIOPA recommends that the revised IORP Directive contains a principle requiring Member States to ensure that there are effective procedures and ongoing controls in place to enable the supervisory authority to assess the fitness and propriety of persons who effectively run the IORP or have other key functions.

6. In particular, each Member State shall ensure that the supervisory authority has effective powers vis-a-vis IORPs registered or authorised in its territory to assess and monitor whether at least persons who effectively run the IORP are fit and proper. The details will be elaborated in Level 2 text.

***What powers should the supervisor exercise when fit and proper requirements are not fulfilled?***

7. EIOPA recommends an addition to the requirements of article 42 Solvency II Framework Directive that would state that the Member States shall ensure that the supervisory authorities have the powers to take measures when fit and/or proper requirements are not fulfilled. The details of the measures will be provided in Level 2 text.

## 20. CfA 15: Risk management

### 20.1. Extract from the call for advice

*The Commission Services would like EIOPA to advise on detailed rules to ensure that IORPs have proper systems in place to identify, measure, monitor, manage and report the risks incurred and has a prospective view on the risks that might possibly occur.*

*The EIOPA advice should address at least the following subjects:*

- The material elements of Article 44 of Directive 2009/138/EC that should be amended or removed to cater for the specificities of risk management practices in IORPs;*
- Differences, if any, in the risk management rules depending on the risk sharing mechanism of the pension scheme: e.g. DB, DC and hybrids.*
- Specific risk management rules governing life cycling in DC schemes, if necessary.*

#### *Extract from the main body of the CfA*

*Although relevant to all types of pension schemes, the areas where DC schemes may require particular attention include at least the following:*

- Investment risk and in particular liquidity risk, i.e. the risk that investments could be insufficiently liquid to meet requirements to pay out balances or benefits to members without incurring avoidable losses. Regulation should ensure that the risk management system of the pension fund is adequately structured and well supervised (see risk management in the Annex);*
- Operational risk, in particular administration risk such as contributions and investment returns allocated to an incorrect account; moreover in a DC scheme it is more likely that the members/beneficiaries bear the cost of operational failures (see security mechanisms, risk management and supervisory review process in the Annex);*

### 20.2. Background

#### Current legal requirements (IORP Directive)

- 20.2.1. The IORP Directive already makes several references to risk management: article 12 requires that the statement of investment principles describes the risk management processes; the investment rules in Article 18 presuppose the existence of an effective risk management system.
- 20.2.2. But there are currently no specific rules on risk management in the IORP Directive.

### International standards, guidelines and good practices

- 20.2.3. Various international standards and recommendations applicable to pension institutions provide more details on the design of risk management.
- 20.2.4. The *OECD Recommendation on the Core Principles of Occupational Pension Regulation of June 2009* stipulates in its second core principle (risk control) that pension entities should have *adequate risk control mechanisms in place* to address investment, operational and governance risks, as well as internal reporting and auditing mechanisms.
- 20.2.5. If they manage more than one pension plan or fund, pension entities should be required to maintain separate accounts and records for each of the pension funds, or where relevant, each of the pension plans that they manage.
- 20.2.6. The *OECD Guidelines for pension fund governance of June 2009* states that the scope and complexity of internal control measures should be „risk-based“ and will vary according to the type and size of pension plan, fund and entity and the type and extent of risks faced.
- 20.2.7. The risk management system should cover the main risks that a pension fund is exposed to, such as investment, biometric and operational risks. These control mechanisms form the basis of good business conduct, enhanced transparency, consistency as to management decisions, and for the protection of all stakeholders of the pension fund.
- 20.2.8. Prudent risk management practices should also consider intangible risk factors such as environmental, political and regulatory changes, as well as the pension fund's potential market impact through its investment decisions. The risk management strategy should seek to proactively identify and explicitly balance short- and long-term, considerations.
- 20.2.9. Good practice 1 (Appropriate Mechanisms) of the *OECD/IOPS Good Practices for Pension Funds' Risk Management Systems of January 2011* recommends that *pension regulatory and supervisory authorities must be satisfied - for licensing/ registration purposes and on an on-going basis - that pension plans or funds have in place a comprehensive risk management system.*
- 20.2.10. An effective risk management system comprises strategies, processes and reporting procedures necessary to identify, measure, monitor, assess, control and report, on a continuous and an ad hoc basis, all material risks, at an individual and an aggregated level, to which the pension fund or plan is or could be exposed, and their interdependencies.
- 20.2.11. The risk management system needs to be well integrated into the organisational structure and in the decision making process of the pension fund.
- 20.2.12. These systems should be commensurate with the nature, scale and complexity of the pension fund, reflecting the scope and degree of sophistication of its activities.

### Results of the public consultation on Green paper on pensions

20.2.13. Green paper on pensions: summary of consultation responses (7.3.2011), question 10.

20.2.14. Many respondents considered the qualitative requirements of Solvency II would be suitable for pension funds.

#### Solvency II Level 1 Directive

20.2.15. Directive 2009/138/EC (Solvency II Framework Directive):

#### *Article 44 Risk management*

*1. Insurance and reinsurance undertakings shall have in place an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies.*

*That risk-management system shall be effective and well integrated into the organisational structure and in the decision-making processes of the insurance or reinsurance undertaking with proper consideration of the persons who effectively run the undertaking or have other key functions.*

*2. The risk-management system shall cover the risks to be included in the calculation of the Solvency Capital Requirement as set out in Article 101(4) as well as the risks which are not or not fully included in the calculation thereof.*

*The risk-management system shall cover at least the following areas:*

- (a) underwriting and reserving;*
- (b) asset–liability management;*
- (c) investment, in particular derivatives and similar commitments;*
- (d) liquidity and concentration risk management;*
- (e) operational risk management;*
- (f) reinsurance and other risk-mitigation techniques.*

*The written policy on risk management referred to in Article 41(3) shall comprise policies relating to points (a) to (f) of the second subparagraph of this paragraph.*

*3. As regards investment risk, insurance and reinsurance undertakings shall demonstrate that they comply with Chapter VI, Section 6.*

*4. Insurance and reinsurance undertakings shall provide for a risk-management function which shall be structured in such a way as to facilitate the implementation of the risk-management system.*

*5. For insurance and reinsurance undertakings using a partial or full internal model approved in accordance with Articles 112 and 113 the risk-management function shall cover the following additional tasks:*

- (a) to design and implement the internal model;*
- (b) to test and validate the internal model;*
- (c) to document the internal model and any subsequent changes made to it;*
- (d) to analyse the performance of the internal model and to produce summary reports thereof;*
- (e) to inform the administrative, management or supervisory body about the performance of the internal model, suggesting areas needing improvement, and up-dating that body on the status of efforts to improve previously identified weaknesses.*

## CEIOPS reports

20.2.16. The Report on Risk Management Rules applicable to IORPs (CEIOPS-OP-22-09), 6 November 2009 summarises the results of the survey on risk management rules applicable to IORPs in each Member State and the supervisory practices adopted to review and control those rules. The survey revealed a wide spectrum of risk management (RM) rules and supervisory practices amongst Member States, mainly reflecting the different stages of development which derives from the varying importance attached to second pillar pensions. The survey illustrated that most Member States have risk management rules for IORPs, but that there are considerable differences.

## **20.3. Explanatory text**

### EIOPA view on issues in the CfA

#### EFFECTIVE RISK MANAGEMENT SYSTEM AND ITS COMPONENTS

- 20.3.1. EIOPA agrees with the principle that IORPs should have an effective risk management system comprising strategies, processes and reporting procedures to identify, measure, monitor, manage and report risks.
- 20.3.2. EIOPA proposes to introduce in general similar risk management requirements as were introduced for insurance and reinsurance undertakings in article 44 (1) of the Solvency II Framework Directive. Although some specifics for IORPs must be considered. One of these specifics is the existence of different risk sharing mechanisms in IORPs across Europe. The differences in the risk management rules for different risk sharing mechanisms of IORPs are dealt with in more details in a separate section below.
- 20.3.3. It must be the responsibility of each IORP to define and implement a consistent and adequate solution for carrying out the risk management requirement.
- 20.3.4. Risk management must depend on the IORP's risk profile. Where risk is borne by members or beneficiaries the IORP should also act as risk manager regarding the investments of these persons with the IORP and take into account the members' risk preferences. An effective risk management system should also deal with this situation.
- 20.3.5. Taking into account the heterogeneous nature of the IORP sector the risk management must be implemented in a reasonable and proportionate manner depending on the nature, scale and complexity of the IORPs activities.
- 20.3.6. It has to be borne in mind that a large number of IORPs outsource one or more of their critical or important functions or activities. Therefore EIOPA's opinion is that the provisions of the revised IORP Directive regulating the risk management system should contain a reference to the effect that the outsourced functions and the decisions and controls regarding those functions are an integral part of the scope of risk management.

- 20.3.7. EIOPA notes that Article 12 of the IORP Directive currently requires IORPs to draw up the Statement of Investment Policy Principles (SIPP). The SIPP should include *inter alia* the investment risk measurement methods and the risk-management processes implemented. When revising the IORP Directive the Commission should ensure that the content of the SIPP does not overlap with the content of the risk management documentation.

#### ARTICLE 44 (1) OF SII DIRECTIVE

- 20.3.8. EIOPA wants to clarify some of the words used in Article 44 (1) of the Solvency II Framework Directive in connection with IORPs.
- 20.3.9. Firstly the need to report risks in this context means to report the risks inside the IORP up to the administrative, managing or supervisory body of the IORP.
- 20.3.10. The administrative, management or supervisory body of the IORP should be required to determine what actions are to be taken with respect to each of the risk management findings and recommendations and shall ensure that those actions are carried out.
- 20.3.11. Secondly EIOPA wants to make a remark on the phrase “on a continuous basis”. In EIOPA’s opinion this means that the strategies, processes and reporting procedures **enable the IORP to** identify, measure, monitor, manage and report the risks **on a continuous basis**.

#### REPORTING TO THE COMPETENT AUTHORITY

- 20.3.12. For reporting requirements to the competent authorities EIOPA refers to CfA 16 about ORSA. In the event it is decided not to introduce ORSA for IORPs, reporting requirements to the Supervisory Authorities should be integrated into the information to supervisors.

#### ARTICLE 44 (2) of S II DIRECTIVE

- 20.3.13. Article 44 (2) states that the risk management system shall cover the risks to be included in the calculation of the Solvency Capital Requirement as set out in Article 101 (4) as well as risks which are not or not fully included in the calculation. Therefore EIOPA suggests shortening the wording in “The risk management system shall cover all risks the IORP faces”.
- 20.3.14. Because outsourced functions and activities should be an integral part of the risk management system of an IORP (see above) EIOPA wants to add the following sentence to this section: “This also includes risks which can occur in outsourced functions and activities as well as the impact on overall risk that is generated through the outsourcing.”
- 20.3.15. Because of the heterogeneous nature of the IORP sector within Europe some of the areas mentioned in the second subparagraph of this section do not fit all IORPs. Therefore the introductory sentence should be changed to “The risk-management system shall cover where applicable the following areas: (this list is not exhaustive)”

20.3.16. EIOPA wants to remark that in case a sponsor bears some or all of the risk of the pensions commitment the risk of a default of the sponsor is already included in the list. It can be subsumed under (a) underwriting and reserving, (d) liquidity and concentration risk management or (f) reinsurance and other risk-mitigation techniques.

20.3.17. Because of the heterogeneous nature of the IORP sector EIOPA cannot exclude that there are significant risks not mentioned in the list given in article 44 (2). Therefore the wording of the last sentence should be changed to "The written policy on risk management referred to in Article 41(3) shall at least comprise policies relating to all significant risks the IORP faces."

#### ARTICLE 44 (3) of S II DIRECTIVE

20.3.18. Chapter VI Section 6 of Solvency II Framework Directive includes the investment rules applicable to insurance and reinsurance companies. In a new IORP directive this reference should be changed to the investment rules applicable to IORPs.

20.3.19. Again EIOPA wants to clarify the wording of this section. In the context of IORPs "demonstrate" means that an IORP should be able to demonstrate it complies with the applicable investment rules on request of or on a periodical basis as required by the supervisory authority.

#### RISK MANAGEMENT FUNCTION

20.3.20. Article 44 (4) states that undertakings shall provide for a risk management function which shall be structured in such a way as to facilitate the implementation of the risk-management system.

20.3.21. On the definition of "function" EIOPA refers to the explanation given in CfA 14 concerning fit and proper.

20.3.22. Because of the heterogeneous nature of the IORP sector in EU member states the risk management function must be implemented in a reasonable and proportionate manner. Each IORP has the responsibility for defining a consistent and adequate solution to carrying out the function.

20.3.23. The risk management function shall as a principle be independent from operating functions. It may not practise risk management and risk taking at the same time. In EIOPA's view the risk management function can be performed in different ways as mentioned in CfA 17 Internal Control system concerning the compliance function.

#### INTERNAL MODEL Article 44 (5)

20.3.24. If a new risk based solvency capital requirement is introduced and IORPs have the opportunity to use a partial or full internal model then this article should apply in the same way than the Solvency II Framework Directive does for insurance and reinsurance undertakings.

20.3.25. To clarify the wording of e) EIOPA suggests to add an "of the IORP" after "body" in order to avoid the impression that the Supervisory Authority is involved.

## DIFFERENCES IN THE RISK MANAGEMENT RULES DEPENDING ON RISK SHARING MECHANISM OF THE PENSION SCHEME

20.3.26. There is a wide variety of risk sharing mechanisms in the occupational pension sector in Europe. It is possible that members or beneficiaries bear all the risk. It is also possible that the entire risk is borne by the IORP and/or a sponsor. Additionally also several mixed types of these two extremes exist. Especially for those risk sharing mechanisms that are equal or near the mechanism where members and beneficiaries bear all the risk EIOPA wants to add the following new paragraph 2a:

“2a. Where members and beneficiaries bear risks all these risks should be considered also from the perspective of members and beneficiaries based on the rules laid down in the agreement between IORP and employer/employee.”

Details of this sentence should be elaborated at level 2.

20.3.27. To justify this EIOPA wants to give the following example. If investment risk is borne by the IORP and an increase in market risk is observed, a sound and prudent risk management would lead to a change in the asset allocation. If the risk is borne by members or beneficiaries no changes are necessary as long as the risk management considers this risk only from the perspective of the IORP. But if the risk is also considered from the perspective of the member or beneficiary this may also lead to a change in the asset allocation given this is possible under the agreement between the IORP and the member or beneficiary.

20.3.28. But it should be noted that where the same products are offered by IORPs and insurance companies this amendment should not impose a higher burden for IORPs than already exists for insurance companies under the Solvency 2 framework directive.

## SPECIFIC RISK MANAGEMENT RULES GOVERNING LIFE CYCLING IN DC SCHEMES

20.3.29. Life cycling is an investment strategy in DC schemes that members can opt for or that is imposed by legislation. When members are approaching the retirement age, the risk in their pension assets is reduced. Typically there is a move from volatile assets (equities) to more secure and less volatile assets (cash and bonds). So life-cycling can be an important risk diminishing technique.

20.3.30. There are important principles of life-cycling to consider in order to achieving good member outcomes. EIOPA therefore proposes the following principles governing life cycling in DC schemes:

- a. Where IORPS provide a life-cycle feature, the risks for members need to be identified and subject to regular review.
- b. To help ensure that members have the investment fund that is the most appropriate for each of them, those running schemes should have adequate internal controls to ensure that the change in asset mix happens efficiently. This implies that adequate internal controls are effective to ensure that the change in assets mix is beneficial to members.

- c. Where default funds are used, the suitability of a life-cycling feature should be identified and reviewed for the scheme's membership profile.

20.3.31. Another important point in life cycling is the communication to the member. EIOPA believes that there are steps that IORPs can take to improve the communication provided to members both

- prior to life cycling commencing to make sure that members know about their expected outcome match their fund outcomes, and
  - where life cycling is ongoing, to review their choice from time to time.
- The communication should be supplemented by additional information to make members aware of the costs of the transition between asset classes.

20.3.32. The principles mentioned in the previous two paragraphs should be considered not only in the case of life cycling but also in any situation where there are investment options or default investment strategies in place.

20.3.33. However, EIOPA is of the opinion that there is no need for additional risk management requirements for life cycling. The general risk management requirements are sufficient to cover also life cycling in DC schemes.

#### Policy options for the issues in the CfA

20.3.34. The following policy options can be derived for risk management.

- Option 1: Leave the IORP directive unchanged
- Option 2: Introduction of general principles of risk management as described in the blue box below.

## **20.4. Impact assessment**

### Positive impacts

Option 1:

No impact.

Option 2:

- In those member states where there are no risk management requirements members and beneficiaries, the IORPs, the sponsoring companies and also the Supervisory Authorities will benefit from the introduction of risk management as this leads to more secure and sustainable pensions.

### Negative impacts

Option 1:

No impact.

## Option 2:

- The introduction of general principles on risk management will lead to additional administrative burden for IORPs and to an additional task for the Supervisory Authorities to supervise. But in many member states principles on risk management are already in place on a national level. Therefore EIOPA does not foresee a high impact of the level 1 requirement with respect to general risk management rules for the IORPs, the sponsoring undertakings, the supervisors or members/beneficiaries of IORPs.

## Conclusion

EIOPA prefers option 2.

- 20.4.1. EIOPA notes that the above assessment of impact is only an estimation and does not in principle replace the need for an impact study to assess the real impact of the new requirements. Furthermore EIOPA stresses that the impact could significantly increase if the principle of proportionality were not appropriately applied.

## **20.5. EIOPA advice**

### **The material elements of Article 44 of Directive 2009/138/EC that should be amended or removed to cater for the specificities of risk management practises in IORPs;**

1. EIOPA proposes to introduce in principle the similar risk management requirements as for insurance and reinsurance undertakings in article 44 of the Solvency II Framework directive
2. However, taking into account the specificities of IORPs the text should be changed and/or amended in the following way:
3. The first sentence in the second paragraph should be shortened to "*The risk management system shall cover all the risks*"
4. To stress the important role of outsourcing in the field of IORPs the second paragraph should be amended by the sentence "*This includes risks which can occur in outsourced functions and activities as well as the impact on overall risk that is generated through the outsourcing.*"
5. Because the list of areas given in section 2 is not applicable to all IORPs the words "at least" in the first sentence of the second subparagraph of the second paragraph should be replaced by the words "where applicable". Furthermore EIOPA wants to add "(the list is not exhaustive)" at the end of this sentence.
6. Because of the different risk sharing mechanisms a risk management system should also consider risks from the perspective of members and beneficiaries if they bear risks. Therefore EIOPA wants to add the following paragraph 2a:

*"2a. Where members and beneficiaries bear risks all these risks should be considered also from the perspective of members and beneficiaries based on the rules laid down in the agreement between IORP and employer/employee."*

7. To clarify the wording the words "of the IORP" should be added in section 5e) after "body".

***Differences, if any, in the risk management rules depending on the risk sharing mechanism of the pension scheme: e.g. DB, DC and hybrids;***

8. Effects of different risk sharing mechanisms on risk management are reflected in number 6 above.

***Specific risk management rules governing life cycling in DC schemes, if necessary.***

9. EIOPA believes that the existing risk management rules are sufficient also regarding life cycling. Therefore no amendment is necessary.
10. Considering all these amendments and/or changes a possible article risk management for IORPs should look like:

#### Article XY

##### *Risk management*

*1. IORPs shall have in place an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies.*

*That risk-management system shall be effective and well integrated into the organisational structure and in the decision-making processes of the IORP with proper consideration of the persons who effectively run the undertaking or have other key functions.*

*2. The risk-management system shall cover **all** the risks. **This also includes risks which can occur in outsourced functions and activities as well as the impact on overall risk that is generated through the outsourcing.***

*The risk-management system shall cover **where applicable** the following areas **(the list is not exhaustive)**:*

- (a) underwriting and reserving;*
- (b) asset–liability management;*
- (c) investment, in particular derivatives and similar commitments;*
- (d) liquidity and concentration risk management;*
- (e) operational risk management;*
- (f) reinsurance and other risk-mitigation techniques.*

*The written policy on risk management referred to in Article 41(3) shall comprise policies relating to **all significant risks an IORP is faced to.***

***2a. Where members and beneficiaries bear risks all these risks should be considered also from the perspective of members and beneficiaries based on the rules laid down in the agreement between IORP and employer/employee.***

*3. As regards investment risk, IORPs shall demonstrate that they comply with the **investment rules for IORPs.***

4. IORPs shall provide for a risk-management function which shall be structured in such a way as to facilitate the implementation of the risk-management system.

5. For IORPs using a partial or full internal model approved in accordance with Articles 112 and 113 the risk-management function shall cover the following additional tasks:

- (a) to design and implement the internal model;
- (b) to test and validate the internal model;
- (c) to document the internal model and any subsequent changes made to it;
- (d) to analyse the performance of the internal model and to produce summary reports thereof;
- (e) to inform the administrative, management or supervisory body **of the IORP** about the performance of the internal model, suggesting areas needing improvement, and up-dating that body on the status of efforts to improve previously identified weaknesses.

## 21. CfA 16: Own risk and solvency assessment

### 21.1. Extract from the call for advice

*The EIOPA advice should address at least the following subjects:*

- The material elements of Article 45 of Directive 2009/138/EC that should be amended or removed to suit the specificities of IORPs;*
- Other rules, if any*

### 21.2. Background

#### Current legal requirements (IORP Directive)

21.2.1. The IORP Directive does not contain any specific provision concerning an Own Risk and Solvency Assessment (ORSA).

#### International standards, guidelines and good practices

21.2.2. International standards, guidelines and good practices for occupational pensions do not contain explicit requirements for pension providers to perform ORSA.

#### Results of the public consultation on Green paper on pensions

21.2.3. As mentioned in section 2.3 of the CfA 13, the summary of consultation responses to question 10 of the Green paper on pensions concludes that many respondents considered the qualitative requirements of Solvency II (pillar 2 and 3) suitable for pension funds.

#### Solvency II Framework Directive

21.2.4. Solvency II Framework Directive in Article 45 provides for the following rules on the ORSA for insurance and reinsurance undertakings:

##### *Article 45*

##### *Own risk and solvency assessment*

*1. As part of its risk-management system every insurance undertaking and reinsurance undertaking shall conduct its own risk and solvency assessment.*

*That assessment shall include at least the following:*

*(a) the overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the undertaking;*

*(b) the compliance, on a continuous basis, with the capital requirements, as laid down in Chapter VI, Sections 4 and 5 and with the requirements regarding technical provisions, as laid down in Chapter VI, Section 2;*

*(c) the significance with which the risk profile of the undertaking concerned deviates from the assumptions underlying the Solvency Capital Requirement as laid down in Article 101(3), calculated with the standard formula in accordance with Chapter VI, Section 4, Subsection 2 or with its partial or full internal model in accordance with Chapter VI, Section 4, Subsection 3.*

*2. For the purposes of paragraph 1(a), the undertaking concerned shall have in place processes which are proportionate to the nature, scale and complexity of the risks inherent in its business and which enable it to properly identify and assess the risks it faces in the short and long term and to which it is or could be exposed. The undertaking shall demonstrate the methods used in that assessment.*

*3. In the case referred to in paragraph 1(c), when an internal model is used, the assessment shall be performed together with the recalibration that transforms the internal risk numbers into the Solvency Capital Requirement risk measure and calibration.*

*4. The own-risk and solvency assessment shall be an integral part of the business strategy and shall be taken into account on an ongoing basis in the strategic decisions of the undertaking.*

*5. Insurance and reinsurance undertakings shall perform the assessment referred to in paragraph 1 regularly and without any delay following any significant change in their risk profile.*

*6. The insurance and reinsurance undertakings shall inform the supervisory authorities of the results of each own-risk and solvency assessment as part of the information reported under Article 35, if required to do so by their supervisory authority.*

*7. The own-risk and solvency assessment shall not serve to calculate a capital requirement. The Solvency Capital Requirement shall be adjusted only in accordance with Articles 37, 231 to 233 and 238.*

*Article 50  
Delegated acts*

*[...]*

*2. Where necessary to ensure appropriate convergence of the assessment referred to in point (a) of Article 45(1), the Commission may adopt delegated acts, in accordance with Article 301a[...], to further specify the elements of that assessment.*

### **21.3. Explanatory text**

#### EIOPA view on issues in the CfA ORSA and its role in the insurance sector

21.3.1. All financial institutions should be able to understand their own financial condition and solvency position. In order for insurance companies to achieve this objective, the Solvency II Framework Directive *inter alia* imposes an

obligation on them to regularly perform their own-risk and solvency assessment (ORSA).

- 21.3.2. The ORSA is an undertaking's economic view of the means required to run its business, irrespective of the requirements set out by the regulator. It is risk-based and founded on the undertaking's business plans and projections. In the Solvency II regime, the ORSA forms an integral part of the management process and decision making framework of the insurance undertaking.
- 21.3.3. The purpose of the ORSA is to consider all material risks that may have an impact on the undertaking's ability to meet its obligations and to assess the capital adequacy relative to the risk profile of the undertaking.

#### Suitability of ORSA for IORPs

- 21.3.4. One argument against including ORSA in the revised IORP Directive is that the purpose of ORSA (see previous paragraph) is adequately covered in the funding calculations. Thus, the added value of the tool is unclear. On the other hand, discretionary benefits (legally un-enforceable promises/intentions to provide benefits) are not included in funding calculations and they can only be captured by ORSA. Moreover, contrary to funding calculations, ORSA includes both qualitative and quantitative elements and both short and long term risks. Furthermore, capital requirements are only quantitative and snapshot, while ORSA is also qualitative and long term.
- 21.3.5. Further argument against suitability of ORSA for IORPs is that IORPs are different from insurance companies in that risks of IORPs do not vary so much on a day to day basis as new membership carries similar risks to the existing membership. In this respect, IORPs have more time and possibilities to recover than insurers. On the other hand, new policyholders imply new risks for insurance companies only if the policyholders take new products (i.e. risks are related to the products not to policyholders). So the difference in this regard does not seem to be that wide.
- 21.3.6. A final argument against implementing ORSA into IORP directive could be that the general objective of ORSA in terms of understanding risks could also be achieved by the proper use of more extensive internal controls and risk management processes. On the other hand, according to article 45 of Solvency II Framework Directive the ORSA is an essential part of the risk management system.
- 21.3.7. The IORPs run their businesses on a long term cycle. The ORSA is a forward-looking concept; therefore it seems generally compatible with their business model. It has a potential to help the management body to gain confidence in understanding the sources of risk to and security of the pension scheme operated by the undertaking. It encourages the professional risk management culture and creates confidence amongst all stakeholders in the viability of the pension funds financial policy.
- 21.3.8. Arguments in favour of including ORSA into the revised IORP Directive seem to prevail over arguments against this option. Thus, the concept of ORSA could apply to IORPs with certain modifications explained below.

#### Scope of ORSA for IORPs and proportionality

- 21.3.9. ORSA could be translated into the pensions environment as an assessment conducted by the IORP of the risks faced by the undertaking and reconciliation of these risks with the available security mechanisms (including 'capital', but also sponsor support). An ORSA for IORPs should therefore cover all security mechanisms (i.e. not only solvency requirements as in Solvency II Framework Directive). This is in line with a general approach to pillar 1 adopted for IORPs, based on a holistic balance sheet.
- 21.3.10. Consistently with the Solvency II Framework Directive, ORSA for IORPs should include, at least, consideration of:
- The IORP's overall solvency needs, taking into account the specific risk profile, approved risk tolerance limits and business strategy.
  - Continuous compliance with the requirements for technical provisions and solvency capital as prescribed by the revised IORP Directive; and
  - The degree to which the IORP's risk profile deviates from the assumptions underlying solvency capital requirements.
- 21.3.11. In principle all IORPs should be required to perform ORSA.
- 21.3.12. The scope of ORSA in the revised IORP Directive should be more flexible than for insurance companies to better take into account the differences in the IORP business models. The regulation should not put an overly excessive burden on IORPs and/or create an unlevel playing field. A blanket requirement to perform full-scale ORSA in all circumstances would be inappropriate.
- 21.3.13. Article 45 (1) of the Solvency II Framework Directive deals with capital requirements almost only. This is inappropriate for IORPs that do not bear the risks alone. As the nature of risks and the size and complexity of the IORPs differs, so must the nature and complexity of ORSAs.
- 21.3.14. In order for ORSA to be commensurate with different IORPs' sizes and business models, the level of its complexity and sophistication should depend on the specific risk profile of IORPs or risk sharing mechanism among IORP, sponsoring undertaking and members. ORSA should not subject undertakings to qualitative measures that are disproportionate to their risk profiles. The level of sophistication exercised in the ORSA should be on a par with that used in risk management and in internal controls.
- 21.3.15. For a pure DC-scheme the ORSA shall be quite limited, since the only capital requirement such an IORP would have would be the cover against operational risk. Furthermore, for DC schemes where IORPs do not bear all the risks but where there are reasonable expectations from beneficiaries, ORSA could also play a role of self-assessment tool aimed at finding out whether the defined investment and risk objectives have been met. It could be reasonable to extend ORSA to assess risks from the angle of different risk owners.
- 21.3.16. For DB schemes ORSA for an IORP where the sponsor bears most or all risks will be different from an ORSA for an IORP that bears most or all of the risks itself.

- 21.3.17. EIOPA therefore suggests that sufficient flexibility be included in the Level 1 text that will provide for the possibility to adjust the scope of ORSA by Member States or supervisory authorities depending on the risk sharing mechanisms among IORP, members and sponsoring undertaking. The revised IORP Directive needs to provide also for the proportionality principle that will enable Member States to apply ORSA proportionately to the nature, scale, size and complexity of IORPs. The legislation should enable supervisors to conduct the scheme-specific exercises, where the IORP, overseen by its national supervisor, undertakes risk assessment activity that is appropriate for the risks it faces.
- 21.3.18. Also, sufficient space for clarification should be left to L2 text. For IORPs with certain risk-sharing mechanisms the scope of ORSA at L2 could include the following additional items:
- Assessment on a long-term horizon of the extent to which the prospects of the IORP are in line with possible results under different economic scenarios.
  - Stress scenarios analyses aimed at assessing the adequacy of available means to deal with crisis scenarios.
  - Consistency test having the objective of assessing whether it is realistic to assume that aspired discretionary benefits, e.g. in relation to indexation, can be fulfilled.
- 21.3.19. Similarly to the insurance regulation, the ORSA for IORPs should not be a one-off exercise or a single report. ORSA should be a documented risk management practice conducted by an IORP on a regular basis. The ORSA must be the responsibility of the IORP and it needs to be reviewed and approved by its administrative or management body.
- 21.3.20. Consistently with the Solvency II Framework Directive, the revised IORP Directive should not require the development of stochastic models or calculation of economic capital as part of ORSA. It also should not itself create a further capital requirement.

#### Role of the sponsoring undertaking in conducting ORSA

- 21.3.21. EIOPA believes that even in case of IORPs where the sponsor bears some risks, it is necessary to ensure that the persons who effectively run the IORP understand the short and long term risks that the IORP is exposed to. Therefore an assessment of those risks, even without any link to own funds requirements, is advisable to ensure that the IORP's overall solvency needs are met at all times.
- 21.3.22. In assessing that the solvency needs are met on a continuous basis, the ORSA needs to take into account the way the available security mechanisms behave in the scenarios that are analysed. In particular, security mechanisms

must be judged on their capacity to neutralise (part of) the effects of certain risks.

21.3.23. In conducting the ORSA, the sponsor should not play a part other than that the IORP has to take into account the sponsor risk borne by IORP (and, if applicable, sponsor support as a security mechanism).

#### Role of the supervisory authority

21.3.24. In addition to being an internal risk management process for an IORP, the ORSA should form part of the supervisory review. Upon their request, supervisors should receive results of each ORSA conducted by an IORP. The results of ORSA would enable supervisory authorities to better understand the firm's attitude towards risk management.

### POLICY OPTIONS

Option 1: Leave the IORP Directive unchanged

Option 2: The revised IORP Directive should include ORSA

## **21.4. Impact assessment**

### Positive Impacts

Option 1: Leave the IORP Directive unchanged

No impact.

Option 2: The revised IORP Directive should include ORSA

- IORP members and beneficiaries

- IORPs will indirectly be able to better deliver benefits expected by members and beneficiaries,

- IORPs and sponsoring employers

- better informed decisions on the part of IORP management as concerns the risks involved and coverage/security mechanisms available;
- signalling effect for operational risks where identified risks are not properly managed;
- risks stemming from benefits not included in funding calculations (discretionary benefits) are minimised;

- the level playing field across Europe is ensured
- Supervisory authorities
  - consistency with existing regulation in Solvency II

#### Negative impact

Option 1: Leave the IORP Directive unchanged

No impact.

Option 2: The revised IORP Directive should include ORSA

- IORP members and beneficiaries
  - Incremental compliance costs to IORP will be ultimately passed on to members and beneficiaries
- IORPs and sponsoring employers
  - Potential additional costs for IORP for risk management function and internal reporting lines.
- Supervisory authorities
  - Low incremental costs at supervisory authorities level (set-up & on-going costs borne).

#### Conclusion

EIOPA prefers option 2.

### **21.5. EIOPA advice**

#### ***The material elements of Article 45 of Directive 2009/138/EC that should be amended or removed to suit the specificities of IORPs;***

1. The revised IORP Directive should require that IORPs regularly conduct an Own Risk and Solvency Assessment (ORSA). The material elements of article 45 of Solvency II Framework Directive are suitable for IORPs.
2. In particular the scope of ORSA should include consideration of:
  - The IORP's overall solvency needs, taking into account the specific risk profile, approved risk tolerance limits and business strategy.
  - Continuous compliance with the requirements for technical provisions and solvency capital as prescribed by the revised IORP Directive; and

- The degree to which the IORP's risk profile deviates from the assumptions underlying solvency capital requirements.
3. A blanket requirement to perform full-scale ORSA in all circumstances would be inappropriate. ORSA should not subject undertakings to qualitative measures that are disproportionate to their risk profiles. The precise scope, level of complexity and sophistication of ORSA should depend on the specific risk profile of the IORP.
  4. Article 45 (1) of the Solvency II Framework Directive deals almost only with capital requirements. This is inappropriate for IORPs that do not bear the risks alone. In DC schemes scope of ORSA should be quite limited, since the only capital requirement such IORP would have would be the cover against operational risk. In these cases ORSA can be also useful to ensure that IORP makes a comprehensive assessment of its risk profile and risk management in view of its business strategy. Furthermore, if appropriate, ORSA for DC schemes should be aimed primarily at considering whether the defined investment and risk objectives (if any) are met. For this type of schemes it could be reasonable to focus ORSA on assessment of risks from the angle of different risk owners.
  5. In schemes where the IORP itself and/or the plan sponsor bear the risks the focus might be more on expected compliance with capital requirements, as suggested above.
  6. EIOPA therefore suggests including sufficient flexibility in the Level 1 text that will enable Member States and supervisory authorities to adjust the scope of ORSA for different risk sharing mechanisms. The revised IORP Directive should enable supervisors to conduct the scheme-specific exercises, where the IORP, overseen by its national supervisor, undertakes risk assessment activity that is appropriate for the risks it faces. The revised IORP directive should also enable adjusting the scope of ORSA for different categories of IORPs at Level 2.
  7. In order to prevent overlap of ORSA with risk management and internal control, the revised IORP directive should also make it clear that ORSA is to be regarded an extension of the risk management system and integral part of IORP's business strategy. The level of sophistication exercised in the ORSA should be on a par with that used in risk management and in internal controls. ORSA cannot result in duplication of the risk management activity. ORSA must be applied proportionately to the nature, size and complexity of IORPs
  8. ORSA should form part of the supervisory review. Member states should have discretion in how they ensure that the supervisory authority is informed about results of ORSA. IORPs may be required to submit the results of ORSA on a regular basis or only upon request of the supervisory authority.

***Other internal audit requirements for IORPs, if any.***

None

## **22. CfA 17: Internal control system**

### **22.1. Extract from the call for advice**

*The Commission Services would like EIOPA to advise on detailed rules by which supervisors can ensure that IORPs have proper internal control systems and a compliance function in place.*

*The EIOPA advice should address at least the following subjects:*

- *The material elements of Article 46 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to internal control systems and the compliance function;*
- *Other internal control requirements for IORPs, if any.*

### **22.2. Background**

#### Current legal requirements (IORP Directive)

- 22.2.1. According to article 14 (1) of the IORP Directive "The competent authorities shall require every institution located in their territories to have sound administrative and accounting procedures and adequate internal control mechanisms." The directive does not provide any further requirements on the internal control system of IORPs.

#### International standards, guidelines and good practices

- 22.2.2. Various international standards and recommendations applicable to pension institutions provide more details on the design of internal controls system.
- 22.2.3. The OECD Recommendation on the Core Principles of Occupational Pension Regulation of June 2009 stipulates in its 6th core principle that adequate internal controls should be in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives set out by the pension fund, and that they comply with the law. Such controls should cover all basic organisational and administrative procedures depending upon the scale and complexity of the plan. The governing body should develop a code of conduct and a conflicts of interest policy. There should also be appropriate controls to promote the independence and impartiality of the decisions taken by the governing body, to ensure the confidentiality of sensitive information pertaining to the fund and to prevent the improper use of privileged or confidential information.
- 22.2.4. Principle 9 of the OECD Guidelines for pension fund governance of June 2009 recommends the same principles.
- 22.2.5. Good practice 6 (control and monitoring mechanisms) of the OECD/IOPS Good Practices for Pension Funds' Risk Management Systems of January 2011 recommends that control and monitoring mechanisms should be implemented and should operate at every level. Monitoring needs to be part

of daily activities but also include separate periodic evaluations of the overall internal control process, with the frequency of monitoring different activities determined by the risks involved and the frequency and nature of changes occurring in the operating environment.

- 22.2.6. Key elements of the risk management and monitoring system are the internal audit and compliance functions – the nature and scope of which should be appropriate to the operations of the pension fund. Performance measurement and compensation mechanisms should be part of risk management systems.
- 22.2.7. The OECD Pension Funds' Risk Management framework: regulation and supervisory oversight of February 2010 examines what sort of risk-management framework pension funds should have in place. At the heart of any risk-management framework are the control mechanisms. These should operate at every level and be an integral part of daily activities, at the top management level, as well as within each department. The core of these mechanisms is to ensure that decision making, execution and checking functions are assigned to different people and have suitable oversight.

#### Results of the public consultation on Green paper on pensions

- 22.2.8. As mentioned in section 2.3 of the CfA 13, the summary of consultation responses to question 10 of the Green Paper on pensions concludes that many respondents considered the qualitative requirements of Solvency II (pillar 2 and 3) suitable for pension funds.

#### Solvency II Framework Directive

- 22.2.9. Solvency II Framework Directive in Article 46 provides for the following rules on the organisation of internal control system for insurance and reinsurance undertakings:

##### *Article 46.*

*"1. Insurance and reinsurance undertakings shall have in place an effective internal control system.*

*That system shall at least include administrative and accounting procedures, an internal control framework, appropriate reporting arrangements at all levels of the undertaking and a compliance function.*

*2. The compliance function shall include advising the administrative, management or supervisory body on compliance with the laws, regulations and administrative provisions adopted pursuant to this Directive. It shall also include an assessment of the possible impact of any changes in the legal environment on the operations of the undertaking concerned and the identification and assessment of compliance risk."*

#### OPC reports

- 22.2.10. The EIOPA OPC Report on management oversight and internal controls rules applicable to IORPs (EIOPA-OP-37-10 Rev1), 9 June 2010, concludes in its sections II. 4, 5 and 6 that the vast majority of respondents have

requirements establishing the existence of an internal control system and most of them also have rules concerning the main components of such a system.

- 22.2.11. As far as functions and their role is concerned, in general rules on independence from operational functions are stronger in the case of the internal audit function compared with the compliance function. The existence of requirements for business continuity planning is already a reality in half of the responding countries. Requirements regarding the proper execution and prior evaluation of the investment policy have proved to be common practice amongst respondents.
- 22.2.12. As for the supervisory practices, results show that around 80% of those requirements are directly handled by the competent authorities. On-site inspections are the most common form of surveillance, with regulatory reporting and analysis and offsite surveys and surveillance ranking next.

## **22.3. Explanatory text**

### EIOPA view on issues in the CfA

- 22.3.1. The IORP Directive already contains the general principle that the competent authorities shall require every institution located in their territories to have sound administrative and accounting procedures and adequate internal control mechanisms (article 14 (1)). There is currently no explicit requirement for a compliance function. The application of these principles varies in the EU. EIOPA acknowledges the necessity of increasing the level of harmonisation in this area.

### Effective internal control system and its components

- 22.3.2. EIOPA agrees with the principle that IORPs should have an effective internal control system. Taking into account the heterogeneous nature of the IORP sector in EU Member States, the internal control system should be proportionate to the nature, scale and complexity of the IORP. However, as regards the wording of Article 46 (1) of the Solvency II Framework Directive, EIOPA has the following observations:
- 22.3.3. Firstly, this article doesn't take into account that a large number of IORPs outsource one or more of their critical or important functions or activities to a service provider. Therefore, EIOPA is of the opinion that the provisions of the revised IORP Directive regulating the internal control system should contain a reference that the outsourced activities are an integral part of the scope of the internal control system.
- 22.3.4. In the event that critical or important functions or activities are outsourced, the IORP should be satisfied whether, having regard to the nature of the outsourced activities, the third party has a well-adapted and effective internal control system in place. If this is not the case, the IORP should itself monitor the activities of the third party and urge the third party to take the appropriate measures in order to comply with the principle of internal control. In no case does outsourcing diminish the responsibility of the IORP.

- 22.3.5. Secondly, the wording of Article 46 (1) of the Solvency II Framework Directive is not fully suitable for IORPs as it singles out some of its internal activities (compliance, reporting) but fails to point out others, e.g. record keeping, outsourcing.
- 22.3.6. Further analysis might reveal the need to further elaborate the framework for internal controls in level 2 implementing measures.
- 22.3.7. Finally EIOPA points out that there is no major difference between IORPs that manage DC schemes and those that manage DB schemes relating to the obligation to implement an internal control system; both two types of IORPs should have such a system. It is inevitable that the implementation of that system will be different. The internal control system should be appropriate to the situation of the IORP. It should therefore also take into account the specific risks that are attached to DB or DC schemes (further analysis might reveal the need to further develop this in the Level 2 implementing measures).

#### Compliance function

- 22.3.8. EIOPA agrees that a regular assessment of compliance is part of an effective internal control system.
- 22.3.9. EIOPA has the following observations as regards suitability of the wording of Article 46 (2) of the Solvency II Framework Directive for IORPs.
- 22.3.10. EIOPA proposes to clarify that the compliance function is required to perform its activities in relation to the administrative, management or supervisory body of the IORP. This wording is more precise and secures that the text clearly refers to the internal "supervisory body" of the IORP and not to the supervisory authority.
- 22.3.11. As stated in article 46(2) of the Solvency II Framework Directive, EIOPA acknowledges that the primary task of the compliance function is to advise the administrative, management or supervisory body of the IORP on compliance with the laws, regulations and administrative provisions. The internal "reporting function" of the compliance function vis-a-vis the IORP is incontestable. However, the future directive should contain a whistle-blowing requirement for the compliance function to inform the supervisory authority in those cases where the administrative, management or supervisory body of the IORP does not take appropriate and timely remedial action. The whistle-blower should be legally protected. Furthermore, the supervisory authority should have the power to require reports from the IORP on compliance.
- 22.3.12. EIOPA suggests making it clear that the compliance function should include not only compliance with the laws, regulations and administrative provisions "adopted pursuant to this Directive", but with all legislation with an impact on the operations of the IORP e.g. Social & Labour law. This is particularly important in cross-border situations where the IORP has to take into account foreign legislation.
- 22.3.13. Regarding the definition of "function", EIOPA refers to the explanation given in CFA 14 concerning fit and proper.

- 22.3.14. Taking into account the heterogeneous nature of the IORP sector in EU Member States, given the big differences that exist between IORPs as regards form, size, pension schemes, risk level and complexity of activities of different IORPs, the principles of good governance (including internal control) must be implemented in a reasonable and proportionate manner.
- 22.3.15. The revised IORP Directive should make it clear that it is the IORP that is responsible for defining a consistent and adequate solution in regard to carrying out the compliance function (depending on the nature, scale and complexity of its activities and hence depending on its risk profile).
- 22.3.16. In EIOPA's view the compliance function can be carried out in different ways (this list is not exhaustive):
- a) The compliance function may be assigned to a person, a compliance officer. The advantage of the designation of a person is that the supervisory authorities or other parties concerned have one contact person. Moreover, it is clear who carries the responsibility. The compliance officer may be a member of the staff or the compliance function may be performed by a member of the board of directors. The competence of that person is essential, but he/she should have the possibility of obtaining external opinions or outsourcing certain tasks when he/she feels he/she does not have the competence required for this purpose (e.g. when asked to provide advice on very specific legal issues the compliance officer should have the opportunity to obtain an external advice/consultation). Nevertheless, if he/she seeks assistance from an external specialists, he/she shall remain responsible for the quality of his/her function.
  - b) The compliance function does not necessarily need to be an internal function. EIOPA insists on leaving the possibility for IORPs to outsource the compliance function. That way, the IORP can use the expertise and knowledge of a third party. Who the third party can be should be determined in the level 2 implementation measures. In that case the competent body of the IORP should monitor the compliance activity and should appoint the persons responsible for following up on the expert's recommendations.
  - c) The general perception that the compliance function requires the appointment of a compliance officer, could be overelaborate for some IORPs of less complex nature, smaller scale and lower complexity. Therefore, on the grounds of proportionality, the IORPs should be allowed to elect to implement alternative measures meeting the general objectives of a compliance function. A hypothetical example of an alternative measure could be that the compliance function is carried out by the administrative, management or supervisory body of the IORP, which for instance discusses the subject at least once a year with a special reference in the minutes. The supervisory authorities should have the possibility to review the proposed alternative measures. However, the Supervisory Authority should, in its consideration, pay extra attention where the IORP operates cross border. Indeed, cross border activities imply a certain level of complexity (structure, administration, communication) where a minimum level of internal control and

supervision of compliance is needed. This could be further developed in the level 2 implementation measures.

22.3.17. Questions about the fit and proper requirements of the compliance function are discussed in CfA 14.

## **22.4. Impact assessment**

OPTION 1 - Leave the IORP directive unchanged.

OPTION 2 - Introduce into the IORP Directive the same principles for the internal control as in Article 46 of the Solvency II Framework Directive. In addition, the revised IORP Directive should include a whistle-blowing requirement for the compliance function to inform the supervisory authority in those cases where the administrative, management or supervisory body of the IORP does not take appropriate and timely remedial action.

The impact is hard to predict because it is one of a number of impacts that could be brought in to a reformed IORP directive. Changes in behaviour of the IORP, or the employer, for example will depend upon the collective weight of a number of impacts. This qualitative assessment does not replace the need to assess the impacts on a quantitative basis.

Note that the impacts could be excessive if the principle of proportionality is not properly applied.

### Option 1

No impact.

### Option 2

#### Positive impacts

##### 1. Members

Article 46 offers increased internal controls requirements compared to those in the IORP directive and increased member protection

##### 2. Supervisory authorities

More formalised governance arrangements, and emphasis on compliance, will support supervision.

#### Negative impacts

##### 1. Members

- Potential to reduce income available to pensioners as a result of the increased cost on IORPs
- Reduction in the supply or the quality of the scheme offered to the workforce by the employer, if costs become unacceptably high

## 2. IORPs and sponsoring employers

Increased administrative costs around particular aspects e.g. a stronger compliance system.

### Conclusion

- 22.4.1. Overall, EIOPA does not foresee a high impact of the level 1 requirement with respect to internal controls for members/beneficiaries of IORPs, sponsors or supervisors but the cost may vary from member state to member state, depending upon their current implementation of the IORP. For some member states, the costs will be higher than for others.
- 22.4.2. EIOPA prefers option 2. In any case, the principle of proportionality (cf. the above remarks) should fully apply to the compliance function in order to prevent the impact of this regulation being overly burdensome and thus potentially undermining the supply of occupational pensions.

## 22.5. EIOPA advice

***The material elements of Article 46 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to internal control systems and the compliance function;***

1. EIOPA agrees with the principle of Article 46 of Directive 2009/138/EC that IORPs should have an effective internal control system and that a regular assessment of compliance is part of this effective internal control system.
2. The framework for internal control should include at least administrative and accounting procedures and reporting and compliance arrangements, outsourcing arrangements and appropriate controls for outsourcing.
3. The compliance function shall include reporting and recommending to the administrative, management or supervisory body of the IORP on compliance with the laws, regulations and administrative provisions with an impact on the operations of the IORP (i.e. including Social and Labour law).
4. The revised IORP Directive should state that it is the responsibility of each IORP to define a consistent and adequate way of carrying out the compliance function. It should enable assigning the compliance function to a member of the staff or a member of the board of directors. On proportionality grounds the IORP should be allowed to outsource the function or employ the alternative measures of carrying out the function while meeting the general objectives of this function. The Supervisory Authorities should have the possibility of reviewing the proposed alternative measures and should, in its consideration, pay extra attention to cross border situations.
5. Moreover, the revised directive should contain a whistle-blowing requirement for the compliance function to inform the supervisory authority in those cases where the administrative, management or supervisory body of the IORP does not take appropriate and timely remedial action. The whistle-blower should be legally protected.

6. Further analysis might reveal the need to further elaborate the details of the framework for internal controls and ways of carrying out the compliance function in level 2 implementing measures.

***Other internal control requirements for IORPs, if any.***

None

## **23. CfA 18: Internal audit**

### **23.1. Extract from the call for advice**

*The Commission Services would like EIOPA to advise on detailed rules by which supervisors can ensure that IORPs have an internal audit function in place.*

*The EIOPA advice should address at least the following subjects:*

- *The material elements of Article 47 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the internal audit function;*
- *Other internal audit requirements for IORPs, if any.*

### **23.2. Background**

#### Current legal requirements (IORP Directive)

23.2.1. The IORP Directive does not contain any specific provision concerning internal audit.

#### International standards, guidelines and good practices

23.2.2. Although the OECD Recommendation on the Core Principles of Occupational Pension Regulation of June 2009 (Core Principle 6 (auditor)) and the OECD Guidelines for pension fund governance of June 2009 recommend adequate internal controls (cf. comments CfA 17), they are silent on the appointment of an internal auditor.

23.2.3. OECD/IOPS Good Practices for Pension Funds' Risk Management Systems of January 2011 (Good practice 6 (control and monitoring mechanisms)) recommends the implementation of Control and Monitoring Mechanisms. Key elements of the risk management and monitoring system are the internal audit and compliance functions – the nature and scope of which should be appropriate to the operations of the pension fund. These functions report directly to the governing board and they should not conflict with other obligations. Those responsible for internal audit and compliance require access to records and the ability to communicate freely to carry out their role effectively.

23.2.4. The internal auditing function within a pension fund should cover the effectiveness of operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and compliance with laws and regulations.

#### Results of the public consultation on Green paper on pensions

23.2.5. As mentioned in section 2.3 of the CfA 13, the summary of consultation responses to question 10 of the Green paper on pensions concludes that

many respondents considered the qualitative requirements of Solvency II (pillar 2 and 3) suitable for pension funds

### Solvency II Framework Directive

23.2.6. Solvency II Framework Directive in Article 47 provides for the following rules on internal audit for insurance and reinsurance undertakings:

#### *Article 47*

*1. Insurance and reinsurance undertakings shall provide for an effective internal audit function.*

*The internal audit function shall include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance.*

*2. The internal audit function shall be objective and independent from the operational functions.*

*3. Any findings and recommendations of the internal audit shall be reported to the administrative, management or supervisory body which shall determine what actions are to be taken with respect to each of the internal audit findings and recommendations and shall ensure that those actions are carried out.*

### OPC reports

23.2.7. EIOPA OPC Report on management oversight and internal controls rules applicable to IORPs (EIOPA-OP-37-10 Rev1), 9 June 2010, points out in its section II.4, 5 and 6 that as far as functions and their role are concerned, in general rules on independence from operational functions are stronger in the case of the internal audit function compared with the compliance function.

23.2.8. For more details see comments regarding CfA 17.

## **23.3. Explanatory text**

### EIOPA view on issues in the CfA

23.3.1. EIOPA holds the opinion that the introduction of an internal audit function in the IORP Directive would be beneficial. Generally, the material elements of article 47 of Solvency II Framework Directive are suitable for IORPs.

### Effective internal audit functions and its components

23.3.2. As in the CfA concerning internal control system, EIOPA is of the opinion that the wording of provisions on internal audit should also take into account that a large number of IORPs outsource one or more of their critical or important functions or activities to a service provider. The provisions of the revised IORP Directive regulating the internal audit should contain a reference that the outsourced critical or important functions or activities of the IORP are an integral part of the scope of the internal audit.

23.3.3. Where critical or important functions or activities are outsourced, the IORP should be satisfied whether, having regard to the nature of the outsourced activities, the third party has a well-adapted and effective internal audit

system in place. If this is not the case, the IORP should itself monitor the activities of the third party and urge the third party to take the appropriate measures in order to comply with the principle of internal audit. In no case does outsourcing diminish the responsibility of the IORP.

- 23.3.4. Regarding for the definition of "function" EIOPA refers to the explanation given in CfA 14 (fit and proper).
- 23.3.5. Taking into account the heterogeneous nature of the IORP sector in EU Member States, given the big differences that exist between IORPs as regards form, size, pension schemes, risk level and complexity of IORPs' activities, the principles of good governance (including internal audit) must be implemented in a reasonable and proportionate manner.
- 23.3.6. The revised IORP Directive should make it clear that it is the IORP that is responsible for defining a consistent and adequate solution in regard to carrying out the internal audit function (depending on the nature, scale and complexity of its activities and hence depending on its risk profile).
- 23.3.7. In EIOPA's opinion the internal audit function can be carried out in different ways (this list is not exhaustive):
  - (i) The internal audit function may be assigned to a member of the staff - an internal auditor. The advantage of the designation of a person is that the supervisory authorities or other parties concerned have one contact person. Moreover, it is clear who carries the responsibility. The internal auditor must be independent and thus cannot be involved in the activities that are subject to audit. An internal auditor cannot be involved in the management of the IORP. The professional competence of that person is essential, but he/she should have the possibility to obtain external opinions or outsource certain investigations when he/she feels he/she does not have the competence required for this purpose. Nevertheless, if he/she seeks assistance from an external specialists, he/she shall remain responsible for the quality of his/her function.
  - (ii) The internal audit function does not necessarily need to be an internal function. EIOPA strongly recommends leaving the possibility of IORPs outsourcing the internal audit function, regardless of the size of the IORP. That way, the IORP can use the expertise and knowledge of a third party. Who this third party can be should be determined in the level 2 implementation measures.
  - (iii) The general perception that the internal audit function requires the appointment of an internal auditor could be overelaborate for some IORPs of simple nature, scale and complexity of the operations<sup>65</sup>. Therefore, on the grounds of proportionality, the IORPs should be allowed to elect to implement alternative measures meeting the general objectives of an internal audit function. The supervisory authorities should have the possibility of reviewing the proposed alternative measures. However, the supervisory authority should, in its

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<sup>65</sup> It should be noted that OECD recommendations do not necessarily support the appointment of an internal auditor for IORPs (Core Principles of occupational Pension Regulation, June 2009; core principle 6; OECD Guidelines June 2009)

consideration, pay extra attention where the IORP works cross border. Indeed, cross border activities imply a certain level of a complexity (structure, administration, communication) where a minimum level of internal supervision is needed. This could be further developed in the level 2 implementation measures.

- 23.3.8. Questions about the fit and proper requirements of the internal audit function are discussed in CfA 14.
- 23.3.9. Finally EIOPA points out that there is no major difference between IORPs that manage DC schemes and those that manage DB schemes related to internal audit; both two types of IORPs should have an internal audit function. It is inevitable that the implementation of that function will be different and should be appropriate to the situation of the IORP. It should therefore also take into account the specific risks that are attached to DB or DC schemes (further analysis might reveal the need to further develop this in the Level 2 implementing measures).

#### Objectiveness and Independence of the internal audit function

- 23.3.10. EIOPA agrees with this principle. Where there is an internal auditor, he/she should be independent of the activities audited. This means that he/she has an appropriate status and performs his task impartially and objectively. He may not be involved in the management of the IORP. Rules with respect to conflicts of interests could be developed in the level 2 implementing measures.
- 23.3.11. The professional competence of the internal auditor is essential for the proper functioning of internal audit. Questions about the fit and proper requirements are discussed in CfA 14.

#### Reporting by internal audit function

- 23.3.12. EIOPA is of the opinion that the internal audit function should have the right to express his/her opinions freely. He/she must report his/her findings and recommendations to the competent administrative, management or supervisory body of the IORP at least once a year.
- 23.3.13. EIOPA proposes to clarify that the internal audit function is required to perform its activities in relation to the administrative, management or supervisory body of the IORP. This wording is more precise and secures that the text clearly refers to the internal "supervisory body" of the IORP and not to the supervisory authority.
- 23.3.14. The administrative, management or supervisory body of the IORP should be required to determine what actions are to be taken with respect to each of the internal audit findings and recommendations and shall ensure that those actions are carried out.
- 23.3.15. As stated in article 47(3) of the Solvency II Framework Directive, EIOPA acknowledges that the internal audit function should primarily report to the administrative, management or supervisory body of the IORP. The internal "reporting function" of the internal audit function vis-a-vis the IORP is incontestable. However, the future directive should contain a whistle-blowing

requirement for the internal audit function to inform the supervisory authority in those cases where the administrative, management or supervisory body of the IORP does not take appropriate and timely remedial action. The whistle-blower should be legally protected. Furthermore, the supervisory authority should have the power to require reports from the IORP on internal audit.

#### Policy options

OPTION 1 Leave the IORP directive unchanged

OPTION 2 - Introduce into the IORP Directive the principles for the internal audit as described in the blue box below.

### **23.4. Impact assessment**

OPTION 1 Leave the IORP directive unchanged

No impact.

OPTION 2 - Introduce into the IORP Directive the principles for the internal audit as described in the blue box below.

#### Positive impacts

1. On members

Potential for improved protection for members

2. On supervisory authorities

workload should be lighter as a result, if there is stronger governance

#### Negative impacts

1. On members

potential to reduce income available to pensioners as a result of the increased cost  
Reduction in the supply or the quality of the scheme offered

2. On IORPs and sponsoring employers

Potential to increase costs and regulatory burden unless this was very proportionately applied.

#### Conclusion

The impact of the level 1 requirement for members and beneficiaries, IORPs and employers and supervisors is hard to predict since this is a new requirement. EIOPA wants to point out that the introduction of an internal audit function could have the potential to be overly burdensome without a corresponding increase in benefits on the scheme, with potential adverse cost impacts for members if the principle of proportionality (cf. the above remarks) is not taken into account.

The cost burden of setting up and running an internal audit function, or an outsourced internal audit function, may be partly borne by a sponsoring employer who provides a scheme but could in some cases ultimately be borne by the member. This is particularly the case with DC schemes where each individual's amount of money available at retirement could be reduced by this additional cost over each year of contribution.

EIOPA prefers option 2.

### 23.5. EIOPA advice

#### **The material elements of Article 47 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the internal audit function.**

1. EIOPA recommends the introduction of an internal audit function in the IORP Directive. In general, the material elements of article 47 of Solvency II Framework Directive are suitable for IORPs.
2. The internal audit function shall include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance of the IORP, including the outsourced critical or important functions or activities.
3. EIOPA points out that taking into account the heterogeneous nature of the IORP sector, the principles of internal audit must be implemented in a reasonable and proportionate manner.
4. The revised IORP Directive should state that it is the responsibility of each IORP to define a consistent and adequate way of carrying out the internal audit function. The revised Directive should enable assigning the internal audit function to a member of the staff. The IORP should be also allowed to outsource the internal audit function or employ the alternative measures for carrying out the function while meeting the general objectives of this function. The supervisory authorities should have the possibility of reviewing the proposed alternative measures and should, in their consideration, pay extra attention to cross border situations.
5. EIOPA proposes to clarify that the internal audit function is required to perform its activities in relation to the administrative, management or supervisory body of the IORP.
6. The relevant body of the IORP should be required to determine what actions and recommendations are to be taken with respect to the internal audit findings and ensure that those actions are carried out.
7. Moreover, the revised directive should contain a whistle-blowing requirement for the internal audit function to inform the supervisory authority in those cases where the administrative, management or supervisory body of the IORP does not take appropriate and timely remedial action. The whistle-blower should be legally protected.
8. Further analysis might reveal the need to further elaborate the details of the internal audit function and ways of filling it in level 2 implementing measures.

#### **Other internal audit requirements for IORPs, if any.**

None

## 24. CfA 19: Actuarial function

### 24.1. Extract from the call for advice

*The Commission Services would like EIOPA to advise, in close cooperation with the actuarial profession, on detailed rules by which supervisors can ensure that IORPs have an actuarial function in place.*

*The EIOPA advice should address at least the following subjects:*

- The material elements of Article 48 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the actuarial function;*
- Other actuarial requirements for IORPs, if any.*

### 24.2. Background

#### Current legal requirements (IORP Directive)

24.2.1. The IORP Directive contains following provisions on the actuary:

##### *Article 9*

##### *Conditions of operation*

*1. Each Member State shall, in respect of every institution located in its territory, ensure that:*

*[...]*

*(d) all technical provisions are computed and certified by an actuary or, if not by an actuary, by another specialist in this field, including an auditor, according to national legislation, on the basis of actuarial methods recognised by the competent authorities of the home Member State;*

*[...]*

##### *Article 15*

##### *Technical provisions*

*4. The calculation of the technical provisions shall be executed and certified by an actuary or, if not by an actuary, by another specialist in this field, including an auditor, according to national legislation, on the basis of actuarial methods recognised by the competent authorities of the home Member State, according to the following principles: [...]*

#### International standards, guidelines and good practices

24.2.2. Both the Core Principle 6 (actuary & delegation and expert advice) of the OECD Recommendation on the Core Principles of Occupational Pension

*Regulation of June 2009 and the OECD Guidelines for pension fund governance of June 2009 recommend the appointment of an actuary by the appropriate body or authority for all defined benefit plans financed via pension funds. The 'whistle blowing' responsibilities of the actuary are emphasized.*

- 24.2.3. *The OECD/IOPS Good Practices for Pension Funds' Risk Management Systems of January 2011 recommends in the Good Practice 3 (Funding and Solvency Risk Control) that the governing board will normally rely on the advice of an actuary when monitoring the funding level of the pension fund. Good Practice 6 stresses out that the actuary should be independent and has 'whistle blowing' responsibilities.*

#### Results of the public consultation on Green paper on pensions

- 24.2.4. As mentioned in section 2.3 of the CfA 13, the summary of consultation responses to question 10 of the Green paper on pensions concludes that many respondents considered the qualitative requirements of Solvency II (pillar 2 and 3) suitable for pension funds.

#### Solvency II Framework Directive

- 24.2.5. Solvency II Framework Directive in Article 48 provides for the following rules on the actuarial function for insurance and reinsurance undertakings:

##### *Article 48*

##### *Actuarial function*

*1. Insurance and reinsurance undertakings shall provide for an effective actuarial function to:*

*(a) coordinate the calculation of technical provisions;*

*(b) ensure the appropriateness of the methodologies and underlying models used as well as the assumptions made in the calculation of technical provisions;*

*(c) assess the sufficiency and quality of the data used in the calculation of technical provisions;*

*(d) compare best estimates against experience;*

*(e) inform the administrative, management or supervisory body of the reliability and adequacy of the calculation of technical provisions;*

*(f) oversee the calculation of technical provisions in the cases set out in Article 82;*

*(g) express an opinion on the overall underwriting policy;*

*(h) express an opinion on the adequacy of reinsurance arrangements;  
and*

*(i) contribute to the effective implementation of the risk-management system referred to in Article 44, in particular with respect to the risk modelling underlying the calculation of the capital requirements set out in Chapter VI, Sections 4 and 5, and to the assessment referred to in Article 45.*

*2. The actuarial function shall be carried out by persons who have knowledge of actuarial and financial mathematics, commensurate with the nature, scale and complexity of the risks inherent in the business of the insurance or reinsurance undertaking, and who are able to demonstrate their relevant experience with applicable professional and other standards.*

## *Article 50*

### *Delegated acts*

*1. The Commission shall adopt delegated acts, in accordance with Article 301a[...], to further specify the following:*

*[...]*

*(b) the functions referred to in Articles 44, 46, 47 and 48;*

## **24.3. Explanatory text**

### EIOPA view on issues in the CfA

#### Evaluation of the actuarial function in general

- 24.3.1. The IORP Directive currently requires an "actuary" (or similar qualified specialist) to execute and certify the calculation of the technical provisions. The article 48 (1) (a) of the Solvency II Framework Directive provides for detailed regulation of the "actuarial function", EIOPA assumes that the "actuary" referred to in the IORP Directive and the "actuarial function" embodied in the Solvency II Framework Directive can be considered to be the same, even if the Solvency II Framework Directive extends the role of the actuarial function considerably.
- 24.3.2. EIOPA observes that Member States have different systems concerning the role of the actuaries. In some Member States, the IORPs are required to have two actuaries: one actuary who executes the actuarial tasks concerning the pension scheme and another (external) actuary who performs a controlling (oversight) task. In other Member States, those two tasks can be performed by one (internal or external) actuary. These roles are covered by the 'actuarial function' as set forth below.
- 24.3.3. Additionally, some Member States require verification (certification) of the actuarial statements and accompanying reports by another actuary in order to increase the credibility of these documents and the level of assurance of the IORP's financial reports. For several reasons (the requirement of a certification would go beyond SII, the high costs of two actuaries for IORPs and ultimately the members and beneficiaries), the rules governing the 'actuarial function' under the new IORP Directive should not impose an

obligation on the actuarial function to perform such certification. But the regulation should not also restrict the possibility for Member States to require the certification either from the actuarial function or from a second external or internal actuary.

- 24.3.4. EIOPA stresses that it is the board of the IORP/its trustees who is/are ultimately responsible for the decision-making. The board/trustees need to take the advice of the actuarial function into consideration, however the advice cannot be binding on them.
- 24.3.5. The actuarial function could be performed by a natural person as well as by a firm. For firms, the same fit and proper requirements have to be fulfilled by the firm's representatives that are actually responsible for the activities carried out for the IORP.
- 24.3.6. EIOPA points out that a wide variety of types of pension schemes exist in Member States. Therefore, it is important that the role of the actuarial function is formulated in the revised IORP directive with sufficient flexibility in order to cater for these differences: the actuarial function must be able to take into account the specific risks that are attached to DB or DC schemes (to be developed further in the Level 2 implementing measures).
- 24.3.7. If an IORP carries biometric risks or provides investment guarantees, EIOPA considers that an actuarial function should be required. In EIOPA's opinion, the actuarial function is not relevant for IORPs that manage only "pure" DC schemes where no investment guarantees are provided and there are no biometric risks involved, either during the accumulation phase or during the pay-out phase (for instance "pure" DC schemes where there is only pay-out of a lump sum or programmed withdrawal). Only these IORPs should be exempted from the obligation to have an actuarial function. However, actuarial skills could be relevant to the projection of future events under such pure DC schemes, notably in relation to the projection of assets, risks and expected outcomes, member communications, ....
- 24.3.8. The definition of "function" is included in paragraph 11.3.8. of CfA 14 (fit and proper).
- 24.3.9. Taking into account the heterogeneous nature of the IORP sector in EU Member States, given the big differences that exist between IORPs as regards form, size, pension schemes, risk level and complexity of IORPs' activities, the principles of good governance must be implemented in a reasonable and proportionate manner.
- 24.3.10. The revised IORP Directive should make it clear that, within the legislative framework established for the actuarial function, it is the IORP that is responsible for defining a consistent and adequate solution in regard to the specifics of carrying out the actuarial function (depending on the nature, scale and complexity of its activities and hence depending on its risk profile).
- 24.3.11. In EIOPA's view the actuarial function can be carried out in different ways: an IORP should be able to assign the actuarial function to an internal or external person (cf. explanation in paragraphs below).

Evaluation of the duties of the actuarial function (article 48, 1 of the Solvency II Framework Directive)

- 24.3.12. The IORP Directive currently requires IORPs to have an "actuary", but his/her tasks are not set in the directive very clearly. EIOPA acknowledges the need to define the scope of the actuarial function more precisely in order to strengthen the existing requirements and to address the risk that the IORP does not have an accurate, consistent and independent view of its liabilities.
- 24.3.13. EIOPA points out that not all the material elements of article 48 (1) of the Solvency II Framework Directive are suitable for IORPs. Therefore, the wording of article 48 (1) should be adapted to the specificities of IORPs.
- 24.3.14. In general, the duties of the actuarial function are not limited to a survey of the global financial equilibrium of the IORP and the way operations are run within the IORP, but he/she should also take the specificities of each managed scheme (contributions, funding level, actuarial assumptions, mortality tables, reinsurance, etc.) into account in his activities.
- 24.3.15. EIOPA has the following remarks concerning the duties of the actuarial function specified in article 48 (1):
- 24.3.16. *Coordination of the calculation of technical provisions* [Article 48 (1) (a) of the Solvency II Framework Directive] - this task is in line with the current duty of the actuary as stated in article 9 (1) (d) and article 15(4) of the current IORP Directive.
- 24.3.17. Ensuring the appropriateness of the methodologies and underlying models used as well as the assumptions made in the *calculation of technical provisions* [Article 48 (1) (b) of the Solvency II Framework Directive] - EIOPA stresses that as it is the board of the IORP/its trustees who is/are ultimately responsible for the decision-making, the advice of the actuarial function cannot be binding on the board/trustees. In any case, the advice needs to be considered by the IORP decision makers. Therefore, the word "ensure" in the text should be replaced by "assess".
- 24.3.18. EIOPA considers the tasks of the actuarial function mentioned below suitable for IORPs without any adjustments:
- assess the sufficiency and quality of the data used in the calculation of technical provisions [Article 48 (1) (c) of the Solvency II Framework Directive],
  - compare best estimates against experience [Article 48 (1) (d) of the Solvency II Framework Directive],
  - oversee the calculation of technical provisions in the cases set out in Article 82 [Article 48 (1) (f) of the Solvency II Framework Directive]
- 24.3.19. The task of informing the administrative, management or supervisory body of the reliability and adequacy of the calculation of technical provisions [Article 48 (1) (e) of the Solvency II Framework Directive] EIOPA considers as important because the IORP should be managed in a sound and prudent manner for which reliable information on the past experience and likely future adequacy of technical provisions is an essential component. The

actuarial function should also be required to comment on the adequacy of future expected contributions to meet the benefits to be provided for future service. Given this importance, EIOPA recommends that the actuarial function should provide the administrative, management or supervisory body of the IORP with written advice. EIOPA also proposes to add the words "of the IORP" after "supervisory body" to make clear that the text refers to an internal body.

24.3.20. However, EIOPA's opinion is that it is insufficient only to supply information to the administrative, management or supervisory body of the IORP. The reporting obligation should be extended also vis-à-vis the supervisory authority. Moreover, the actuary function should be tasked with the whistle-blowing responsibility. The whistle-blower should be legally protected.

a) Reporting towards the supervisory authority: to be able to fulfil its role, the supervisory authority should at all times have the power to require reports, statements and any information reasonably needed for the supervision of the IORP from the actuarial function on a periodical basis or upon request.

b) The whistle-blowing responsibility of the actuarial function: the internal "warning function" vis-a-vis the IORP of the actuarial function is incontestable. However, the actuarial function shall inform the supervisory authority if the IORP does not take appropriate and timely remedial action as soon as the actuarial function:

- realises that there is a risk that the IORP is unlikely to comply with a materially significant statutory requirement (e.g. when the actuary considers that members' rights are threatened or the financial condition of the IORP may be jeopardised);
- observes a materially significant breach of the legislation or regulations applicable to the IORP and its activities in the context of his/her function.

24.3.21. To be able to perform his/her duties in a correct and timely manner, the actuarial function should receive without delay any information he/she considers indispensable for the performance of his/her tasks (including from external service providers). Moreover, the whistle-blower should be legally protected.

24.3.22. As regards the task of the actuarial function to express an opinion on the overall underwriting policy [Article 48 (1) (g) of the Solvency II Framework Directive] - EIOPA points out that this is not generally relevant to IORPs. Most IORPs are set up by an employer to manage its pension scheme, so the IORP doesn't have the liberty to accept or refuse risks. Therefore EIOPA recommends starting the sentence with "*when applicable*".

24.3.23. Regarding the task of the actuarial function to express an opinion on the adequacy of reinsurance arrangements [Article 48 (1) (h) of the Solvency II Framework Directive] EIOPA recommends redrafting this sentence as follows: "when applicable, express an opinion on the adequacy of insurance or reinsurance arrangements". The specific tasks of the actuarial function

regarding the different ways in which IORPs may use insurance, or quasi-insurance, arrangements should be further analysed in level 2 implementing measures.

- 24.3.24. Regarding the task of the actuarial function to contribute to the effective implementation of the risk-management system referred to in Article 44, in particular with respect to the risk modelling underlying the calculation of the capital requirements set out in Chapter VI, Sections 4 and 5, and to the assessment referred to in Article 45 [Article 48 (1) (i) of the Solvency II Framework Directive], EIOPA notes that if a new risk based solvency capital requirement is introduced, then this subparagraph should apply to IORPs in an adequate way.
- 24.3.25. Finally, more details on the specific duties of the actuarial function could be further elaborated in the level 2 implementing measures.

Evaluation of the qualifications of the actuarial function (article 48, 2 of the Solvency II Framework Directive)

- 24.3.26. The material elements of article 48 (2) of the Solvency II Framework Directive are suitable for IORPs, but EIOPA recommends supplementing this article with the requirement of independence.
- 24.3.27. EIOPA is of the opinion that the management of an IORP is required to ensure that it takes competent, appropriate and independent actuarial advice into account when making its decisions. The statements and advice of the actuarial function can only increase the level of credibility of the IORPs' financial reports if he/she acts independently. Therefore, the actuarial function should have "operational independence" and mustn't perform a function which gives rise to a conflict of interest, or belong to a provider of other services which could lead to such a conflict, unless sufficient measures are in place to guarantee his/her independence. In some cases, the consulting firm may provide additional services to the IORP e.g. administration and record keeping, investment advice or management, and this should not be prohibited, again provided appropriate safeguards are in place. Further analysis might reveal the need to further develop this matter in the Level 2 implementing measures.
- 24.3.28. Member States should have nevertheless the option to admit that the actuarial function is carried out by a member of the staff or the administrative, management or supervisory body of the IORP. In that case, sufficient measures should be in place to guarantee his/her independence.
- 24.3.29. IORPs need to ensure that the actuarial function should be performed by persons who are knowledgeable and have relevant experience. Criteria may include:
- Qualified by specified initial and ongoing educational requirements;
  - Membership in the local professional body at an appropriate level;
  - A minimum specified period of relevant practice as an actuary since qualification at that level.

Further analysis might reveal the need to further develop this matter in the Level 2 implementing measures.

- 24.3.30. The requirements regarding who could be appointed as an actuarial function may be defined in the legislation or supervisory rules.
- 24.3.31. Since the actuarial function is a key function, EIOPA refers to CfA 14 concerning the conditions of fitness and propriety and the accompanying role of the supervisory authority.

#### Groupe Consultatif Actuariel Européen (GCAE)

- 24.3.32. To respond to the request of the European Commission to give advice in close cooperation with the actuarial profession, a first draft was submitted to the GCAE.
- 24.3.33. In general the GCAE agreed with the analysis of the position and the related issues as set out in the paper, but had some comments and suggestions for clarification, a few linked to issues discussed in other work streams.

#### Policy options

- 24.3.34. The following policy options can be set out for the actuarial function.

Option 1: Leave the IORP directive unchanged

Option 2: Introduce into the IORP Directive the principles for actuarial function as described in the blue box below.

This option consists of defining the scope, tasks and qualifications of the actuarial function more precisely than the current IORP directive by copying article 48 of the Solvency II framework Directive, provided that the wording is adapted to the specificities of IORP's as described in the blue box below.

### **24.4. Impact assessment**

#### Positive impacts

Option 1:

No impact.

Option 2:

- Standardisation of the requirements regarding the actuarial function will lead to more harmonisation across the EU. This will increase confidence of members and beneficiaries in their pensions and may also alleviate cross border activity.
- By having a more precise description of the tasks and qualifications of the actuarial function, IORP's and sponsoring undertakings should have a more accurate and independent view of their liabilities.

- From the Supervisory Authorities perspective, they should be able to take greater comfort that the actuarial function is actually performed as intended.

#### Negative impacts

Option 1:

No impact.

Option 2:

- The introduction of new tasks for the actuarial function will lead to additional administrative burden for IORPs. But in many Member States provisions on the scope, tasks and qualifications of the actuarial function are already in place. Therefore EIOPA doesn't foresee high impact of the level 1 requirement for the IORPs, the sponsoring undertakings, members/beneficiaries of IORPs or the supervisors.

#### **Conclusion / Concluding remark/**

24.4.1. EIOPA prefers option 2.

24.4.2. EIOPA notes that the above assessment of impact is only an estimation and does not in principle replace the need for an impact study to assess the real impact of the new requirements. Furthermore EIOPA stresses that the impact could significantly increase if the principle of proportionality were not appropriately applied.

#### **24.5. EIOPA advice**

##### **The material elements of Article 48 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to the actuarial function;**

1. EIOPA acknowledges the need to define the scope of the actuarial function more precisely than in the current IORP directive in order to strengthen the existing requirements, and to address the risk that the IORP does not have an accurate and independent view of its liabilities. This does not restrict Member States from requiring an additional certification of the actuarial statements and accompanying reports by another actuary.
2. EIOPA stresses that it is the board of the IORP/its trustees who is/are ultimately responsible for the decision-making. The board/trustees need to take the advice of the actuarial function into consideration, however the advice cannot be binding on them.
3. Taken into account the specific risks that are attached to DB or DC schemes, EIOPA points out that the role of the actuarial function is not relevant for "pure" DC schemes where no investment guarantees are provided, there are no biometric risks for the IORP and there is no risk pooling of members' and/or beneficiaries' biometric risks either during the accumulation phase, or during the pay-out phase.

4. The revised IORP Directive should state that it is the responsibility of each IORP to define a proportionate, consistent and adequate way of carrying out the actuarial function within the legislative framework established for the actuarial function. It should enable the assigning of the actuarial function to an internal or external person.
5. Regarding the role of the actuarial function, EIOPA suggests adapting the wording of article 48 (1) of the Solvency II Framework Directive to the specificities of IORPs as follows:
  - (b) (appropriateness): as the IORP bears the final responsibility, the word "ensure" should be replaced by "assess";
  - (e) (reporting): the obligation of reporting should be extended vis-a-vis the supervisory authority and the revised directive should provide for the whistle-blowing responsibility of the actuarial function if the IORP does not take any appropriate remedial action. To clarify the wording of this paragraph, the words "of the IORP" should be added after "supervisory body";
  - (g) (underwriting policy): EIOPA recommends starting the sentence with "when applicable";
  - (h) (reinsurance): EIOPA recommends starting the sentence with "when applicable" and adding "insurance arrangements"
6. Regarding the qualification of the actuarial function, article 48 (2) of the Solvency II Framework Directive is suitable for IORPs but EIOPA recommends emphasising the requirement of independence. The statements and advice of the actuarial function can only increase the level of credibility of the IORPs' financial reports if he/she acts independently. Therefore, the actuarial function must not perform a function which gives rise to a conflict of interest, or belong to a provider of other services which could lead to such a conflict, unless sufficient measures are in place to guarantee the actuary's independence. Member States should have nevertheless the option to permit that the actuarial function is carried out by a member of the staff or the administrative, management or supervisory body of the IORP. In that case, sufficient measures should be in place to guarantee his/her independence.
7. Further analysis might reveal the need to further develop this matter in the Level 2 implementing measures.
8. Moreover, the revised directive should contain a whistle-blowing requirement for the actuarial function to inform the supervisory authority in those cases where the administrative, management or supervisory body of the IORP does not take appropriate and timely remedial action. The whistle-blower should be legally protected.
9. EIOPA doesn't foresee a high impact of the Level 1 requirement for the pension industry, supervisors or scheme members/beneficiaries of IORPs.

**Other actuarial requirements for IORPs, if any.**

None

## 25. CfA 20: Outsourcing

### 25.1. Extract from the call for advice

*The Commission Services would like EIOPA to advise on detailed rules on outsourcing for IORPs.*

*The EIOPA advice should address at least the following subjects:*

- The material elements of Article 49 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to outsourcing;*
- Other outsourcing requirements for IORPs, if any.*

### 25.2. Background

#### Current legal requirements (IORP Directive)

25.2.1. The IORP Directive in its current wording permits IORPs to transfer some or all of their activities to a third party service provider. This transfer is explicitly referred to as “outsourcing” in several provisions of the Directive:

*Article 9 (4): “A Member State may permit or require institutions located in its territory to entrust management of these institutions, in whole or in part, to other entities operating on behalf of those institutions.”*

*Article 19 (1): “Member States shall not restrict institutions from appointing, for the management of the investment portfolio, investment managers established in another Member State and duly authorised for this activity, in accordance with Directives 85/611/EEC, 93/22/EEC, 2000/12/EC and 2002/83/EC, as well as those referred to in Article 2(1) of this Directive.”*

*Article 19 (2): “Member States shall not restrict institutions from appointing, for the custody of their assets, custodians established in another Member State and duly authorised in accordance with Directive 93/22/EEC or Directive 2000/12/EC, or accepted as a depositary for the purposes of Directive 85/611/EEC.*

*The provision referred to in this paragraph shall not prevent the home Member State from making the appointment of a depositary or a custodian compulsory.”*

#### International standards, guidelines and good practices

25.2.2. With regard to outsourcing the applicable international standard (OECD/IOPS good practices for pension funds' risk management systems) requires pension institution to develop a written policy on outsourcing.

25.2.3. Furthermore, the relations between pension institution and service provider must be set in the written outsourcing agreement that should at least contain the following elements:

- a) the ultimate responsibility for the outsourced activity must remain with the pension institution,
- b) the service provider must commit itself to enable monitoring of its activities by the IORPs governing bodies themselves or via audit as well as supervisory authority on an on-going basis. This should include access to the information and the premises of the service provider (where appropriate), including right of the supervisory authority to perform or require an audit of the service provider. The service providers may not charge a fee for providing information or access.

#### Results of the public consultation on Green paper on pensions

25.2.4. As mentioned in section 2.3 of the CfA 13, the summary of consultation responses to question 10 of the Green paper on pensions concludes that many respondents considered the qualitative requirements of Solvency II (pillar 2 and 3) suitable for pension funds.

#### Solvency II Framework Directive

25.2.5. Solvency II Framework Directive in Article 49 provides for the following rules on outsourcing for insurance and reinsurance undertakings:

##### *"Article 49*

##### *Outsourcing*

*1. Member States shall ensure that insurance and reinsurance undertakings remain fully responsible for discharging all of their obligations under this Directive when they outsource functions or any insurance or reinsurance activities.*

*2. Outsourcing of critical or important operational functions or activities shall not be undertaken in such a way as to lead to any of the following:*

*(a) materially impairing the quality of the system of governance of the undertaking concerned;*

*(b) unduly increasing the operational risk;*

*(c) impairing the ability of the supervisory authorities to monitor the compliance of the undertaking with its obligations;*

*(d) undermining continuous and satisfactory service to policy holders.*

*3. Insurance and reinsurance undertakings shall, in a timely manner, notify the supervisory authorities prior to the outsourcing of critical or important functions or activities as well as of any subsequent material developments with respect to those functions or activities.*

#### OPC reports

25.2.6. In 2007 – 2008 CEIOPS OPC carried out a survey regarding applicable outsourcing principles for the IORPs among the EEA Member States. This survey obtained information on how Member States regulate outsourcing of IORPs functions and activities and how the supervision of the outsourced functions and activities is done. The results were summarized in the Report on

outsourcing by IORPs (CEIOPS-OP-12-08M final), OPC, 30 October 2008 (Outsourcing Report). The explanatory text below builds on the most important finding of the survey.

### **25.3. Explanatory text**

#### EIOPA view on issues in the CfA

25.3.1. The IORP Directive currently provides that Member States may permit to entrust to third party service providers the whole or part of IORP management. Furthermore, it also requires Member States not to restrict an IORP from appointing for the management of investment portfolio and the custody of assets the investment managers or custodian established in another Member State duly authorised for these activities. Finally, it permits the home Member State to make the appointment of depository or custodian compulsory. These principles are pivotal for the functioning of IORPs in most EU Member States. EIOPA therefore suggests that they must be maintained also in the new regulatory regime for IORPs.

#### Responsibility for outsourced functions

25.3.2. The outsourcing report concluded that in the majority of Member States the IORP remains ultimately responsible for functions they outsource to a third party service provider, even in the case of mandatory outsourcing. EIOPA is of the view that the principle of keeping with the IORP the ultimate responsibility for outsourced critical or important functions or activities should be explicitly prescribed in the revised IORP Directive.

25.3.3. The IORP that outsources its critical or important functions or activities must be able to perform regular monitoring of how they are carried out by the service provider. The IORP cannot be required to have the technical knowledge to perform the activities outsourced to third parties, especially when critical or important functions (e.g. asset management) are outsourced mandatorily by law. With specific reference to asset management activities, many IORPs outsource mainly because of the lack of internal investment expertise; furthermore in some Member States outsourcing of the investment activity is mandatory by law, to ensure that it is carried out by professional managers. It is important to emphasise that IORPs are required, even when outsourcing investment activity, to ensure full understanding and control of the investment process as a whole, and that they still remain fully responsible for all aspects and for the general consistency of the investment process.

#### Approach to outsourcing

25.3.4. In EU Member States there are two different approaches to outsourcing:

- a) for the majority of Member States, a limited number of functions and activities have to be carried out by IORPs themselves and all the other functions and activities may or must be carried out by a third party service provider;
- b) in a small number of Member States, IORPs cannot outsource the majority of their functions and activities to third party service providers.

25.3.5. At the national level the outsourcing is subject to a various specific limitations:

- a) Certain (critical) functions and (important) activities may be outsourced only to service providers established under the specific legal framework and subject to supervision. The other functions can be carried out by undertakings which do not fall under specific prudential supervision.
- b) In almost half of the EU Member States it is also possible to outsource some of its activities to another IORP.
- c) Outsourcing cannot prejudice the integrity of the IORP's own systems and controls,
- d) The IORP must verify prior to outsourcing that the third party service provider is competent and financially sound.

25.3.6. With reference to the established practices at the national level and in order to ensure that members and beneficiaries are sufficiently protected, EIOPA suggests that outsourcing of critical or important functions or activities of IORPs should be made subject to certain limitations that would be included in the revised IORP Directive. Outsourcing cannot lead to operating inefficiency in IORPs. Furthermore, it cannot hinder the exercise of an effective supervision by Supervisory Authorities.

25.3.7. In this context, the principles in Article 49 (2) of the Solvency II Framework Directive are broadly applicable to IORPs. However, EIOPA suggests drafting the limitation to outsourcing in a positive way vs. the negative way as drafted in Solvency II Framework Directive. Furthermore it is suggested to add a principle requiring IORPs to ensure the proper functioning of the outsourced activities through the selection process and ongoing monitoring

25.3.8. The specifications of the above principles, as well as of requirements for particular cases, such as the outsourcing of key functions to the sponsoring undertaking, could be regulated at Level 2.

25.3.9. Finally, in the majority of Member States, IORPs are required to have a legally enforceable document for any outsourced activity, in a written form. The national legislation also often provides for the minimum content of such contract. EIOPA therefore considers the written outsourcing agreement an effective tool ensuring high level of transparency in both domestic and cross-border outsourcing and facilitating the effective supervision of outsourced functions and activities.

25.3.10. EIOPA suggests that the revised IORP Directive contains a principle requiring IORPs to have a written outsourcing agreement. Level 2 would then provide for the minimum contents (chapter list) of the agreement. In providing for this minimum content, it could be useful to provide that, in the case of outsourcing of critical or important functions or activities (such as investment management), fiduciary duties are extended to the provider of the outsourced services.

#### Role of the supervisory authority

25.3.11. Regarding the applicability of article 49 (3) of the Solvency II Framework Directive to IORPs, two mutually exclusive approaches are possible:

- a) The obligation to notify is applicable to IORPs. Thus under the revised IORP directive, IORPs will be required to notify to the supervisory authority prior to the outsourcing of critical or important functions as well

as any subsequent material developments. This requirement, however, cannot be interpreted as a prior approval of the supervisor to outsource.

- b) The obligation to notify is not applicable to IORPs. Thus under the revised IORP directive, IORPs will not be required to notify to the supervisory authority prior to the outsourcing of a critical or important functions as well as any subsequent material developments. However, the revised IORP directive should make it possible for Member States to impose on IORP the obligation to notify (national option).

25.3.12. In any case the Supervisory Authority has to have the necessary powers to request all information on outsourcing at any time of the outsourcing process. It is also important to ensure that the Supervisory Authority has the power to intervene if necessary.

25.3.13. As the level of outsourcing and the approach followed on the supervision of the outsourced activity varies enormously between countries, it is important that the solution suggested should guarantee a certain degree of flexibility in the system, leaving Member States to choose the level of burden taking into account the characteristics of the domestic pension funds and supervisory system. The supervisory authority has to be focussed on the supervision of critical situations that could arise from the outsourced activities/function and the IORP should be responsible for the outsourced activities. Member States should have maximum powers to have all the information - but how they use this power – e.g. ask in advance etc., is up to them.

25.3.14. At the same time, given the large heterogeneity of IORPs among Member States, it is necessary to ensure a minimum common standard in how to inform/notify Supervisory authority on outsourced functions or activities.

25.3.15. As a possible solution, EIOPA suggests that Member States must ensure supervisory authorities have necessary powers at any time to request information on outsourced functions and activities. In addition, Member States may decide to provide that IORPs shall, in a timely manner, inform or notify the supervisory authorities on the outsourcing of critical or important functions or activities.

## POLICY OPTIONS

Option 1: Leave the IORP Directive unchanged

Option 2: Introduce the Article 49 of the Solvency II Framework Directive into the revised IORP Directive with the modifications set out in the blue box.

## **25.4. Impact assessment**

### POSITIVE IMPACTS

Option 1: Leave the IORP Directive unchanged

No impact.

Option 2: Apply material aspects of solvency II framework directive requirements on outsourcing

- IORP members and beneficiaries
  - Higher level of protection
- IORPs and sponsoring employers
  - Specification that IORPs do not need to have the technical knowledge to perform the outsourced activities, although they remain ultimately responsible for outsourced activities and must have sufficient knowledge to monitor the activities of service providers
  - Common set of principles for outsourcing
- Supervisory authorities
  - Incremental powers on outsourced functions or activities
  - Increase in standardisation of outsourcing process

#### NEGATIVE IMPACT

Option 1: Leave the IORP Directive unchanged

No impact.

Option 2: Apply material aspects of solvency II requirements on outsourcing

- IORP members and beneficiaries
  - Potential additional administrative costs for members and beneficiaries
- IORPs and sponsoring employers
  - Potential additional administrative costs for IORP,
  - Increase in requirements for outsourcing
- Supervisory authorities
  - Potential increase in administrative burden

#### Conclusion

EIOPA prefers option 2.

## 25.5. EIOPA advice

***The material elements of Article 49 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to outsourcing;***

1. EIOPA holds the view that the material elements of article 49(1) of the Solvency II Framework Directive are generally applicable to IORPs. EIOPA considers also useful to maintain principle on outsourcing stated in article 9(4) of the current Directive.
2. The IORP cannot be required to have detailed technical knowledge to carry out the activities outsourced to third parties. Member States shall ensure that IORPs remain fully responsible when they outsource functions or activities to third parties.
3. Outsourcing of critical or important functions or activities must be undertaken in such a way that:
  - (a) the quality of the system of governance remain intact;
  - (b) there is no undue increase in operational risk;
  - (c) supervisory authorities remain sighted of the outsourcing and are able to monitor the compliance;
  - (d) a satisfactory service to members and beneficiaries continues to be delivered;
  - (e) the competent operational body of the IORP has to ensure the proper functioning of the outsourced activities in how both the selection process and the ongoing monitoring is carried out.
4. IORPs are required to have a legally enforceable document for any outsourced activity, in a written form.
5. Member States must ensure that supervisory authorities have the necessary powers at any time to request information on outsourced functions and activities. Member States may decide to provide that IORPs shall, in a timely manner, inform or notify the supervisory authorities on the outsourcing of critical or important functions or activities as well as any subsequent changes with respect to those functions or activities.
6. Nothing in the provisions on outsourcing should deprive member states of their power to prohibit outsourcing of certain IORPs` functions and/or activities.

***- Other outsourcing requirements for IORPs, if any.***

***EIOPA suggests to maintain the art. 19(1) of the current IORP Directive.***

## 26. CfA 21: Custodian / depository

### 26.1. Extract from the call for advice

*The Commission Services would like EIOPA to advise on the issues identified below:*

- The need to create a more consistent approach, from a supervisory perspective, in relation to the appointment of a custodian/depositary, the type of body which is appointed to fulfil this role and the function that it performs.*
- The need to consider rules regarding conflicts of interest or incompatibility.*
- The extent to which the rules on depositaries in the UCITS IV Directive (articles 22 to 26) adequately protect the assets from IORPs from a supervisory perspective.*
- The effectiveness of the powers and procedures followed by the competent authorities to prohibit the free disposal of assets by a foreign custodian/depositary, as required by article 19(3) of the IORP Directive.*
- Other advice, if any.*

### 26.2. Background

#### Current legal requirements (IORP Directive)

26.2.1. The IORP Directive enables an IORP to use a custodian/depositary located in another Member State. However, it may need to be reviewed in order to ensure that the custodians/depositaries of IORPs, irrespective of their location within the EU, adequately protect the interest of the members/beneficiaries. The relevant provisions are as follows:

#### *Article 19*

#### *Management and custody*

*[...]*

*2. Member States shall not restrict institutions from appointing, for the custody of their assets, custodians established in another Member State and duly authorised in accordance with Directive 93/22/EEC or Directive 2000/12/EC, or accepted as a depositary for the purposes of Directive 85/611/EEC.*

*The provision referred to in this paragraph shall not prevent the home Member State from making the appointment of a depositary or a custodian compulsory.*

*3. Each Member State shall take the necessary steps to enable it under its national law to prohibit, in accordance with Article 14, the free disposal of assets held by a depositary or custodian located within its territory at the request of the institution's home Member State.*

#### International standards, guidelines and good practices

- 26.2.2. In implementing guideline 6.8 for Core Principle 6 of Occupational Pension Regulation, June 2009, it is stated that custody of the pension fund assets may be carried out by the pension entity, the financial institution that manages the pension fund, or by an independent custodian. If an independent custodian is appointed by the governing body to hold the pension fund assets and to ensure their safekeeping, the pension fund assets should be legally separated from those of the custodian. The custodian should not be able to absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safekeeping.
- 26.2.3. The OECD Guidelines for pension fund governance, June 2009, further complement the above by stating that, where appropriate, the appointment of an independent custodian may be required.
- 26.2.4. Besides holding the pension fund assets and ensuring their safekeeping, the custodian may also provide additional services such as securities lending, cash management, investment accounting and reporting, and performance measurement. In some cases, the custodian may also play an external 'whistle blowing' function similar to that of the auditor with respect to, for example, the investment of pension assets.
- 26.2.5. According to the OECD/IOPS Good Practices for Pension Funds' Risk Management Systems, January 2011, in addition to – and working with – the internal control mechanisms, independent external parties, such as external auditors, actuaries and custodians, should be appointed as part of the risk management of a pension system.
- 26.2.6. In addition it is stated that mechanisms are needed to assess regularly the performance of the pension funds' external service providers, including those providing custody.

#### UCITS IV Directive

### CHAPTER IV

#### OBLIGATIONS REGARDING THE DEPOSITARY

##### Article 22

- 1. The assets of a common fund shall be entrusted to a depositary for safe-keeping.*
- 2. A depositary's liability as referred to in Article 24 shall not be affected by the fact that it has entrusted to a third party all or some of the assets in its safe-keeping.*
- 3. A depositary shall:*
  - (a) ensure that the sale, issue, repurchase, redemption and cancellation of units effected on behalf of a common fund or by a management company are carried out in accordance with the applicable national law and the fund rules;*
  - (b) ensure that the value of units is calculated in accordance with the applicable national law and the fund rules;*

- (c) carry out the instructions of the management company, unless they conflict with the applicable national law or the fund rules;*
- (d) ensure that in transactions involving a common fund's assets any consideration is remitted to it within the usual time limits;*
- (e) ensure that a common fund's income is applied in accordance with the applicable national law and the fund rules.*

### *Article 23*

- 1. A depositary shall either have its registered office or be established in the UCITS home Member State.*
  - 2. A depositary shall be an institution which is subject to prudential regulation and ongoing supervision. It shall also furnish sufficient financial and professional guarantees to be able effectively to pursue its business as depositary and meet the commitments inherent in that function.*
  - 3. Member States shall determine which of the categories of institutions referred to in paragraph 2 shall be eligible to be depositaries.*
  - 4. The depositary shall enable the competent authorities of the UCITS home Member State to obtain, on request, all information that the depositary has obtained while discharging its duties and that is necessary for the competent authorities to supervise the UCITS compliance with this Directive.*
  - 5. Where the management company's home Member State is not the UCITS home Member State, the depositary shall sign a written agreement with the management company regulating the flow of information deemed necessary to allow it to perform the functions set out in Article 22 and in other laws, regulations or administrative provisions which are relevant for depositaries in the UCITS home Member State.*
  - 6. The Commission may adopt implementing measures in relation to the measures to be taken by a depositary in order to fulfil its duties regarding a UCITS managed by a management company established in another Member State, including the particulars that need to be included in the standard agreement to be used by the depositary and the management company in accordance with paragraph 5.*
- Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 112(2).*

### *Article 24*

*A depositary shall, in accordance with the national law of the UCITS home Member State, be liable to the management company and the unit-holders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them.*

*Liability to unit-holders may be invoked directly or indirectly through the management company, depending on the legal nature of the relationship between the depositary, the management company and the unit-holders.*

#### *Article 25*

*1. No company shall act as both management company and depositary.*

*2. In the context of their respective roles, the management company and the depositary shall act independently and solely in the interest of the unit-holders.*

#### *Article 26*

*The law or the fund rules shall lay down the conditions for the replacement of the management company and the depositary and rules to ensure the protection of unit-holders in the event of such replacement.*

### OPC reports

26.2.7. In 2006 the CEIOPS Occupational Pensions Committee decided to examine in depth the existence and the characteristics, in the different member states, of specific rules regarding IORPs custodians/depositaries. The survey focused its attention on the possible role of the custodian/depositary, because Directive 2003/41/EC, through references to the Directives 93/22/EEC, 2000/12/EC and 85/611/EEC, makes different kinds of institutions equivalent for the purpose of the appointment by IORPs. In particular, while the institutions that are authorised on the basis of the Directives 93/22/EEC or 2000/12/EC run an activity limited to the investment services and custody of liquidity, the institutions operating as depositaries on the basis of Directive 85/611/EC have a wider role, including for instance, in addition to the safe-keeping of the assets, the control of the way investments are carried out and whether the value of the units is calculated in compliance with the law and the fund rules.

26.2.8. Replies provided by CEIOPS members to the questionnaire on custodian/depositary pointed out that the appointment of a custodian/depositary is compulsory in the majority of countries (16), considering the custodian/depositary a crucial prudential safeguard for IORP members. In the other cases the appointment could be made on a voluntary basis. In general it is also possible (15 countries) to appoint more than one custodian/depositary.

26.2.9. With regards to the typology of eligible custodian/depositary, there is an heterogeneous list of eligible entities across the States. Normally the entity is a credit institution. In some countries, the custodian/depositary can also be an asset management company, an investment firm, an insurance company, an investment brokerage company or another financial institution. Only 10 States have specific rules regarding incompatibility and conflicts of interests between the custodian and the IORP asset managers.

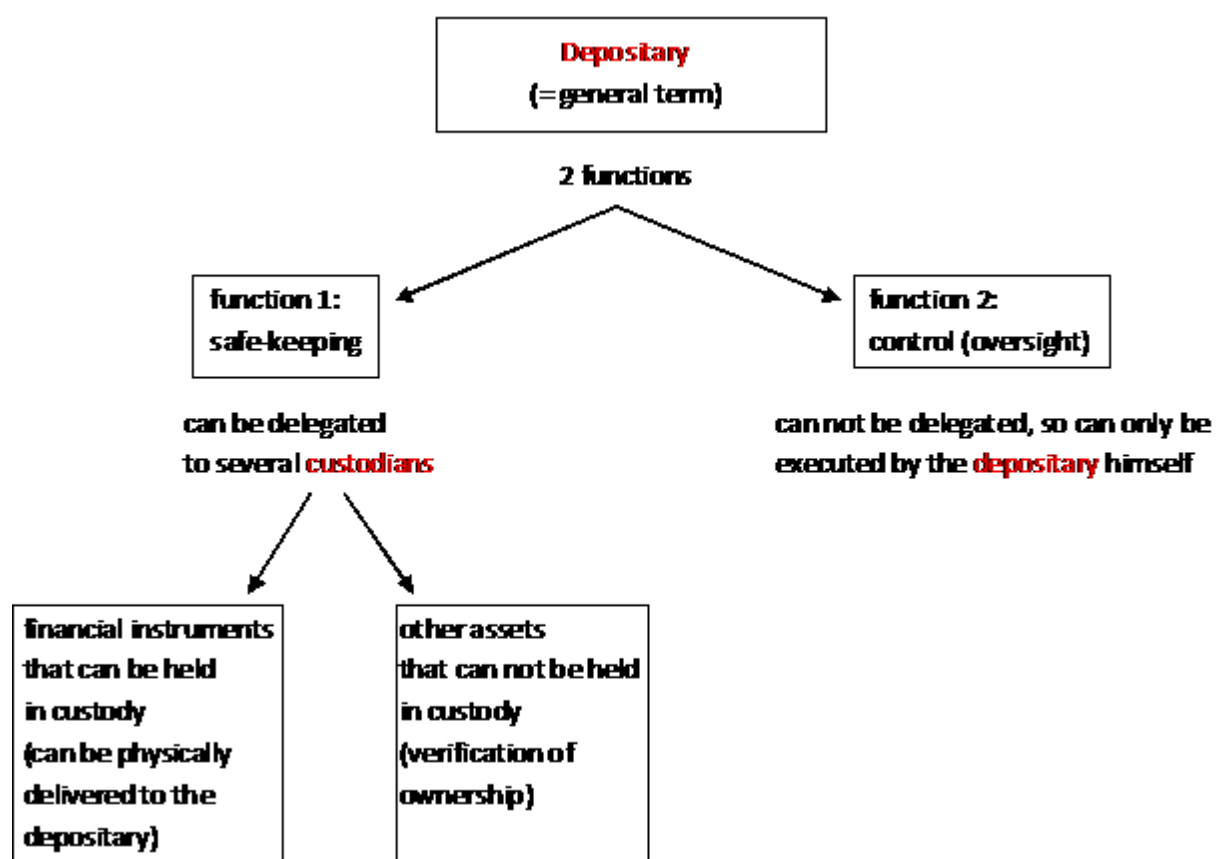
26.2.10. CEIOPS OPC Report on Initial review of key aspects of the implementation of the IORP Directive (CEIOPS-OP-03-08 final), 31 March 2008, concludes, based on the questionnaire on custodian/depositary, that there are differences across Member States in relation to the appointment of a

custodian, the type of body which is appointed to fulfil this role and the function that it performs. Diversity also exists around the role of competent authorities, some of whom play a role in the process of the custodian's appointment.

26.2.11. The Commission Report on some key aspects concerning the IORP Directive, 30 April 2009, takes note of the analysis carried out by CEIOPS, but does not exclude that there may be a need for legislative change at a later stage.

#### Clarification of the roles played by custodians and depositaries

26.2.12. Having in mind that the terms custodian/depositary might correspond to different types of functions, depending on the jurisdiction and type of institution, EIOPA finds it relevant to first establish a common and harmonised understanding of the roles played by custodians and depositaries. For that EIOPA refers to the interpretation under the Directive 2011/61/EU on Alternative Investment Fund Managers (AIFM Directive). The AIFM Directive is a more recent and advanced piece of legislation on the depositary subject than the UCITS IV framework and will serve as a benchmark to the development of UCITS V Directive.



26.2.13. According to the AIFM Directive the depositary has two primary functions: to safe-keep assets and to oversee compliance with the fund rules and applicable law. The custodian function relates only to the safe-keeping of assets.

- 26.2.14. Additionally, depositaries can choose to delegate the safe-keeping of assets to sub-custodians, provided that some conditions are met.
- 26.2.15. The following description aims only to provide a general view of the functions and duties that are expected of depositaries, taking into account the AIFM Directive text and, when relevant, the ESMA's draft technical advice to the European Commission on possible implementing measures under this Directive.

#### Safe-keeping of assets

- 26.2.16. Depending on the type of assets the depositary is entrusted with for safe-keeping, the tasks it will need to perform in order to fulfil its safe-keeping functions can take the form of custody – for financial instruments that can be held in custody – or record-keeping – for the other assets.

#### Custody

- 26.2.17. The Article 21(8)(a)(i) of the AIFM Directive generally defines financial instruments which can be held in custody as all financial instruments that can be registered in a financial instruments account opened in the depositary's books or can be physically delivered to the depositary.
- 26.2.18. The definition of the term financial instruments and the type of financial instruments that can be included in the scope of the depositary's custody functions is still under discussion.
- 26.2.19. To comply with its obligations pursuant to Article 21(8)(a) – safe-keeping duties related to financial instruments that can be held in custody – at the current stage of the discussion it is expected that the depositary should be required to at least:
- Ensure the financial instruments are properly registered in segregated accounts in order to be identified at all times as belonging to the Alternative Investment Fund (AIF);
  - Exercise due care in relation to the financial instruments held in custody to ensure a high level of protection;
  - Assess and monitor all relevant custody risks. In particular, depositaries should be required to assess the custody risks related to settlement systems and inform AIFM of any material risk identified;
- 26.2.20. Where the depositary has delegated its custody functions, the depositary should ensure that sub-custodians comply with these above mentioned obligations and especially the segregation obligations. This requirement is supposed to mitigate the consequences of the insolvency of the sub-custodian. The depositary should monitor the delegated custody functions.

#### Record-keeping

- 26.2.21. With regard to the depositary's record-keeping function which applies to all other assets, the Article 21(8)(b) of the AIFM Directive imposes two

obligations on the depositary: to verify the ownership of such assets and to maintain a record of those assets.

26.2.22. According to the current discussion it is expected that financial instruments which would fall under the other assets category would include, but not be limited to:

- Physical assets that do not qualify as financial instruments or cannot be physically delivered to the depositary;
- All financial contracts (e.g., derivatives contracts);
- All financial instruments, including units and share of collective investment schemes, issued in a nominative form or registered directly with the issuer or through a registrar acting on behalf of the issuer;
- All financial instruments provided as collateral under a title transfer collateral arrangement;
- Cash deposits with a third party entity.

26.2.23. In order to be able to properly perform its record-keeping function, the depositary should have access to all relevant information it needs, including from third parties.

26.2.24. Pursuant to Article 21 of the AIFM Directive, the depositary's liability can be triggered either in the event of failure or negligence or in the event of loss of a financial instrument held in custody by the depositary itself or a sub-custodian.

26.2.25. It is worth noting that the AIFM Directive reinforces significantly the depositary's liability regime compared to its liability under the UCITS IV framework in case of 'loss' of the financial instruments in custody by the depositary or any of its sub-custodians. It introduces the obligation for the depositary to return a financial instrument of the identical type or the corresponding amount without undue delay, unless it can demonstrate that the loss was a result of an external event beyond reasonable control, the consequences of which were unavoidable despite all reasonable efforts to the contrary.

26.2.26. Financial instruments held in custody by the depositary or by a sub-custodian should be considered 'lost' if one of the following conditions is met:

- Where the financial instruments no longer exists or never did (e.g. disappeared by means of an accounting error, never existed as a result of a falsified evidence of title,...);
- Where the financial instruments exist but the AIF has lost its rights of ownership over them (on a permanent basis);
- Where the AIF still holds the ownership right but cannot dispose of the financial instruments (on a permanent basis).

26.2.27. The depositary would therefore be responsible for returning a financial instrument of an identical type or a corresponding amount in case of 'loss' of financial instruments held in custody as a result from circumstances such as:

- Insolvency of a sub-custodian;
- Fraud within the depositary's network or one of its sub-custodians;
- Operational failures.

#### Oversight function

26.2.28. The AIFM Directive contains the same provisions regarding the depositary's oversight functions as those required under the UCITS Directive.

26.2.29. Along with its oversight liabilities, the Directive further assigns the depositary with a requirement to ensure that cash flows are properly monitored (cash monitoring function).

26.2.30. Under its cash monitoring function, the depositary is required to have a full overview of all cash flow movements. Considering that AIF may have cash accounts at various entities outside the depositary, the depositary should have access to all information related to each cash account opened at a third party. The depositary is also required to ensure that payments made by or on behalf of investors upon the subscription of units or shares of an AIF have been received.

26.2.31. The relevant provisions laid down in AIFM Directive text are as follows:

#### *Article 21*

#### *Depositary*

*1. For each AIF it manages, the AIFM shall ensure that a single depositary is appointed in accordance with this Article.*

*2. The appointment of the depositary shall be evidenced by written contract. The contract shall, inter alia, regulate the flow of information deemed necessary to allow the depositary to perform its functions for the AIF for which it has been appointed as depositary, as set out in this Directive and in other relevant laws, regulations or administrative provisions.*

*3. The depositary shall be:*

*(a) a credit institution having its registered office in the Union and authorised in accordance with Directive 2006/48/EC;*

*(b) an investment firm having its registered office in the Union, subject to capital adequacy requirements in accordance with Article 20(1) of Directive 2006/49/EC including capital requirements for operational risks and authorised in accordance with Directive 2004/39/EC and which also provides the ancillary service of safe-keeping and administration of financial instruments for the account of clients in accordance with point (1) of Section B of Annex I to Directive 2004/39/EC; such investment firms shall in any*

*case have own funds not less than the amount of initial capital referred to in Article 9 of Directive 2006/49/EC; or*

*(c) another category of institution that is subject to prudential regulation and ongoing supervision and which, on 21 July 2011, falls within the categories of institution determined by Member States to be eligible to be a depositary under Article 23(3) of Directive 2009/65/EC.*

*(...)*

*4. In order to avoid conflicts of interest between the depositary, the AIFM and/or the AIF and/or its investors:*

*(a) an AIFM shall not act as depositary;*

*(b) a prime broker acting as counterparty to an AIF shall not act as depositary for that AIF, unless it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF. Delegation by the depositary to such prime broker of its custody tasks in accordance with paragraph 11 is allowed if the relevant conditions are met.*

*5. The depositary shall be established in one of the following locations:*

*(a) for EU AIFs, in the home Member State of the AIF;*

*(b) for non-EU AIFs, in the third country where the AIF is established or in the home Member State of the AIFM managing the AIF or in the Member State of reference of the AIFM managing the AIF.*

*(...)*

*7. The depositary shall in general ensure that the AIF's cash flows are properly monitored, and shall in particular ensure that all payments made by or on behalf of investors upon the subscription of units or shares of an AIF have been received and that all cash of the AIF has been booked in cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF at an entity referred to in points (a), (b) and (c) of Article 18(1) of Directive 2006/73/EC, or another entity of the same nature, in the relevant market where cash accounts are required provided that such entity is subject to effective prudential regulation and supervision which have the same effect as Union law and are effectively enforced and in accordance with the principles set out in Article 16 of Directive 2006/73/EC.*

*Where the cash accounts are opened in the name of the depositary acting on behalf of the AIF, no cash of the entity referred to in the first subparagraph and none of the depositary's own cash shall be booked on such accounts.*

*8. The assets of the AIF or the AIFM acting on behalf of the AIF shall be entrusted to the depositary for safe-keeping, as follows:*

*(a) for financial instruments that can be held in custody:*

*(i) the depositary shall hold in custody all financial instruments that can be registered in a financial instruments account opened in the depositary's books and all financial instruments that can be physically delivered to the depositary;*

*(ii) for that purpose, the depositary shall ensure that all those financial instruments that can be registered in a financial instruments account opened in the depositary's books are registered in the depositary's books within segregated accounts in accordance with the principles set out in Article 16 of Directive 2006/73/EC, opened in the name of the AIF or the AIFM acting on behalf of the AIF, so that they can be clearly identified as belonging to the AIF in accordance with the applicable law at all times;*

*(b) for other assets:*

*(i) the depositary shall verify the ownership of the AIF or the AIFM acting on behalf of the AIF of such assets and shall maintain a record of those assets for which it is satisfied that the AIF or the AIFM acting on behalf of the AIF holds the ownership of such assets;*

*(ii) the assessment whether the AIF or the AIFM acting on behalf of the AIF holds the ownership shall be based on information or documents provided by the AIF or the AIFM and, where available, on external evidence;*

*(iii) the depositary shall keep its record up-to-date.*

*9. In addition to the tasks referred to in paragraphs 7 and 8, the depositary shall:*

*(a) ensure that the sale, issue, re-purchase, redemption and cancellation of units or shares of the AIF are carried out in accordance with the applicable national law and the AIF rules or instruments of incorporation;*

*(b) ensure that the value of the units or shares of the AIF is calculated in accordance with the applicable national law, the AIF rules or instruments of incorporation and the procedures laid down in Article 19;*

*(c) carry out the instructions of the AIFM, unless they conflict with the applicable national law or the AIF rules or instruments of incorporation;*

*(d) ensure that in transactions involving the AIF's assets any consideration is remitted to the AIF within the usual time limits;*

*(e) ensure that an AIF's income is applied in accordance with the applicable national law and the AIF rules or instruments of incorporation.*

*10. In the context of their respective roles, the AIFM and the depositary shall act honestly, fairly, professionally, independently and in the interest of the AIF and the investors of the AIF.*

*A depositary shall not carry out activities with regard to the AIF or the AIFM on behalf of the AIF that may create conflicts of interest between the AIF, the investors in the AIF, the AIFM and itself, unless the depositary has functionally and hierarchically separated the performance of its depositary*

*tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF.*

*The assets referred to in paragraph 8 shall not be reused by the depositary without the prior consent of the AIF or the AIFM acting on behalf of the AIF.*

*11. The depositary shall not delegate to third parties its functions as described in this Article, save for those referred to in paragraph 8.*

*The depositary may delegate to third parties the functions referred to in paragraph 8 subject to the following conditions:*

*(a) the tasks are not delegated with the intention of avoiding the requirements of this Directive;*

*(b) the depositary can demonstrate that there is an objective reason for the delegation;*

*(c) the depositary has exercised all due skill, care and diligence in the selection and the appointment of any third party to whom it wants to delegate parts of its tasks, and keeps exercising all due skill, care and diligence in the periodic review and ongoing monitoring of any third party to whom it has delegated parts of its tasks and of the arrangements of the third party in respect of the matters delegated to it; and*

*(d) the depositary ensures that the third party meets the following conditions at all times during the performance of the tasks delegated to it:*

*(i) the third party has the structures and the expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF or the AIFM acting on behalf of the AIF which have been entrusted to it;*

*(ii) for custody tasks referred to in point (a) of paragraph 8, the third party is subject to effective prudential regulation, including minimum capital requirements, and supervision in the jurisdiction concerned and the third party is subject to an external periodic audit to ensure that the financial instruments are in its possession;*

*(iii) the third party segregates the assets of the depositary's clients from its own assets and from the assets of the depositary in such a way that they can at any time be clearly identified as belonging to clients of a particular depositary;*

*(iv) the third party does not make use of the assets without the prior consent of the AIF or the AIFM acting on behalf of the AIF and prior notification to the depositary; and*

*(v) the third party complies with the general obligations and prohibitions set out in paragraphs 8 and 10.*

*Notwithstanding point (d)(ii) of the second subparagraph, where the law of a third country requires that certain financial instruments be held in custody by a local entity and no local entities satisfy the delegation requirements laid*

*down in that point, the depositary may delegate its functions to such a local entity only to the extent required by the law of the third country and only for as long as there are no local entities that satisfy the delegation requirements, subject to the following requirements:*

*(a) the investors of the relevant AIF must be duly informed that such delegation is required due to legal constraints in the law of the third country and of the circumstances justifying the delegation, prior to their investment; and*

*(b) the AIF, or the AIFM on behalf of the AIF, must instruct the depositary to delegate the custody of such financial instruments to such local entity.*

*The third party may, in turn, sub-delegate those functions, subject to the same requirements. In such a case, paragraph 13 shall apply mutatis mutandis to the relevant parties.*

*For the purposes of this paragraph, the provision of services as specified by Directive 98/26/EC by securities settlement systems as designated for the purposes of that Directive or the provision of similar services by third-country securities settlement systems shall not be considered a delegation of its custody functions.*

*12. The depositary shall be liable to the AIF or to the investors of the AIF, for the loss by the depositary or a third party to whom the custody of financial instruments held in custody in accordance with point (a) of paragraph 8 has been delegated.*

*In the case of such a loss of a financial instrument held in custody, the depositary shall return a financial instrument of identical type or the corresponding amount to the AIF or the AIFM acting on behalf of the AIF without undue delay. The depositary shall not be liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.*

*The depositary shall also be liable to the AIF, or to the investors of the AIF, for all other losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations pursuant to this Directive.*

*13. The depositary's liability shall not be affected by any delegation referred to in paragraph 11.*

*Notwithstanding the first subparagraph of this paragraph, in case of a loss of financial instruments held in custody by a third party pursuant to paragraph 11, the depositary may discharge itself of liability if it can prove that:*

*(a) all requirements for the delegation of its custody tasks set out in the second subparagraph of paragraph 11 are met;*

*(b) a written contract between the depositary and the third party expressly transfers the liability of the depositary to that third party and makes it possible for the AIF or the AIFM acting on behalf of the AIF to make a claim*

*against the third party in respect of the loss of financial instruments or for the depositary to make such a claim on their behalf; and*

*(c) a written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF, expressly allows a discharge of the depositary's liability and establishes the objective reason to contract such a discharge.*

*14. Further, where the law of a third country requires that certain financial instruments are held in custody by a local entity and there are no local entities that satisfy the delegation requirements laid down in point (d)(ii) of paragraph 11, the depositary can discharge itself of liability provided that the following conditions are met:*

*(a) the rules or instruments of incorporation of the AIF concerned expressly allow for such a discharge under the conditions set out in this paragraph;*

*(b) the investors of the relevant AIF have been duly informed of that discharge and of the circumstances justifying the discharge prior to their investment;*

*(c) the AIF or the AIFM on behalf of the AIF instructed the depositary to delegate the custody of such financial instruments to a local entity;*

*(d) there is a written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF, which expressly allows such a discharge; and*

*(e) there is a written contract between the depositary and the third party that expressly transfers the liability of the depositary to that local entity and makes it possible for the AIF or the AIFM acting on behalf of the AIF to make a claim against that local entity in respect of the loss of financial instruments or for the depositary to make such a claim on their behalf.*

*15. Liability to the investors of the AIF may be invoked directly or indirectly through the AIFM, depending on the legal nature of the relationship between the depositary, the AIFM and the investors.*

*16. The depositary shall make available to its competent authorities, on request, all information which it has obtained while performing its duties and that may be necessary for the competent authorities of the AIF or the AIFM. If the competent authorities of the AIF or the AIFM are different from those of the depositary, the competent authorities of the depositary shall share the information received without delay with the competent authorities of the AIF and the AIFM.*

*(...)*

### **26.3. Explanatory text**

#### EIOPA view on issues in the CfA

The need to create a more consistent approach, from a supervisory perspective, in relation to the appointment of a depositary, the type of body which is appointed to fulfil this role and the function that it performs

- 26.3.1. The current IORP Directive contains very general provisions regarding the appointment of depositaries. The focus of the existing regulation is to ensure the freedom of services provided by depositaries within the EU. The most specific rule concerns the possibility of Member States making the appointment of a depositary compulsory.
- 26.3.2. There are also no specific requirements regarding the type of body and the functions that it performs, nor concerning the responsibilities or liabilities of a depositary.
- 26.3.3. Regarding the need to create a more consistent approach among Member States in relation to the appointment of a depositary, EIOPA has kept in mind that following the current Directive many IORPs do not have a depositary. Therefore, any changes in the related provisions, in particular establishing a compulsory requirement for the appointment of a depositary, may not fit all jurisdictions and cause unjustified changes to their pension systems, including also increases in costs to some IORPs. Such changes would need to be properly assessed and justified.

#### Comparisons between IORP and other directives

- 26.3.4. To assess the need and importance of having a depositary performing safe-keeping of assets and oversight functions, EIOPA has referred to the current and expected future practices among other financial sectors, namely the UCITS and AIFM legal framework and Solvency II.
- 26.3.5. While in the first case an increasing attention has been drawn to the role of depositaries, the respective prudential regulation (Solvency II) for insurance companies does not comprise such a notion.
- 26.3.6. This is mainly because insurance companies “manage” assets that are under its own ownership and generally bear the cost of any operational failures associated with the asset safeguard and investment operations. Therefore, the need to legally separate management functions from assets safe-keeping and oversight functions in order to protect policyholders’ interests is not so imperative.
- 26.3.7. The situation is fundamentally different in case of institutions managing segregated pools of assets co-owned by unit-holders, where it is essential that a depositary separate from the management company is appointed to exercise external safe-keeping of assets and oversee the activities of manager, in order to ensure that the assets are handled with due care and to mitigate the risk of fraud by the manager.

#### The issue of legal personality

- 26.3.8. In an attempt to frame the position for IORPs, EIOPA emphasised that a distinction in the IORP framework can be made according to whether assets of members and beneficiaries are being held in a separate legal entity or as segregated assets within another management company. Following this criterion, two types of IORPs can be generally identified according to its legal form: IORPs with legal personality and IORPs without legal personality.

- 26.3.9. IORPs with legal personality share some similarities with the insurance companies in the sense that IORPs are legal owners and “manage”/“administrate” assets entrusted to them by members and beneficiaries.
- 26.3.10. On the other hand, IORPs without legal personality are a segregated pool of assets managed by another institution. The assets of members and beneficiaries are segregated from the assets of the management company. This type of IORP comprises the trust based system of UK, Ireland and Malta, and the contract based system of Portugal and Spain. In Romania IORPs do not have a legal personality either.
- 26.3.11. From this perspective, IORPs without legal personality are more similar to the UCITS and AIFM cases, where the UCITS is constituted as a common fund managed by a management company or where the AIF is not in the position to act by itself because it has no legal personality.
- 26.3.12. Indeed, is important to clarify that UCITS can be constituted in accordance with contract law (as common funds managed by management companies), trust law (as unit trust) or statute (as investment companies, which can either appoint a management company or designate itself as “self-managed”). For the purpose of the implementation of the UCITS IV Directive, common funds also comprise the notion of unit trust. In principle, the appointment of a depositary is required regardless of the form under which the UCITS are constituted.
- 26.3.13. In relation to the AIFM Directive, where the legal form of the AIF permits internal management and where AIF’s governing body chooses not to appoint an external AIFM, the AIF is also the AIFM and should comply with all requirements for AIFMs under this Directive, including the one referring to the appointment of a depositary.
- 26.3.14. If only practices under the UCITS and AIFM Directives are taken into account, and if the purpose is to establish the same level of standards and protection in relation to IORPs, sponsoring undertakings and members/beneficiaries, then it would be appropriate to extend the compulsory requirement to all IORPs regardless of its legal form.
- 26.3.15. However, for IORPs with legal personality which, as referred previously, share some similarities with the insurance companies, this would represent a tougher requirement than the one underlying Solvency II, leading to an uneven treatment between insurance and pension sectors.
- 26.3.16. Considering that the importance of having a depositary is ultimately related to the protection of members/beneficiaries, EIOPA does not find it necessary to recommend making the appointment of depositaries compulsory for IORPs with legal personality in the sense that IORPs will most likely bear the cost of potential operational failures associated with the assets safeguard and investment operations itself, at least in relation to DB schemes.

In addition, it also has to be taken into account that, in general, IORPs have their specific objectives and social responsibilities, therefore not being entirely comparable to the UCITS and AIFM realities.

#### Defined contribution IORPs

- 26.3.17. On the other hand, the cost of operational failures stemming from administration risks such as contributions and investment returns allocated to an incorrect account, is more likely to be borne by members/beneficiaries of DC schemes.
- 26.3.18. In fact, the appointment of a depositary is already seen as a widespread risk mitigation mechanism among Member States providing pure DC schemes.
- 26.3.19. EIOPA believes that further consistency and increases in the level of standards can alternatively be achieved by looking from the perspective of which stakeholder has to deal with the consequences of operational failures and investment risks. Therefore, it proposes to make the appointment of a depositary compulsory for both safe-keeping and oversight in the case of DC schemes, where members/beneficiaries bear the risks.
- 26.3.20. The implementation of this principle will have to take into consideration that there are different types of hybrids schemes and that it may not be appropriate to subject all of them to this principle. Under this option, further clarification on the application of this requirement to hybrids would be needed.
- 26.3.21. Furthermore, it has to be taken into account that in some Member States' pension systems additional requirements may already be in place to ensure that the activities of the management company are being properly performed.

#### Trust based system

- 26.3.22. For instance, in relation to trust based system, trustees are required by law to do oversight function and remain fully responsible. Therefore, appointing a depositary with oversight duties will lead to a duplication of role/cost with no extra benefit in terms of members/beneficiaries protection. In addition, trustees have a duty to make sure that the pension scheme's assets are held securely, for instance by a custodian on their behalf i.e. trustees must put the scheme money they receive in a suitable account with a bank or building society separate from the sponsor's account. In effect, there is common practice to have contractual relationship between the trustees (responsible for the pension scheme), the investment manager (in charge of the investment of the assets) and the custodian (the keep holder of the assets).

#### Options

- 26.3.23. Taking into account the previous considerations, EIOPA believes that the following options could be explored:
- 26.3.24. Option 1: Maintain the current provision, leaving to Member States the decision of whether to make the appointment of a depositary for safe-keeping of assets or for safe-keeping of assets and oversight functions compulsory, according to the option that best suits the needs of its own occupational pension system.
- 26.3.25. Option 2: EIOPA proposes that the revised IORP Directive should comprise different depositary regimes depending on the legal form of the IORP. More specifically:

- For IORPs without legal personality in a contract based system, the appointment of a depositary for safe-keeping of assets and oversight functions should be compulsory.
- For IORPs without legal personality in a trust based system, the appointment of a depositary for safe-keeping of assets should be compulsory.
- For IORPs with legal personality, the decision whether to require the appointment of a depositary should remain at the discretion of the Member State concerned.

26.3.26. Option 3: EIOPA proposes that the revised IORP Directive should comprise different depositary regimes depending on the type of pension scheme. More specifically:

- The appointment of a depositary for safe-keeping of assets and oversight function should be compulsory for DC schemes, with the exception of those managed by trust based system, in relation to which the appointment of a depositary for oversight function should not be required.
- The appointment of a depositary for DB schemes should remain at the discretion of the Member State concerned.

26.3.27. As regards the appointment of a depositary EIOPA prefers to keep the flexibility under option 1, which was also supported by the majority of respondents of the consultation on this topic.

26.3.28. Given the heterogeneity of IORPs between jurisdictions, EIOPA has come to the conclusion that further convergence in relation to the appointment of a depositary will be difficult to achieve.

26.3.29. For instance, in the case of option 2 the overall level of converge will still be minimal as in the majority of countries IORPs have legal personality.

26.3.30. Furthermore, in Member States where the appointment is not compulsory, alternative mechanisms that offer similar level of protection to members and beneficiaries might already be in place. Therefore, making this requirement compulsory might lead to an increase of costs that will likely outweigh the additional benefits linked to the expertise and statutory independent of a depositary.

26.3.31. Taking into account the previous considerations, EIOPA advises to leave the decision of making the appointment compulsory to each Member State, in order to avoid unjustified changes to their pension systems and increase of costs that will ultimately be pass on to members and beneficiaries.

26.3.32. This does not however prevent the creation of a more consistent approach from a supervisory perspective in relation to the eligible institutions, the liability regime, the duties of a depositary in case it is appointed to perform oversight functions, the rules regarding conflicts of interest or incompatibility, etc.

26.3.33. In addition, standards can also be raised by improving the general requirements that should be verified in case a depositary is not appointed.

26.3.34. In cases where there is no appointment of a depositary, the paragraph 26.3.35 and 26.3.47 are important.

#### Eligible depositary

26.3.35. With regard to the typology of eligible depositary, EIOPA does not find the need to lay down a more detailed list of institutions at level 1 text. However, the references in Article 19(2) of the current IORP Directive need to be updated according to the following:

- Directive 93/22/EEC of 10 May 1993 on investment services in the securities field has been repealed since 1 November 2007 by Directive 2004/39/EC of 21 April 2004 on markets in financial instruments (MiFID), as mentioned in Directive 2006/31/EC of 5 April 2006;
- Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions has been replaced by **Directive 2006/48/EC** of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) or CRD (capital requirements directive);
- Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) has been replaced by **Directive 2009/65/EC** of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (recast) or UCITS IV.

#### Relationship between a depositary and an IORP

26.3.36. Keeping in mind that the delegation of safe-keeping of assets to a depositary also involves some risks, EIOPA believes that it is relevant to include some further provisions on this matter.

26.3.37. In order to improve pension scheme members and beneficiaries protection, EIOPA considers that it is relevant to clearly establish the relationship between the depositary and the IORP. Therefore, it proposes that the appointment of depositaries should be formalised in a written contract regulating at least the flow of information necessary to enable the depositary to perform its function. Furthermore, the elements of the contract should be detailed in level 2 text.

26.3.38. If a depositary is appointed to ensure the safe-keeping of assets, a provision should be included stating that the pension scheme's assets should be legally separated from those of the depositary.

26.3.39. Additionally, the depositary should be liable to IORPs and pension scheme members and beneficiaries for any loss suffered as a result of its unjustifiable failure to perform its obligations or its improper performance of them. In particular, it should not be able to absolve itself of its responsibility by entrusting to a third party all or some of the assets in its safe-keeping.

Further details in relation to depositary's liability regime should be introduced in level 2 text.

26.3.40. Under the principle that IORPs should have in place mechanisms to assess regularly the performance of external service providers, these should also include those providing custody and record-keeping services.

26.3.41. EIOPA sees the following advantages regarding the use of a depositary for the purpose of safe-keeping of assets:

- The depositary is required at any time to provide a comprehensive and up to date inventory of all assets under its safe-keeping;
- It ensures that the information is centralised in one place;
- It reduces the risk of fraud and operational risks of the IORP;
- The depositary can alert the IORP to a material risk identified in a specific market settlement system;
- It may be easier for the supervisory authorities to limit or prohibit the free disposal of assets.

26.3.42. Therefore, for cases where there is no appointment of a depositary, EIOPA finds it relevant to include further provisions in the revised IORP Directive text, in order to ensure that appropriate procedures/controls in respect to the risk of a loss of assets or of right in connection with those assets (as a result of a fraud, poor administration, inadequate record-keeping, negligence or other operational risks within the IORP) are in place and that, although not having a depositary, a similar level of safety is provided to members and beneficiaries. Therefore, an IORP should, at least:

- Ensure that financial instruments are subject to due care and protection;
- Keep records that enable them at any time and without delay identify all assets;
- Take the necessary measures to avoid any conflicts of interest or incompatibility;
- The supervisory authority, upon request, shall be informed about the manner in which assets are kept.

26.3.43. In addition to the safe-keeping of assets, EIOPA is of the view that depositaries can play an important oversight role. The appointment of a depositary with oversight duties do not aim to duplicate any task (in particular, related to operational/internal control) already performed by the IORP itself, but to act as an additional external and independent control mechanism.

26.3.44. On the oversight function, EIOPA proposes to include a list of tasks that depositaries should at least perform in case they are appointed for this function, taking as reference those laid down in UCITS and AIFM Directives but adapting it to the specificities of IORPs:

- carry out instructions of the IORP, unless they conflict with the applicable national law or the IORP rules;
- ensure that in transactions involving an IORP or pension scheme's assets any consideration is remitted to it within the usual time limits;
- ensure that income produced by assets is applied in accordance with the applicable national law and the IORP rules.

26.3.45. In addition EIOPA proposes to include in the Directive the possibility for Member States to introduce whistle-blowing duties for depositaries, meaning that the depository should inform competent supervisor authorities in case breaches of national laws or IORP rules are revealed.

26.3.46. Furthermore, Member States should not be prevented from laying down other oversight tasks that a depository could perform and make them compulsory.

26.3.47. In fact, the current experience shows that oversight tasks performed by depositaries are especially important for Member States with DC pension schemes where the members/beneficiaries bear the risks, where not only safe-keeping of the assets but also some oversight duties are already delegated to depositaries.

26.3.48. Finally, it will be relevant to require IORPs to implement procedures which ensure that the tasks, otherwise subject to oversight by depositaries, are being properly performed within the IORP.

#### Rules regarding conflicts of interest or incompatibility

26.3.49. The current IORP Directive is silent on the rules regarding conflicts of interest or incompatibility.

26.3.50. EIOPA is of the view that potential conflicts of interest or incompatibility could be an obstacle for appropriate functioning of the safe-keeping and oversight duties and therefore should be avoided. Thus, some further provisions should be included in the revised text of the IORP Directive.

26.3.51. For cases where a depository is appointed, EIOPA proposes to adopt provisions similar to the ones laid down in Article 21(10) of the AIFM Directive, with the necessary rewording.

*10. In the context of their respective roles, the AIFM and the depository shall act honestly, fairly, professionally, independently and in the interest of the AIF and the investors of the AIF.*

*A depository shall not carry out activities with regard to the AIF or the AIFM on behalf of the AIF that may create conflicts of interest between the AIF, the investors in the AIF, the AIFM and itself, unless the depository has functionally and hierarchically separated the performance of its depository tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF.*

*The assets referred to in paragraph 8 shall not be reused by the depositary without the prior consent of the AIF or the AIFM acting on behalf of the AIF.*

- 26.3.52. This could be very crucial for those Member States where not only safe-keeping of assets but also some control tasks over the investment process is delegated to the depositary to ensure actions are in the best interests of the pension scheme's members and beneficiaries.
- 26.3.53. It would also be advisable to provide that these general provisions should not prevent Member States from laying down more detailed rules to ensure elimination of the conflicts of interest or incompatibility.
- 26.3.54. Where a depositary is not appointed, IORPs should make arrangements to ensure that conflicts of interest between tasks otherwise performed by a depositary and asset management function are avoided or effectively managed.

#### Appropriateness of UCITS IV Directive (articles 22 to 26)

- 26.3.55. To assess the appropriateness of Articles 22 to 26 of the UCITS IV Directive, two main observations should be made in the first place, which solely determine the inappropriateness of some provisions under Articles 22 to 26 of the UCITS Directive:
- According to the current and proposed future framework of the IORP Directive, part or all Member States would be able to choose whether to require the IORPs to appoint a depositary or not, while in the UCITS IV Directive (Articles 22(1) and 25(1)) the appointment of a depositary is compulsory for all;
  - For the safe-keeping of assets, the IORP Directive offers to European depositaries the opportunity for cross-border activity without the obligation to have a registered office or branch in the same state as the IORP. However, the UCITS IV Directive (Article 23(1)) specifies that the depositary must have its registered office either in the same Member State as the authorised fund, i.e. the Member State where the UCITS is authorised, or in the Member State where UCITS has a branch.
- 26.3.56. Furthermore, EIOPA believes that not only the UCITS IV Directive but also the AIFM Directive should be taken into account for the rules on depositaries, due to the following reasons:
- The UCITS IV Directive does not make a clear distinction between the safe-keeping and oversight duties of the depositary;
  - The AIFM Directive reflects the most recent and advanced piece of legislation on the depositary subject;
  - Meanwhile, the preliminary work on UCITS V also refers to the AIFM Directive;

- The whole subject of depositary is more developed in the AIFM Directive and therefore more comprehensible. Taken into account the scope of the AIFM Directive, this Directive is likely to become the European (even global) standard.

26.3.57. EIOPA therefore is of the view that the relevant provisions to be included in the revised text of the IORP Directive in case a depositary is appointed could be to some extent similar to those set by the UCITS or the AIFM Directive, according to what best suits the IORP's specificities.

26.3.58. Regarding the institutions there are eligible for performing safe-keeping and oversight duties, EIOPA prefers to refer to the provisions under the Article 3(a)(b)(c) of the AIFM Directive, which is consistent with the proposal of allowing Member States to appoint depositaries duly authorised in accordance with Directives 2004/39/EC, 2006/48/EC or accepted as a depositary for the purposes of Directive 2009/65/EC (which correspond to the updated Directives from the current IORP provisions), instead of the broader definition established in Article 23(2) of the UCITS IV Directive.

26.3.59. EIOPA finds that, in relation to the requirement of having a written agreement between the depositary and the IORP, the provision under Article 21(2) of the AIFM Directive should be adopted. The preference for the AIFM Directive over the UCITS IV Directive relates to the fact that the provision under the AIFM Directive presents a wider scope and therefore is deemed more appropriate for the purpose of reducing weakness in the relationship between the depositary and the IORP.

26.3.60. With regard to the liability regime however, EIOPA proposes to follow the provisions laid down in Article 24 of the UCITS IV Directive. This is due to the fact that the liability regime under the AIFM is too burdensome: many observers noted that increased liability regime will be extremely costly for AIFMs as well as burdensome for depositaries. The increased costs could undermine the supply of affordable occupation pensions, which should be avoided.

26.3.61. On oversight functions, similar provisions are laid down in both UCITS IV and AIFM Directives. However, EIOPA highlights that not all functions are appropriate considering the specificities of IORPs and types of pension schemes, namely the first two tasks:

*(a) ensure that the sale, issue, repurchase, redemption and cancellation of units effected on behalf of a common fund or by a management company are carried out in accordance with the applicable national law and the fund rules;*

*(b) ensure that the value of units is calculated in accordance with the applicable national law and the fund rules;*

26.3.62. Finally, regarding potential conflicts of interest, EIOPA suggests to take into account the Article 21(10) of the AIFM Directive, as it is more developed than the provision included in Article 25(2) of the UCITS IV Directive.

#### Effectiveness of the powers and procedures followed by the competent authorities

26.3.63. EIOPA supports that in relation to cases where a depositary is located in another Member State from the IORP, it is useful to improve cooperation between the IORP's supervisory authority and the other European depositary supervisory authority, in particular to guarantee the appropriate application of Article 19(3) of the IORP Directive in the case of freezing of the assets.

26.3.64. However, there seems to be a lack of practical experience among Member States on the powers and procedures followed by competent authorities in case of prohibition of the free disposal of assets held by a foreign custodian.

26.3.65. At this stage, there is not enough evidence that indicates the need to include additional provisions regarding powers and procedures followed by the competent authorities. Therefore, the proposal would be to maintain Article 19(3) as it is and to develop details in Level 2 implementing measures, if further analysis on this issue shows the need to do so.

## **26.4. Impact assessment**

### Policy options

26.4.1. The impact assessment for the depositaries covers two issues, for which a number of options have been proposed. The issues and options considered are:

(i) Introduction of general requirements regarding: (a) the need for written contract; (b) the role of a depositary in terms of safe-keeping; (c) the liability regime of depositaries; (d) the list of minimum oversight functions that should be performed; (e) conflict of interest

Option 1: Leave the IORP Directive unchanged

Option 2: Introduce the requirements presented in the blue box concerning the topics identified

### Positive impacts

Option 1:

No impact.

Option 2:

- Members/beneficiaries

Further clarification and harmonization of the roles played by depositaries and its duties will improve the general level of protection for members/beneficiaries and enhanced their confidence on the pension system.

- IORPs/sponsoring employers

A written contract will more clearly define the obligations of the parties involved in terms of relevant flow of information deemed necessary to allow the depositary to perform its functions.

On the other hand, further clarification and harmonization of the roles played by depositaries and its duties will improve the level of IORPs/sponsoring employers protection.

Additionally, adequate management of conflicts of interests might lead to a saving of costs, as the saved costs of litigation plus damages to reputation could outweigh the effort required.

- Supervisory authorities

More consistency will be achieved.

#### Negative impacts

Option 1:

No impact.

Option 2:

- Members/beneficiaries

When applicable, potential increase of fees charged to members/beneficiaries.

- IORPs/sponsoring employers

Potential increase of administration burden and costs for IORPs/sponsoring employers.

- Supervisory authorities

Increase of the number of items that should be supervised by the competent supervisory authority.

#### Conclusion

26.4.2. EIOPA notes that the above impact assessment is only an estimation and does not in principle replace the need for a study to assess the real impact of the new requirements on different jurisdictions and types of IORSs (e.g., considering the structure, size and type of scheme, etc.), including a search for numbers/figures. Furthermore, EIOPA stresses that the impact could significantly increase the cost of IORPs, and this impact should be measure as precise as possible, since it can affect members/beneficiaries as cost get passed on and jeopardize the specific objectives and social responsibilities of IORPs.

26.4.3. EIOPA prefers option 2.

## 26.5. EIOPA advice

**The material elements of Articles 19(2) and 19(3) of the IORP Directive that should be reviewed in order to ensure that the custodians/depositaries of IORPs, irrespective of their location within the EU, adequately protect the interest of the members/beneficiaries:**

1. In light of the fact that under the AIFM Directive the concept of depositary comprises both safe-keeping and oversight functions, whereas the custodian function relates only to the safe-keeping of assets, EIOPA proposes to refer always to the word "depositary" in the legal text, as in the case of the AIFM Directive. Consequently, the headline of Article 19 should also be changed to "Management and Depositary".
2. EIOPA agrees to maintain the Articles 19(2) and 19(3) as it is in the current IORP Directive text, with the appropriate rewording.
3. Furthermore, EIOPA proposes to include additional provisions to the revised text of the IORP Directive according to the proposals and considerations described in the explanatory text. The revised article would have the following wording:

[...]

*"2. Member States shall not restrict IORP from appointing, for the safe-keeping of their assets, depositaries established in another Member State and duly authorised in accordance with Directive 2004/39/EC or Directive 2006/48/EC, or accepted as a depositary for the purposes of Directive 2009/65/EC.*

*The provision referred to in this paragraph shall not prevent the home Member State from making the appointment of a depositary for safe-keeping of assets or for safe-keeping of assets and oversight functions compulsory."*

*3. Each Member State shall take the necessary steps to enable it under its national law to prohibit, in accordance with Article 14, the free disposal of assets held by a depositary located within its territory at the request of the institution's home Member State.*

*4. The appointment of the depositary shall be evidenced by written contract. The contract shall, inter alia, regulate the flow of information deemed necessary to allow the depositary to perform its functions for the pension scheme for which it has been appointed as depositary, as set out in this Directive and in other relevant laws, regulations or administrative provisions.*

*5. In case assets of a pension scheme are entrusted to a depositary for safe-keeping, the following shall be applied:*

*(a) for financial instruments that can be held in custody:*

*(i) the depositary shall hold in custody all financial instruments that can be registered in a financial instruments account opened in the depositary's*

*books and all financial instruments that can be physically delivered to the depositary;*

*(ii) for that purpose, the depositary shall ensure that all those financial instruments that can be registered in a financial instruments account opened in the depositary's books are registered in the depositary's books within segregated accounts in accordance with the principles set out in Article 16 of Directive 2006/73/EC, opened in the name of the IORP, so that they can be clearly identified as belonging to the IORP or the pension scheme's members and beneficiaries in accordance with the applicable law at all times;*

*(b) for other assets:*

*(i) the depositary shall verify the ownership of the IORP or the pension scheme's members and beneficiaries of such assets and shall maintain a record of those assets for which it is satisfied that the IORP or the pension scheme's members and beneficiaries holds the ownership of such assets;*

*(ii) the assessment whether the IORP or the pension scheme's members and beneficiaries holds the ownership shall be based on information or documents provided by the IORP and, where available, on external evidence;*

*(iii) the depositary shall keep its record up-to-date.*

*6. A depositary shall, in accordance with the national law of the IORP's home Member State, be liable to the IORP, or the pension scheme members/beneficiaries for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance of them.*

*7. A depositary's liability as referred to in the previous paragraph shall not be affected by the fact that it has entrusted to a third party all or some of the assets in its safe-keeping.*

*8. In case a depositary is not appointed for the safe-keeping of assets, IORP shall, at least:*

*(a) ensure that financial instruments are subject to due care and protection;*

*(b) keep records that enable them at any time and without delay identify all assets;*

*(c) take the necessary measures to avoid conflicts of interest or incompatibility;*

*(d) inform the supervisory authority, upon request, about the manner in which assets are kept.*

*9. In addition to the tasks referred to in paragraph 5 the depositary appointed for oversight function shall:*

*(a) carry out instructions of the IORP, unless they conflict with the applicable national law or the IORP rules;*

*(b) ensure that in transactions involving an IORP or pension scheme's assets any consideration is remitted to it within the usual time limits;*

*(c) ensure that income produced by assets is applied in accordance with the applicable national law and the IORP rules.*

*10. The provision referred to in the previous paragraph shall not prevent home Member State from establishing other oversight duties to be performed by the depositary and make them compulsory.*

*11. In case a depositary is not appointed for oversight functions, the IORP shall implement procedures which ensure that the tasks, otherwise subject to oversight by depositaries, are being properly performed within the IORP.*

*12. In the context of their respective roles, the IORP and the depositary shall act honestly, fairly, professionally, independently and in the interest of the pension scheme's members and beneficiaries.*

*A depositary shall not carry out activities with regard to the IORP that may create conflicts of interest between the IORP, the pension scheme's members and beneficiaries and itself, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the pension scheme's members and beneficiaries.*

*Where a depositary is not appointed, IORPs should make arrangements to ensure that conflicts of interest between tasks otherwise performed by a depositary and asset management function are avoided or effectively managed.*

*13. The general provisions in paragraphs 12 shall not prevent IORP's home Member States from laying down more detailed rules regarding conflicts of interest or incompatibility.*

## **27. Disclosure requirements**

The final two chapters respond to the calls for advice on disclosure: to supervisors and members/beneficiaries. They comprise:

- CfA 22: Information to supervisors
- CfA 23: Information to members/beneficiaries

## 28. CfA 22 Information to supervisors

### 28.1. Extract from the call for advice

The Commission Services would like EIOPA to advise on detailed rules on information to be provided for supervisory purposes.

The EIOPA advice should address at least the following subjects:

- The material elements of Article 35 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to supervisory reporting;
- Other requirements for IORPs, if any: e.g. specific reporting requirements for DB, DC and hybrids schemes.

### 28.2. Background

#### Current legal requirements (IORP Directive)

The IORP Directive already contains, within article 13, provisions on reporting to pension fund supervisory authorities.

#### Article 13: Information to be provided to the competent authorities

*Each Member State shall ensure that the competent authorities, in respect of any institution located in its territory, have the necessary powers and means:*

- (a) to require the institution, the members of its board of directors and other managers or directors or persons controlling the institution to supply information about all business matters or forward all business documents;*
- (b) to supervise relationships between the institution and other companies or between institutions, when institutions transfer functions to those other companies or institutions (outsourcing), influencing the financial situation of the institution or being in a material way relevant for effective supervision;*
- (c) to obtain regularly the statement of investment-policy principles, the annual accounts and the annual reports, and all the documents necessary for the purposes of supervision. These may include documents such as:*
  - (i) internal interim reports;*
  - (ii) actuarial valuations and detailed assumptions;*
  - (iii) asset-liability studies;*
  - (iv) evidence of consistency with the investment-policy principles;*
  - (v) evidence that contributions have been paid in as planned;*

(vi) reports by the persons responsible for auditing the annual accounts referred to in Article 10

(d) to carry out on-site inspections at the institution's premises and, where appropriate, on outsourced functions to check if activities are carried out in accordance with the supervisory rules.

#### International standards (OECD/IOPS, etc...)

#### OECD Principles of Occupational Pension regulation

##### Core Principle 7: Supervision

*Effective supervision of pension funds and plans must be set up and focus on legal compliance, financial control, actuarial examination and supervision of managers. Appropriate supervisory bodies, properly staffed and funded, should be established in order to conduct when relevant off and on site supervision, at least for some categories of funds and in particular when problems are reported. Supervisory bodies should be endowed with appropriate regulatory and supervisory powers over individual plans, in order to prevent mis-selling cases arising from irregularities in the distribution and expenses methods.*

#### IOPS Principles of Private Pension Supervision

##### Principle 4: Adequate Powers

*Pension supervisory authorities should be endowed with the necessary investigatory and enforcement powers to fulfil their functions and achieve their objectives*

4.4 *The pension supervisory authority should have the power to conduct a full investigation when a problem is suspected or observed, obliging funds and other relevant parties (such as asset managers, custodians, auditors) to make documents and information available. Necessary powers include the ability to impose corrective measures and remedial actions if the authority's orders are not carried out. The scope of the powers may extend to the power to impose administrative sanctions such as fines, to direct management, to revoke licences and to refer matters for criminal prosecution. In some cases, powers may include the ability to issue binding regulation.*

#### OECD/IOPS Good Practices for Pension Funds' Risk Management Systems

##### *Extracts from Good Practice 7: Information, Reporting and Communication*

7.1 *Adequate and comprehensive channels for the reporting and communication of internal data, external information (e.g. from service providers and to pension supervisory authorities) and external market information (in particular to plan /fund members) should be established, with all information required to be reliable, timely, accessible and consistent. A policy should also be in place to ensure that confidential information is treated appropriately...*

##### *Extract from **Annotations***

*. ...Appropriate reporting mechanisms to the pension supervisory authority are also required (reporting activities on an on-going, regular basis, not only performance numbers). Such reporting should include notifying the pension supervisory authority, in a timely manner, prior to the outsourcing of critical or important functions as well as of any subsequent material developments with respect to those activities (e.g. a change in service provider, a major problem with the performance of a service provider etc.)....*

## Solvency II Directive

### Article 35 – Information to be provided for supervisory purposes

- 1. Member States shall require insurance and reinsurance undertakings to submit to the supervisory authorities the information which is necessary for the purposes of supervision. That information shall include at least the information necessary for the following when performing the process referred to in Article 36:*
  - (a) to assess the system of governance applied by the undertakings, the business they are pursuing, the valuation principles applied for solvency purposes, the risks faced and the risk-management systems, and their capital structure, needs and management;*
  - (b) to make any appropriate decisions resulting from the exercise of their supervisory rights and duties.*
- 2. Member States shall ensure that the supervisory authorities have the following powers:*
  - (a) to determine the nature, the scope and the format of the information referred to in paragraph 1 which they require insurance and reinsurance undertakings to submit at the following points in time:*
    - (i) at predefined periods;*
    - (ii) upon occurrence of predefined events;*
    - (iii) during enquiries regarding the situation of an insurance or reinsurance undertaking;*
  - (b) to obtain any information regarding contracts which are held by intermediaries or regarding contracts which are entered into with third parties; and*
  - (c) to require information from external experts, such as auditors and actuaries.*
- 3. The information referred to in paragraphs 1 and 2 shall comprise the following:*
  - (a) qualitative or quantitative elements, or any appropriate combination thereof;*

- (b) *historic, current or prospective elements, or any appropriate combination thereof; and*
  - (c) *data from internal or external sources, or any appropriate combination thereof.*
- 4. *The information referred to in paragraphs 1 and 2 shall comply with the following principles:*
  - (a) *it must reflect the nature, scale and complexity of the business of the undertaking concerned, and in particular the risks inherent in that business;*
  - (b) *it must be accessible, complete in all material respects, comparable and consistent over time; and*
  - (c) *it must be relevant, reliable and comprehensible.*
- 5. *Member States shall require insurance and reinsurance undertakings to have appropriate systems and structures in place to fulfil the requirements laid down in paragraphs 1 to 4 as well as a written policy, approved by the administrative, management or supervisory body of the insurance or reinsurance undertaking, ensuring the ongoing appropriateness of the information submitted.*
- 6. *The Commission shall adopt implementing measures specifying the information referred to in paragraphs 1 to 4, with a view to ensuring to the appropriate extent convergence of supervisory reporting.*
- 7. *Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

#### OPC reports

The CEIOPS Key Implementations report<sup>66</sup>, Section 4.3.1 and Annex A, has shown that reporting requirements differ widely between Member States. This difference concerns the amount of information, its content and timing. While in most Member States the information needs to be submitted by the IORP itself, the reporting obligations can also be attributed to other parties (e.g. fund manager, administrator or custodian).

Most of the Member States have gone beyond the minimum requirements in the IORP Directive (e.g. whistle-blowing reports, composition of membership, benefit payments, return on investment based on standardised formulae, stress tests, projections, asset allocation and commissions).

A follow up report on Reporting Requirements to Supervisory Authorities provided a more in depth analysis of the differences in type of information, its content and frequency amongst member states. It confirmed that there continues to be wide variations between member states.

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<sup>66</sup> Initial review of key aspects of the implementation of the IORP Directive (EIOPA-OP-03-08 final).

The same report sought a link between these differences and other indicators such as type of supervisory approach, whether DB or DC arrangements predominated in the member state, and the amount of IORPs supervised. No particular linkage could be found except that where there were large numbers of IORPs, there was some evidence of a heavier reliance on exceptional reporting, such as whistle-blowing, or reporting on the request of the supervisor, rather than reporting as a matter of course.

### **28.3. Explanatory text**

#### EIOPA view on issues in the CfA

- 28.3.1. Effective supervisory regimes are based on accurate and timely reporting of a range of indicators that enable a supervisor to discharge their primary duty of protecting members' benefits.
- 28.3.2. The current framework in the IORP directive in Article 13(a) contains an overarching requirement that supervisors have the powers to require IORPs to supply information about all business matters and to be able to have access to all relevant business documents.
- 28.3.3. In addition to this general power, the IORP directive goes on to specify specific documentation reporting in the form of the annual report and accounts, and the statement of investment policy principles [Article 13(c)]. The same provision identifies other documents, such as internal interim reports, actuarial valuations, asset liability studies, evidence of consistency with the investment policy, evidence that contributions have been paid and audit reports linked to the Annual accounts, as the type of documents that could be obtained regularly as part of 'all the documents necessary for supervision'.
- 28.3.4. The frequency of reporting is that of 'obtaining regularly'. There is evidence from work carried out by the OPC that many Member States have built up from these provisions to call in (sometimes extensive) documentation at various frequencies, in order for the supervisor to properly overview the IORP's operation.
- 28.3.5. The CEIOPs Report on Reporting Requirements<sup>67</sup> showed that there are some common sets of data (for example, the statement of investment principles, the amounts of contributions paid in) which are universally requested, although not necessarily with the same frequency. Sometimes a common approach to data is linked to the nature of the information – the Annual Accounts and Report for example is reported as collected on a yearly basis by most Member States.
- 28.3.6. However, it is also a fair reflection of the Report to say that the types of documentation and data called in, and the frequency and format of reporting, vary considerably across Member States.

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<sup>67</sup> CEIOPS-OP-68-10 Rev5(public) Report on Reporting Requirements  
479/515

- 28.3.7. These large differences in the information collected reflect a number of factors. They range from the different types of pension arrangement, differences in legal form, and the size, complexity and number of IORPs in a Member State, to the different supervisory framework which underpins the requirements and different supervisory approaches and priorities.
- 28.3.8. Differences in existing practice should not, by themselves, be the basis for change unless that change brings benefits to member protection in a sustainable and proportionate way.
- 28.3.9. On the basis of current understanding, IORPs have a number of characteristics which should be taken into account. IORPs generally represent less of a systemic risk than insurance undertakings, are linked to a sponsoring employer, and are usually provided on a not for profit basis.
- 28.3.10. For these reasons therefore, it is particularly important to balance the cost and regulatory burden of collecting and delivering information with that of the need to provide essential information on a flexible basis in a way that supports member protection.
- 28.3.11. So, care must be taken in developing a proportionate information regime for IORPs as the cost of providing information, if over burdensome, could have the unwanted effect of reducing the income to the member in retirement through increased administration costs, or cause a reduction in voluntary provision by employers unwilling to meet the costs of provision and an increased take up of 'opting out' of pension savings
- 28.3.12. EIOPA recognises the importance of information however and the key role it plays in the third pillar of the supervisory framework in Solvency II. Without a common information regime as provided by the framework of Solvency II, supervisory practices may take longer to converge and harmonise. Also, other changes in the IORP directive may require solvency reporting arrangements. However, harmonisation of reporting requirements should not limit the possibility for individual Member States to require additional information.
- 28.3.13. Where other changes in the IORP directive bring forward different demands for supervisory information, there may be a need for implementing measures, as is provided for in the Solvency II directive. Information requirements would be largely drawn from the existing IORP powers, subject to an additional clause that provides for further implementing measures.
- 28.3.14. Another position is to take the Solvency II framework on supervisory information in its entirety. Article 35 sets a principle for the information that supervisory authorities should require, in that it asks for that information which is necessary to enable the authorities to conduct the supervision process as set out in Article 36.
- 28.3.15. Article 36 says that supervisory authorities shall in particular review and evaluate compliance with the system of governance, including the Own Risk and Solvency Assessment, technical provisions, capital, the investment rules of the IORP, own funds and internal models (if used).

- 28.3.16. So the Solvency II requirement requires on the supervisory authority to conduct its information requirements with particular processes in mind whereas the IORP directive places the emphasis on the Member States giving their supervisors sufficient powers to call in documents without a link in itself to a supervisory process.
- 28.3.17. Article 36 could lead to more common information requirements and these could be helpful in other contexts – as in the need for comparable data during a period of financial instability - and in some Member States occupational pensions are delivered through financial institutions that will be subject to the requirements of Solvency II and are already operating similar information systems for their IORPs.
- 28.3.18. For these reasons therefore EIOPA wishes to consider the applicability of Article 35 to IORPs. It is noted that Article 35 gives weight to qualitative assessment and the possibility of gathering data for future scenarios which is not a feature of the current IORP requirements. It is noted also, that in other areas of the call for advice, a requirement to report may be a feature of EIOPA's advice.
- 28.3.19. Within these considerations, it is also acknowledged that Article 35 does not contain specific requirements as to the contents and frequency of reporting. Under the Solvency II Directive, contents and frequency are dealt with in Level 2/3 Regulations. It might therefore be possible to adopt Article 35 completely for IORPs, and take the proportionality issue into account when developing further regulations at a later stage. It would also be necessary for further regulations to take into account the differing appropriate reporting requirements for IORPs compared with insurance undertakings.

#### Differences between DB, DC and Hybrid IORPs

- 28.3.20. EIOPA is of the view that there could be different information requirements for different pension arrangements and especially with regard to DB and DC, as in the latter it is generally the case that the member bears the investment risk.
- 28.3.21. From the point of view of member protection, supervisors may be interested in different sets of indicators in determining their supervisory approaches to achieving good outcomes for members in DC arrangements, but this needs further analysis.
- 28.3.22. For DB arrangements, the cost of actuarial valuations and detailed assumptions in the context of the long term investment is a consideration in determining frequency of collection of actuarially supported data.
- 28.3.23. There needs to be detailed consideration given to the different data needs and this has not been possible in the short timescale of this advice. EIOPA therefore recommends that this detailed consideration be taken forward, either in implementing measures or in EIOPA guidance to be determined over a longer time scale.

#### Policy options

**Option 1:**

Leave the IORP Directive unchanged, subject to an additional clause on implementing measures.

This means that Article 13 – information to be provided to the competent authorities – continues to apply to IORPs. It already provides for significant supervisory powers to be made available to supervisors and these can be used to collect essential information on a frequent and regular basis, with the possibility of ad hoc information as and when necessary.

However, to recognise the fact that other potential changes to the IORP Directive may give rise to a need for harmonised data, Article 13 should be amended to allow for implementing measures.

**Option 2:**

The proposal here is to adopt Article 35 of the Solvency II Directive in its entirety. This Article sets a very broad scope of the nature of information that supervisors can request and, given the potential changes in other areas, it is necessary to make this change also. It also expressly provides for implementing measures to ensuring appropriate convergence of supervisory reporting.

**28.4. Impact assessment**

The nature of supervisory reporting means that the main impacts will fall upon the IORPs themselves, and their supervisory authorities. In many member states, any increased cost of reporting by IORPs will be borne by the sponsoring employer and/or the members.

Positive impacts

Option 1: Leave the IORP Directive unchanged

No impact

Option 2: Adopt Article 35 of the Solvency II Directive in its entirety

- IORP members and beneficiaries
  - Potentially higher level of protection
- IORPs and sponsoring employers
  - n/a
- Supervisory authorities
  - Provides comparable information between supervisors
  - Provides a means by which supervisory convergence can take place over time
  - Provides for information that could in future be necessary

## Negative impacts

Option 1: Leave the IORP Directive unchanged

No impact

Option 2: Adopt Article 35 of the Solvency II Directive in its entirety

### ➤ IORP members and beneficiaries

- Incremental compliance costs to IORP will be ultimately passed on to members and beneficiaries
- Potential to increase member opt out if resulting costs mean that pension saving is not seen as cost effective and/or a withdrawal from employers willing to sponsor.

### ➤ IORPs and sponsoring employers

- Significant cost and burden of collecting a common set of data from IORPs, especially in the start-up stage, but also afterwards.

### ➤ Supervisory authorities

- Risk of convergence leading to information which is not relevant for IORPs in every member state, which might make effective supervision more difficult.

## 28.5. EIOPA advice

*The Commission Services would like EIOPA to advise on detailed rules on information to be provided for supervisory purposes.*

*The EIOPA advice should address at least the following subjects:*

- *The material elements of Article 35 of Directive 2009/138/EC that should be amended or removed to adequately address the specificities of IORPs in relation to supervisory reporting;*
1. EIOPA considers that increased harmonisation of information to be provided to supervisors might be sensible if the revised IORP Directive would lead to a larger degree of harmonisation. In particular it sees some benefits to convergence of information provision as reducing the cost of operating cross-border, though there are concerns that any large scale new requirements would not necessarily increase member protection and will significantly increase costs borne by the member. The revised IORP Directive should not limit the possibility for Member States to require additional information from IORPs.
  2. EIOPA considers that both the current IORP requirements and Article 35 of the Solvency II Directive would provide a helpful starting point to provide the information necessary for supervisors to discharge their primary role of protecting members' benefits.
    - *Other requirements for IORPs, if any: e.g. specific reporting requirements for DB, DC and hybrids schemes.*
  3. EIOPA's view is that the supervisory reporting for these types of schemes is different in that the member protection concerns change for those schemes where the member bears some or all of the investment risk.
  4. That said, EIOPA is of the view that both the IORP directive and the Solvency II directive provide sufficient powers to enable MS to ensure that the right data is collected for the different types of scheme.

## **29. CfA 23: Information to members / beneficiaries**

### **29.1. Extract from the Call for Advice**

#### **SECTION 23: INFORMATION TO MEMBERS AND BENEFICIARIES**

The Commission Services would like EIOPA to advise on how to strengthen the information requirements to provide useful information on a consistent basis across the EU. This should at least cover the issues identified below.

- The extent to which the KII Document can be used for IORPs as regards pre-contractual information disclosure. This includes advice on the material elements of Articles 78-82 of Directive 2009/65/EC that should be amended or removed to adequately address the specificities of IORPs with a view to replacing Article 9c and 9f of Directive 2003/41/EC.
- The content, format and timing of ongoing information disclosures to strengthen and make more consistent the current provisions of Article 11a and 11c. This should also include advice on the possibility to delete Article 20(7) of Directive 2003/41/EC.
- The extent to which Articles 51-56 of Directive 2009/138/EC can be used for IORPs as regards public disclosure through the report on solvency and financial condition.
- Other requirements for IORPs, if any: e.g. specific reporting requirements for DB, DC and hybrid schemes.

## 29.2. Background

Current legal requirements (IORP Directive, extracts)

### **Article 9: Conditions of operation**

1. Each Member State shall, in respect of every institution located in its territory, ensure that:

.....

(c) properly constituted rules regarding the functioning of any pension scheme operated by the institution have been implemented and members have been adequately informed of these rules;

.....

(f) the members are sufficiently informed of the conditions of the pension scheme, in particular concerning:

(i) the rights and obligations of the parties involved in the pension scheme;

(ii) the financial, technical and other risks associated with the pension scheme;

(iii) the nature and distribution of those risks.

.....

### **Article 11: Information to be given to the members and beneficiaries**

1. Depending on the nature of the pension scheme established, each Member State shall ensure that every institution located in its territory provides at least the information set out in this Article.

2. Members and beneficiaries and/or, where applicable, their representatives shall receive:

(a) on request, the annual accounts and the annual reports referred to in Article 10, and, where an institution is responsible for more than one scheme, those relating to their particular pension scheme;

(b) within a reasonable time, any relevant information regarding changes to the pension-scheme rules.

3. The statement of investment policy principles, referred to in Article 12, shall be made available to members and beneficiaries and/or, where applicable, to their representatives on request.

4. Each member shall also receive, on request, detailed and substantial information on:

- (a) the target level of the retirement benefits, if applicable;*
- (b) the level of benefits in case of cessation of employment;*
- (c) where the member bears the investment risk, the range of investment options, if applicable, and the actual investment portfolio as well as information on risk exposure and costs related to the investments;*
- (d) the arrangements relating to the transfer of pension rights to another institution for occupational retirement provision in the event of termination of the employment relationship.*

*Members shall receive every year brief particulars of the situation of the institution as well as the current level of financing of their accrued individual entitlements.*

*5. Each beneficiary shall receive, on retirement or when other benefits become due, the appropriate information on the benefits which are due and the corresponding payment options.*

### **Article 12: Statement of investment policy principles**

*Each Member State shall ensure that every institution located in its territory prepares and, at least every three years, reviews a written statement of investment-policy principles. This statement is to be revised without delay after any significant change in the investment policy. Member States shall provide that this statement contains, at least, such matters as the investment risk measurement methods, the risk-management processes implemented and the strategic asset allocation with respect to the nature and duration of pension liabilities.*

### **Article 20: Cross-border activities**

.....

*7. In particular, an institution sponsored by an undertaking located in another Member State shall also be subject, in respect of the corresponding members, to any information requirements imposed by the competent authorities of the host Member State on institutions located in that Member State, in accordance with Article 11.*

.....

## **29.3. Explanatory text**

### **General EIOPA view on issues in the CfA**

#### The purpose of information requirements in the IORP Directive

- 29.3.1. The point of departure for EIOPA, while developing new regulations on information provision, is that people generally find retirement planning a difficult issue. At the same time, saving for retirement is one of the most important elements of lifetime financial planning. Information requirements are an essential element of the protection of IORP members, especially when they bear the investment risk. Current and potential members/beneficiaries need information to 'understand' and make judgements about on the one hand the functioning of an IORP and its scheme, and if applicable to make informed decisions (concerning the provider, different investment options, opting-in or out). On the other hand, people need information to make choices that concern their broader retirement planning, the IORP scheme being only one element of it. Finally, information requirements contribute to trust in the pension sector, in this case specifically in IORPs.
- 29.3.2. EIOPA recognises that there is a link between the level of harmonisation of information requirements for IORPs and the level of their cross-border activity. We aim for a high level of security, inter alia through information requirements, throughout the European Union. Moreover, we recognise that if cross-border activities take place, it would be desirable to have a comparable framework for information requirements on a minimum basis.
- 29.3.3. At the same time EIOPA highlights the importance to take into account the principle of subsidiarity and to consider what can be best decided upon at a Member State-level. It is of crucial importance to take into account that IORPs are both financial vehicles and social insurance institutions. This implies that in various places uniform detailed rules would be inappropriate. In different Member States different information requirements will be essential, as people's understanding of pension saving via an IORP is strongly interwoven with the characteristics of the pension system, the social and labour law and the historical and recent developments of the pension system within their country. These characteristics of the IORP Market – which is then in fact not a typical market – imply that detailed rules in combination with maximum harmonisation would often be inappropriate.
- 29.3.4. Finally, EIOPA stresses the need to apply the principle of proportionality to any new information requirement: whether the potential effect is substantial enough, in terms of the importance of the information provided for the choices to be made by members, to justify the introduction of a new requirement.

#### Principles-based vs. detailed information requirements

- 29.3.5. A preliminary, general issue to consider is the desired level of detail of the regulation. The EC wishes to stimulate integration of IORPs into a single market. EIOPA recommends achieving a higher level of harmonisation of information regulation compared with the current situation, especially for DC funds where members bear the investment risk. On information requirements, the current IORP Directive may be considered a principles-based directive, with no specific requirements delegated at level 2. In this matter, the revised IORP Directive could again be principles-based, but could be extended somewhat. Further, level 2 measures may provide the necessary additional details to specific aspects of the EU regulation; anyway, room should be left to country-specific information.
- 29.3.6. Another key issue that needs to be taken into account when revising the information requirements in the IORP Directive is whether members individually bear all or most of the investment risk, or whether risk is shared collectively. Information to members and beneficiaries has to make clear the risks to which they are exposed. EIOPA recognizes the wide diversity of ways across Europe in which risk is allocated between members/beneficiaries, the IORP, the employer(s) and possibly other entities. Nevertheless, EIOPA believes that the DB/DC distinction is still useful on practical grounds. Different elements of information are necessary in these two cases. EIOPA's view is that EU-level information requirements for DC schemes have to be reinforced, as suggested by the direct and substantial impact that the financial crisis has had on the position of members of certain DC schemes. Information requirements currently in place for DB schemes are more or less appropriate; however, it should be made clear that information on the existence of benefit adjustment mechanisms of any kind should be an essential part of the description of risk-sharing mechanisms.
- 29.3.7. The new regulation should explicitly recognise that information should be 1) correct, 2) understandable and 3) not misleading. 'Correct' implies that the information provided should be regularly updated, in particular after substantial changes to the scheme. 'Understandable' implies that all information documents are written in a way and have been given a lay-out that have proved to be clear and understandable and hence useful for people (for instance, the use of visual devices should be encouraged). 'Not misleading' implies that members should not receive information which gives them an unjust impression of the functioning of the pension scheme
- 29.3.8. Information overload should be avoided. Information to be mandatorily delivered to members should be concise and kept as simple and straightforward as possible; relevant additional information (with an adequate level of complexity) should be easily available to members, beneficiaries and stakeholders.
- 29.3.9. Another general criterion that should be introduced as a trend to be encouraged is providing information also through digital means, (this is also mentioned in the context of the Green Paper on pensions). The revised Directive should bring the potential of digital information disclosure to the foreground (see 23.4).

#### Pre-enrolment and ongoing information; differences with respect to financial instruments

- 29.3.10. Article 11 of the current IORP Directive specifies the information to be given to members and beneficiaries of the pension schemes that fall within its scope. Rules concerning information requirements are contained also in articles 9.1 c) and f), article 12, and article 20.7 (the latter only in the case of cross-border activity).
- 29.3.11. The CfA asks for separate consideration of the information requirements for the pre-contractual and the ongoing phases, suggesting that articles 9.1 c) and f) may be interpreted as pre-contractual requirements, while article 11 contains the ongoing requirements.
- 29.3.12. As a preliminary point, as discussed in the EIOPA Report on pre-enrolment information requirements for pension plans, the wording “pre-contractual information” – which is used in the context of financial products – is not really appropriate for IORPs: pre-enrolment information, or information “at joining” seems to be more adequate because the membership in the IORP is connected to the labour relationship. What is more, in many cases the relationship between the IORP and its members and beneficiaries is that of participating in a non-profit entity and not that of a contract between a commercial, profit-making firm and its clients. Besides the member and the IORP, the employer is also involved. In various Member States the characteristics of pension schemes are outcomes of collective labour negotiations. In the following text we prefer to use the more general wording ‘pre-enrolment’ (as has also been used in the OPC Report on pre-enrolment information requirements).
- 29.3.13. Currently, the articles of the IORP Directive do not make a clear distinction between pre-enrolment and ongoing information requirements. In particular, Articles 9.1c) and 9.1f) do not refer explicitly to the pre-enrolment phase; 11.4c) applies to members who bear the investment risk and seems to concern mainly the pre-enrolment phase.
- 29.3.14. While for pure financial instruments consumer protection concentrates mainly on the phase surrounding the purchase of the product, when the purchaser becomes exposed to the most significant risks, for IORPs (and pension plans in general) information requirements should ensure that the member is informed throughout all phases of his/her relationship with the IORP. Indeed, the participation of an individual in a specific pension scheme carries a unique role in long-term financial planning; the development of pension entitlements over time is an essential aspect to be monitored by members.
- 29.3.15. Members should be given the information that is useful to them to make the choices (if any) they are asked to make in the different phases of their participation in the pension scheme: contribution rates, switches between investment options and providers, etc. (see on this the *OPC Report on pre-enrolment information requirements*, available on the EIOPA website).
- 29.3.16. The set of information documents to be made available at joining, including general rules and rights, should remain always available to members, potential members, and beneficiaries as well (for instance on the IORP website and/or on request delivered on paper). The EU requirement to actually deliver documents at or before joining should be limited to a summary document such as the Key Investor Information Document (KIID), subject to certain qualifications (see below). In cases where scheme

members are enrolled automatically information should anyway be made available to (potential) members but actual delivery to them may happen after enrolment. When certain decisions (such as opting-out) have to be taken within a certain time period, the actual delivery should take place early enough to allow these decisions to be taken in an informed way.

- 29.3.17. In the ongoing phase, a document informing each member of the evolution of his/her own account (for DC schemes) or of his/her accrued individual entitlements (for DB schemes) should be delivered to members annually (see below).
- 29.3.18. As regards the payout phase, information requirements should apply equally to DC and DB schemes, as in this phase the DC/DB distinction becomes irrelevant. As provided by the current IORP directive, each beneficiary should receive, on retirement or when other benefits become due, appropriate information on the benefits which are due and the corresponding payment options as laid down in article 11(5) of the IORP Directive.
- 29.3.19. When a significant level of investment risk is carried by beneficiaries in the payout phase (as in the case of with-profits annuities), appropriate, additional information is needed. The need for any additional information should be assessed carefully, according to the principle of proportionality.
- 29.3.20. Finally, EIOPA recommends that in the revised IORP Directive all the information requirements should be located in one article (or in a group of contiguous articles).

## **Specific sub-CfA 23.1**

### **Specific Call for Advice**

– The extent to which the KII Document can be used for IORPs as regards pre-contractual information disclosure. This includes advice on the material elements of Articles 78-82 of Directive 2009/65/EC that should be amended or removed to adequately address the specificities of IORPs with a view to replacing Article 9c and 9f of Directive 2003/41/EC;

### **Background: Articles 78-82 of UCITS IV Directive**

#### Art.78

*1. Member States shall require that an investment company and, for each of the common funds it manages, a management company draw up a short document containing key information for investors. That document shall be referred to as 'key investor information' in this Directive. The words 'key investor information' shall be clearly stated in that document, in one of the languages referred to in Article 94(1)(b).*

*2. Key investor information shall include appropriate information about the essential characteristics of the UCITS concerned, which is to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product that is being offered to them and, consequently, to take investment decisions on an informed basis.*

*3. Key investor information shall provide information on the following essential elements in respect of the UCITS concerned:*

*(a) identification of the UCITS;*

*(b) a short description of its investment objectives and investment policy;*

*(c) past-performance presentation or, where relevant, performance scenarios;*

*(d) costs and associated charges; and*

*(e) risk/reward profile of the investment, including appropriate guidance and warnings in relation to the risks associated with investments in the relevant UCITS.*

*Those essential elements shall be comprehensible to the investor without any reference to other documents.*

*4. Key investor information shall clearly specify where and how to obtain additional information relating to the proposed investment, including but not limited to where and how the prospectus and the annual and half-yearly report can be obtained on request and free of charge at any time, and the language in which such information is available to investors.*

*5. Key investor information shall be written in a concise manner and in non-technical language. It shall be drawn up in a common format, allowing for comparison, and shall be presented in a way that is likely to be understood by retail investors.*

*6. Key investor information shall be used without alterations or supplements, except translation, in all Member States where the UCITS is notified to market its units in accordance with Article 93.*

*7. The Commission shall adopt implementing measures which define the following:*

*(a) the detailed and exhaustive content of the key investor information to be provided to investors as referred to in paragraphs 2, 3 and 4;*

*(b) the detailed and exhaustive content of the key investor information to be provided to investors in the following specific cases:*

*(i) for UCITS having different investment compartments, the key investor information to be provided to investors subscribing to a specific investment compartment, including how to pass from one investment compartment into another and the costs related thereto;*

*(ii) for UCITS offering different share classes, the key investor information to be provided to investors subscribing to a specific share class;*

*(iii) for fund of funds structures, the key investor information to be provided to investors subscribing to a UCITS, which invests itself in other UCITS or other collective investment undertakings referred to in Article 50(1)(e);*

*(iv) for master-feeder structures, the key investor information to be provided to investors subscribing to a feeder UCITS; and*

*(v) for structured, capital protected and other comparable UCITS, the key investor information to be provided to investors in relation to the special characteristics of such UCITS; and*

*(c) the specific details of the format and presentation of the key investor information to be provided to investors as referred to in paragraph 5.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 112(2).*

#### Art. 79

*1. Key investor information shall constitute pre-contractual information. It shall be fair, clear and not misleading. It shall be consistent with the relevant parts of the prospectus.*

*2. Member States shall ensure that a person does not incur civil liability solely on the basis of the key investor information, including any translation thereof, unless it is misleading, inaccurate or inconsistent with the relevant parts of the prospectus. Key investor information shall contain a clear warning in this respect.*

## Art.80

1. Member States shall require that an investment company and, for each of the common funds it manages, a management company, which sells UCITS directly or through another natural or legal person who acts on its behalf and under its full and unconditional responsibility provides investors with key investor information on such UCITS in good time before their proposed subscription of units in such UCITS.

2. Member States shall require that an investment company and, for each of the common funds it manages, a management company, which does not sell UCITS directly or through another natural or legal person who acts on its behalf and under its full and unconditional responsibility to investors provides key investor information to product manufacturers and intermediaries selling or advising investors on potential investments in such UCITS or in products offering exposure to such UCITS upon their request. Member States shall require that the intermediaries selling or advising investors on potential investments in UCITS, provide key investor information to their clients or potential clients.

3. Key investor information shall be provided to investors free of charge.

## Art.81

1. Member States shall allow investment companies and, for each of the common funds they manage, management companies, to provide key investor information in a durable medium or by means of a website. A paper copy shall be delivered to the investor on request and free of charge.

*In addition, an up-to-date version of the key investor information shall be made available on the website of the investment company or management company.*

2. The Commission may adopt implementing measures which define the specific conditions which need to be met when providing key investor information in a durable medium other than on paper or by means of a website which does not constitute a durable medium.

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 112(2).*

## Art.82

1. UCITS shall send their key investor information and any amendments thereto, to the competent authorities of their home Member State.

2. The essential elements of key investor information shall be kept up to date

## **EIOPA view**

### The contents of the KIID vs. the requirements of the current IORP Directive

29.3.21. The CfA from the European Commission requests that EIOPA considers the option to introduce a document such as the KIID of the UCITS IV Directive as a pre-enrolment information requirement. Indeed, such a starting point for information requirements has been recently put forward by the Commission for all long term-savings products offered to the public.

- 29.3.22. The contents of the KIID are listed in art. 78 of the UCITS IV directive. Besides the identification of the UCITS, it should contain:
- a short description of its investment objectives and investment policy;
  - past-performance presentation or, where relevant, performance scenarios;
  - costs and associated charges;
  - a risk/reward profile of the investment.
- 29.3.23. They are all contents relative to investments and consistent with the nature of UCITS, an investment vehicle directed to the general public where the investment risk is borne by its holders, and typically there is no guarantee. From the point of view of investment, it is a situation similar to that of pure DC pension schemes (although the latter have a longer-term perspective and are less likely to encounter any liquidity problems).
- 29.3.24. A comparison of these contents with those required by the current IORP directive is not straightforward. First of all, as noted above, in the current directive there is no clear distinction between pre-enrolment and ongoing information requirements. In addition, in the current directive:
- the investment objectives and investment policy are to be included in the Statement of Investment Policy Principles (SIPP) of art.12, mentioned in art. 11.3; in addition, where members bear the investment risk, the actual investment portfolio and information on risk exposure has to be provided to members (art. 11.4.c);
  - again when members bear the investment risk, the costs related to investments have to be disclosed (art.11.4.c).
- 29.3.25. On the other hand, the current IORP directive does not require information to members regarding:
- performance information, except to some extent through article 11.2.a) the annual report/ account and 11.4 the yearly information on the particulars of the situation of the institution;
  - the risk/reward profile of investment (this is a different, though connected, concept than that of providing just the risk exposure as stipulated in art. 11.4.c); the first one is defined ex-ante; the second observed ex-post).
- 29.3.26. Hence, if members wish to assess the relative quality of their pension scheme, the necessary information is currently:
- a) scattered throughout various information documents;
  - b) typically not presented in such a way that it is easy to understand for members;
  - c) following from point 1 and 2 - highly complex to compare for different pension schemes.

29.3.27. What could a KIID-like document for IORPs add to the current IORP Directive? As well as its contents, the most important innovation introduced with a KIID-like document would be that of having a single, concise document with all the key information regarding the pension scheme (or at least regarding its investments).

29.3.28. EIOPA supports the introduction of a mandatory KIID-like document, with the following main qualifications:

- a KIID-like document is particularly useful for DC schemes, where members bear the investment risk and are asked to make choices at individual level; it is not necessary where employers/IORPs carry the investment risks and members are not asked to make choices specifically regarding their pension scheme;
- The format of a potential KIID-like document cannot be fully standardised at EU level, as country-specific information is often essential (with particular reference to information related to the national pension system and social and labour law);
- the contents should be made relevant to pension schemes and should extend to aspects beyond investment. That may instead lead to a name such as KID, or Key Information Document. Indeed, this would recognise that IORPs are not only investment vehicles; rather, pension schemes such as those operated by IORPs have several other important aspects, such as contribution arrangements, the role of employers, risk-sharing arrangements, structural links with first-pillar pensions, that may need to be mentioned in a compact document directed to members.
- A pre-enrolment document, but with a different lay-out than the KID, could also be useful for other kinds of pension schemes. This document may or may not include information on investments; indeed, as in DB schemes members do not carry the investment risk, the availability of the SIPP to members and/or their representatives may be sufficient. Therefore the contents specified in articles 9 and 11 of the current IORP Directive could be appropriate. Yet this document needs to be written concisely and needs to be understandable for members. Member States should consider such a document as an option and set more detailed rules.

29.3.29. A KID would potentially serve members, employers, and IORPs. It would add value in comparison with the pre-enrolment requirements in the current IORP Directive.

- First, a KID would enable (future) members to obtain comparable information on pension schemes, based on its key elements. It would enable them to assess whether 1) they wish to enrol at all or opt-out (if applicable), 2) make choices of different investment options (if applicable), 3) assess whether they need to adjust or not their broader individual retirement strategy. The KID would indeed be useful not only in the pre-enrolment phase, but also as a summary document to be consulted by members in the ongoing phase, and for this purpose it should be made constantly available in a durable medium. It would also be useful in assessing the consequences of any change of employment that requires a change of occupational scheme.

- Second, a KID would enable employers to compare other IORP schemes to the scheme they offer to their employees. They could take action if the quality level is different than they wish.
- Third, for IORPs themselves a KID would raise awareness of the relative quality of their scheme and it might encourage them to take actions to improve the functioning of the scheme.

#### Content of the KID for IORPs

- 29.3.30. Various elements of the KID are appropriate to loosely set as main principles. These are 1) the identification of the IORP; 2) a brief description of the objectives and investment policies; 3) performance information; 4) the costs/charges; 5) risk/ reward profile. These elements however, cannot be presented according to the exact rules as they are set in the UCITS Directive. EIOPA discusses some of these points in more detail below, while reflecting on the fit of the specific articles concerning the KIID in UCITS with pure DC pension schemes.
- 29.3.31. In addition to these elements EIOPA recommends to add 6) information on contribution arrangements, including the amounts to be paid by the employer and the employee as a percentage of salary. This is a crucial indication of the quality of a pension scheme.
- 29.3.32. Another key element of a KID for IORP schemes is 7) practical information. This element would enable Member States to require specific information which they believe is relevant. This would do justice to the different pension systems in the various EU Member States.
- 29.3.33. Another element EIOPA recommends is to add the element 8) cross-references. The KID for pure DC schemes should be a comprehensive document of 2 pages maximum which provides a brief overview based on the key elements of a pension scheme. Hence, the KID would typically lack the legal background of the scheme. Under the heading 'cross-references' it should refer to the relevant legal documents. These documents would most likely contain the rules of the functioning of the pension scheme, the rights and obligations, and set out the risks in more detail. From this recommendation also follows that the rule contained in articles 9 c and f cannot be removed from the IORP Directive. They contain more than can be set out in a KID for pure DC schemes.

#### The option to introduce the KID as a pre-enrolment requirement and its relationship with other information documents

- 29.3.34. Especially for DC pensions, or more generally where the member bears the investment risk, the possible introduction of the KID raises the issue of the legal implications, in terms of the commitments that the IORP makes with respect to its members, of the KID itself and of the other documents that convey information.
- 29.3.35. Indeed, Art.79 of the UCITS Directive stipulates that, in terms of commitments to members, the KIID has a "softer" nature compared with the so-called "prospectus". The introduction for IORPs of a KIID-like document would as well require clarification of which are the documents where

members can actually find the rules and the commitments that the IORP makes with respect to them.

29.3.36. In particular, it should be clarified that such a role should not be played by the Statement of Investment Policy Principles (SIPP) of art.12 of the IORP Directive. Indeed, the SIPP should keep its current, prevalent “internal governance” role regarding risk management and control in the investment process, although it is usually made available on request to members and beneficiaries. In order to do so, that the SIPP may be interpreted as carrying formal commitments with respect to members/beneficiaries, should be avoided.

29.3.37. The introduction of a single, comprehensive information document (distinct from the SIPP and of a similar nature to the “prospectus” in the UCITS IV context) could be a possibility available to Member States and/or, within them, individual IORPs. The option to make a prospectus-like document mandatory for IORPs at EU level should not be considered at this stage, although it should be left as an option for individual Member States.

#### Comments on specific articles

29.3.38. As a general, preliminary point on the discussion of the individual articles of the UCITS IV directive mentioned in the CfA23.1, it is useful to emphasize that EIOPA considers that the introduction on the KID is necessary only for DC schemes. Therefore the discussion of art. 78-82 of the UCITS IV directive is meant to refer only to these schemes.

#### Art 78 of UCITS IV Directive

As regards articles 78.1 and 78.2, following the general discussion made above, EIOPA recommends the introduction of a KID to be extended to aspects beyond investments.

29.3.39. Art. 78.3, that stipulates on the contents of the KID, needs specific analysis.

29.3.40. Letter c) of art. 78.3 requires a presentation of past performance or, where relevant, performance scenarios. EIOPA members believe that information on past performance is a necessary element of the KID. However, it is recognized that, in the case of pension schemes, it is unlikely that meaningful data on past performance are available for a time horizon that is sufficiently long to give a well-founded idea of future, long term performance. For example, in many jurisdictions IORPs have been in place for only a few years, and often investment rules have been substantially changed and therefore their past performance refers to an investment “opportunity set” that is different (and often more limited) than the one that is going to be relevant for the future. Therefore, EIOPA is of the opinion that, while information of past performance should (where available) anyway be included in the KID, performance scenarios are also useful in the presentation of performance information.

29.3.41. However, performance scenarios for pension schemes are tricky. They have to be based on several assumptions about the longer term that would be controversial. If one wants to give an idea of what the expected pension will be, assumptions are needed about future wages, career paths, and

contribution rates. In addition, assumptions on the conversion of the accrued capital to an annuity would also be needed.

29.3.42. Limiting the attention to financial variables, nominal and real rates of return should be stipulated for several decades in the future; it is not clear whether past performance of financial markets would be applied, or some judgemental assumption. Additional issues are:

- whether, for the sake of prudence (and where relevant for comparability), financial assumptions should be made uniform across IORPs, at national and perhaps at EU level;
- how to deal with the uncertainty surrounding the scenarios considered;
- how to avoid excessive complexity, as members would disregard information that is perceived as too detailed and complicated.

29.3.43. Dealing with all these aspects, given the difficulties, should be via level 2 implementing measures.

29.3.44. Letter d) of art. 78.3 requires the presentation of costs and associated charges. EIOPA believes that this should be an essential part of the KID for IORPs. For UCITS, implementation measures have been defined. Also for IORPs, level 2 legislation (and possibly EIOPA guidelines) are the best place to deal with details of cost disclosure. An issue that will have to be considered is whether and how the very long-term nature of pension promises implies a reinforced level of cost disclosure compared with UCITS. On the other hand, the non-profit nature of many IORPs may make interest alignment on cost issues easier than in the case of UCITS.

29.3.45. Letter e) of art. 78.3 requires the presentation of a risk/reward profile. For pension schemes, this is much trickier than for most financial instruments as it implies an assessment of risk of different investment policies and asset allocations across different time horizons, up to the very long term. For example, in the long run is an equity-oriented portfolio really more risky than a bond-oriented one, when we take into account inflation risk? Are short-term risk measures (such as the one-year VAR used in the solvency II framework) of any use for the long-term assessment of risk? It is not clear whether implementing measures could ever solve these issues, as technical problems may be overwhelming and may hide different attitudes across countries toward long-term risk in the pension systems that may have to be dealt with at a higher level. In other terms, while it is in principle important to attribute a risk label to different investment options, the relative ranking of these options may be conditioned to the time horizon of the member and may not be an objective characteristic of the option itself. A possibility worth exploring is to label the investment options according to their investment horizon and not to the level of risk.

29.3.46. In addition to the contents discussed above, in the case of IORPs, information on contribution arrangements (levels agreed between employers and employees, possibility to make additional contributions and/or to reduce or suspend them, etc.), and practical information to be defined at national level, should also be part of the KID.

- 29.3.47. Art.78.4 contains the principle that the KID should clearly specify where and how to obtain additional information, with particular reference to other documents issued. However, cross-reference to the appropriate documents will have to be adapted to those relevant for IORPs (e.g., no half-yearly report is envisaged for IORPs). As regards the language, in the case of IORPs the KID should be written in the language of the host state and leave to Member States the option to require that it should be also made available in other languages (in order to take account of workers that are not native speakers of the country's language).
- 29.3.48. Article 78.5 provides for a common format, allowing for comparison. Comparison may have different priority across countries and kinds of pension schemes. In many cases, a common format might anyway be useful in order to ensure a standard for transparency and the development of a common language. On the other hand, the diversity of pension schemes across Europe and the need to refer to aspects of the national pension system and SLL makes a common, comprehensive European format for IORPs inappropriate at this stage. However, certain specific aspects of the format and the contents of the KID could be defined at EU level by implementation measures, consistently with the above discussion.
- 29.3.49. Article 78.6 is linked to the level of harmonisation on information requirements that is desirable / achievable with IORP II. This issue is referred to also below, in the context of sub-CfA 23.2. With specific reference to the KID, Member States may require, as part of their SLL, that the KID may/should also contain information on the structural linkages between first pillar pension plans and the plan offered by the IORP (such as retirement age, contribution arrangements such as opt-out clauses, or on the fiscal treatment of plans; some countries may also consider comprehensive statements on 1st and 2nd pillar pensions). In addition, the level of comparability between pension schemes (including IORPs and non-IORPs) and therefore the information requirements favouring comparability may be considered to fall under SLL, as the desired level of comparability across pension schemes may be linked to structural features of the labour market and of industrial relations in a specific country.
- 29.3.50. Article 78.7 specifies the implementing measures to be defined as level 2 EU regulation. As already noted, certain specific aspects of the format and the contents of the KID could be defined at EU level by level 2 implementation measures, consistently with the above discussion. However, room should be left to country-specific information.

#### Article 79 of UCITS IV Directive

- 29.3.51. Article 79 of the UCITS IV directive is a crucial one in terms of legal implications of the KID. First of all, as already noted, the very concept of "pre-contractual" information in the case of IORPs is controversial. In the occupational pensions environment, the operation of both non-profit and commercial entities must be considered. For non-profit associations among members, or trust-based entities instituted by employers for the benefit of members, the legal relation between the IORP and the members is not the same as that between a financial firm and its customers. Instead of pre-

contractual information, one should more usefully talk of pre-enrolment information or of information before or at joining.

- 29.3.52. Moreover, Article 79 shows that in the case of UCITS the KID coexists with the prospectus, and that, in terms of commitments to members, the KID has a “softer” nature compared with the prospectus. For schemes where members bear the investment risk, the introduction of a similar provision in the case of IORPs would probably require clarification of which are the documents where members can actually find the rules and the formal commitments of the IORP. EIOPA does not recommend at this stage that there be a mandatory, comprehensive, prospectus-like information document at EU level, although it should be a possibility available to Member States and/or, within them, individual IORPs.
- 29.3.53. As already noted above, a related issue is the relationship between the KID (once introduced also for IORPs) and the Statement of Investment Policy Principles (SIPP) stipulated by article 12 of the current IORP Directive. For instance, what would be the legal implications of the information contained in the SIPP as regards the relationship between the IORP and the members, particularly when the members bear the investment risk? Article 79.2 (or a similar provision) should apply not only to the KID, but also possibly to the SIPP.
- 29.3.54. More generally, the nature of the SIPP should probably be clarified, not only in relation to the possible introduction of the KIID but also as regards its role in the definition of the investment strategy of the IORP and as a means for the supervisory authority to check the risk management process of the IORP (see CfAs 7 and 15).

#### Article 80 of UCITS IV Directive

- 29.3.55. This article refers to the responsibility for delivering the KIID to the potential investor. For IORPs it would be a new field, as it is not covered by the current IORP directive. The very concept of “selling” should be qualified in the IORP context. In particular, the role of employers as “delivery channel” between the IORP and its members should be recognised. EIOPA’s preliminary view on this topic is that the responsibility for the content of the KID and providing it to the “delivery” entities (employers included) should stay with the IORP.

#### Article 81 of UCITS IV Directive

- 29.3.56. The substance of this article is probably appropriate also for IORPs. Indeed, it is fully consistent with the need (noted above) to make sure that in the case of IORPs information is made available to members both in the pre-enrolment and in the ongoing phase.
- 29.3.57. One position is that in the case of IORPs a paper copy of the KID should be delivered; another position is that only an electronic version is delivered, for

instance by means of an e-mail. EIOPA believes that the decision on the means with which to provide the KID can be left to individual Member States.

29.3.58. However, as occupational pensions may have certain “environmental” features that make them different from financial products (e.g. the use of company intranet and other communication channels internal to sponsors), implementing measures may be needed.

#### Article 82 of UCITS IV Directive

29.3.59. This article stipulates that the KIID for UCITS is sent to the competent supervisory authority of the home member state; implicitly the KIID is not subject to an a priori authorisation by the supervisory authority.

29.3.60. In the IORP context, it should be noted that, for countries where the number of IORPs in place is huge, it is unfeasible that the supervisory authority receives the KID (and any updating of it) from all IORPs. EIOPA recommends that Member States should have the power to decide how they wish to deal with the KID; they could stipulate that IORPs should send the KID only at a request of the national supervisory authority.

29.3.61. In the case of cross-border activity, the delivery of the KID to the supervisory authority should be consistent with the competences of the home and the host Member States as regards information requirements (see below CfA 23.2).

## **Specific sub-CfA 23.2**

### **Specific Call for Advice**

– The content, format and timing of ongoing information disclosures to strengthen and make more consistent the current provisions of Article 11a and 11c. This should also include advice on the possibility to delete Article 20(7) of Directive 2003/41/EC.

### **EIOPA view**

29.3.62. The distinction between pre-enrolment and ongoing information should not be over-emphasised in the case of IORPs. In particular, the information to be provided at joining (such as the KID to be introduced for DC schemes) is also going to be useful during the ongoing phase. Both at joining and during the ongoing phase, information should be linked to the choices that members may make, in terms of contribution rates, switching between investment lines and providers, etc. and in principle in respect of broader financial planning in general.

29.3.63. As regards other aspects of the ongoing information requirements of the revised IORP Directive, there are three issues that need to receive additional attention:

- For DC pension schemes, where members bear the risk, an annual statement should be delivered to each member with his/her own accrued balance and a summary of inflows and outflows, with particular reference to employer's and employee's contributions; this statement could also contain other information, such as the charges actually levied and the performance in that particular year. For DB pension schemes, individual annual statements should also be provided, with the accrued individual entitlements (as stipulated by the current IORP directive).
- Information requirements for DC schemes should also include the possibility of the individual members obtaining (e.g. through electronic devices) personalised pension projections, based on the accumulated individual position, the flow of contributions and a set of macroeconomic assumptions in order to estimate future returns. When the employers or the IORP bears the investment risk, a simplified information notice with brief particulars of the situation of the institution, the individual member's accrued entitlements and their level of financing (as of art. 11.4.d of the current IORP directive) would suffice.
- specific information on benefits and possible options offered to members (as stipulated by the current IORP directive).

29.3.64. On all these aspects, level 2 implementation measures may be needed. Anyway, no required, comprehensive common format at EU level should be stipulated. A specific important point will be that of cost disclosure, with the need to provide consistent concepts of "ex-ante" costs, to be disclosed in the KID document, and "actually levied" costs, to be disclosed ex-post in the annual statements. The issue of disclosing investment transactions costs should be specifically considered.

## Art 20.7 of the IORP Directive and the level of harmonisation of information requirements

- 29.3.65. As regards the possibility of deleting article 20.7 of the IORP Directive, one position is that information requirements should in general remain the competence of the host Member state. As such, information requirements are part of national social and labour law, and therefore harmonisation is not possible by means of an internal market Directive.
- 29.3.66. Another position would not push the argument so far, but anyway underline the fact that occupational pension schemes are part of the social policy of member states and their design is strongly interrelated with the other pillars of the national pension system. Accurate information to scheme members and beneficiaries should take into account the specificities of the national pension legislation and practice.
- 29.3.67. Given this diversity EIOPA believes that it is impossible and undesirable to fully harmonise information requirements regarding occupational pensions, managed by IORPs or others pension providers. It is therefore highly desirable to maintain art. 20.7 of the actual directive. Host member states must have the opportunity to lay down information requirements for all pension schemes falling under their social and labour law, independent of the location of the pension provider, taking into account the specificities of national legislation and practice.
- 29.3.68. Nevertheless, against this general assessment in favour of keeping art. 20.7, it should be noted that the current IORP Directive already sets some minimum level of information requirements that all Member States have to ensure. EIOPA recognizes that this minimum harmonisation level could be raised, harmonising certain additional aspects of information requirements especially for DC schemes still leaving the option to home and host member states to introduce additional information requirements.

### **Specific sub-CfA 23.3**

#### **Specific Call for Advice**

- The extent to which Articles 51-56 of Directive 2009/138/EC can be used for IORPs as regards public disclosure through the report on solvency and financial condition.

#### **Background**

##### Current legal requirements (Solvency II Directive)

###### *Recital 38*

*In order to guarantee transparency, insurance and reinsurance undertakings should publicly disclose – that is to say make it available to the public either in printed or electronic form free of charge – at least annually, essential information on their solvency and financial condition. Undertakings should be allowed to disclose publicly additional information on a voluntary basis.*

###### *Article 51*

#### **Report on solvency and financial condition: contents**

*1. Member States shall, taking into account the information required in paragraph 3 and the principles set out in paragraph 4 of Article 35, require insurance and reinsurance undertakings to disclose publicly, on an annual basis, a report on their solvency and financial condition.*

*That report shall contain the following information, either in full or by way of references to equivalent information, both in nature and scope, disclosed publicly under other legal or regulatory requirements:*

- (a) a description of the business and the performance of the undertaking;*
- (b) a description of the system of governance and an assessment of its adequacy for the risk profile of the undertaking;*
- (c) a description, separately for each category of risk, of the risk exposure, concentration, mitigation and sensitivity;*
- (d) a description, separately for assets, technical provisions, and other liabilities, of the bases and methods used for their valuation, together with an explanation of any major differences in the bases and methods used for their valuation in financial statements;*
- (e) a description of the capital management, including at least the following:*
  - (i) the structure and amount of own funds, and their quality;*
  - (ii) the amounts of the Solvency Capital Requirement and of the Minimum Capital Requirement;*

(iii) the option set out in Article 304 used for the calculation of the Solvency Capital Requirement;

(iv) information allowing a proper understanding of the main differences between the underlying assumptions of the standard formula and those of any internal model used by the undertaking for the calculation of its Solvency Capital Requirement;

(v) the amount of any non-compliance with the Minimum Capital Requirement or any significant non-compliance with the Solvency Capital Requirement during the reporting period, even if subsequently resolved, with an explanation of its origin and consequences as well as any remedial measures taken.

2. The description referred to in point (e)(i) of paragraph 1 shall include an analysis of any significant changes as compared to the previous reporting period and an explanation of any major differences in relation to the value of such elements in financial statements, and a brief description of the capital transferability.

The disclosure of the Solvency Capital Requirement referred to in point (e)(ii) of paragraph 1 shall show separately the amount calculated in accordance with Chapter VI, Section 4, Subsections 2 and 3 and any capital add-on imposed in accordance with Article 37 or the impact of the specific parameters the insurance or reinsurance undertaking is required to use in accordance with Article 110, together with concise information on its justification by the supervisory authority concerned.

However, and without prejudice to any disclosure that is mandatory under any other legal or regulatory requirements, Member States may provide that, although the total Solvency Capital Requirement referred to in point (e)(ii) of paragraph 1 is disclosed, the capital add-on or the impact of the specific parameters the insurance or reinsurance undertaking is required to use in accordance with Article 110 need not be separately disclosed during a transitional period ending no later than 31 October 2017.

The disclosure of the Solvency Capital Requirement shall be accompanied, where applicable, by an indication that its final amount is still subject to supervisory assessment.

## Article 52

### **Information for and reports by CEIOPS**

1. Member States shall require the supervisory authorities to provide the following information to CEIOPS on an annual basis:

(a) the average capital add-on per undertaking and the distribution of capital add-ons imposed by the supervisory authority during the previous year, measured as a percentage of the Solvency Capital Requirement, shown separately as follows:

(i) for all insurance and reinsurance undertakings;

(ii) for life insurance undertakings;

(iii) for non-life insurance undertakings;

(iv) for insurance undertakings pursuing both life and non-life activities;

*(v) for reinsurance undertakings;*

*(b) for each of the disclosures set out in point (a), the proportion of capital add-ons imposed under points (a), (b) and (c) of Article 37(1) respectively.*

*2. CEIOPS shall publicly disclose, on an annual basis, the following information:*

*(a) for all Member States together, the total distribution of capital add-ons, measured as a percentage of the Solvency Capital Requirement, for each of the following:*

*(i) all insurance and reinsurance undertakings;*

*(ii) life insurance undertakings;*

*(iii) non-life insurance undertakings;*

*(iv) insurance undertakings pursuing both life and non-life activities;*

*(v) reinsurance undertakings;*

*(b) for each Member State separately, the distribution of capital add-ons, measured as a percentage of the Solvency Capital Requirement, covering all insurance and reinsurance undertakings in that Member State;*

*(c) for each of the disclosures referred to in points (a) and (b), the proportion of capital add-ons imposed under points (a), (b) and (c) of Article 37(1) respectively.*

*3. CEIOPS shall provide the information referred to in paragraph 2 to the European Parliament, the Council and the Commission, together with a report outlining the degree of supervisory convergence in the use of capital add-ons between supervisory authorities in the different Member States.*

## **Article 53**

### **Report on solvency and financial condition: applicable principles**

*1. Supervisory authorities shall permit insurance and reinsurance undertakings not to disclose information where:*

*(a) by disclosing such information, the competitors of the undertaking would gain significant undue advantage;*

*(b) there are obligations to policy holders or other counterparty relationships binding an undertaking to secrecy or confidentiality.*

*2. Where non-disclosure of information is permitted by the supervisory authority, undertakings shall make a statement to this effect in their report on solvency and financial condition and shall state the reasons.*

*3. Supervisory authorities shall permit insurance and reinsurance undertakings, to make use of – or refer to – public disclosures made under other legal or regulatory requirements, to the extent that those disclosures are equivalent to the information required under Article 51 in both their nature and scope.*

4. Paragraphs 1 and 2 shall not apply to the information referred to in Article 51(1)(e).

#### Article 54

##### **Report on solvency and financial condition: updates and additional voluntary information**

1. In the event of any major development affecting significantly the relevance of the information disclosed in accordance with Articles 51 and 53, insurance and reinsurance undertakings shall disclose appropriate information on the nature and effects of that major development.

For the purposes of the first subparagraph, at least the following shall be regarded as major developments:

(a) non-compliance with the Minimum Capital Requirement is observed and the supervisory authorities either consider that the undertaking will not be able to submit a realistic short-term finance scheme or do not obtain such a scheme within one month of the date when non-compliance was observed;

(b) significant non-compliance with the Solvency Capital Requirement is observed and the supervisory authorities do not obtain a realistic recovery plan within two months of the date when non-compliance was observed.

In regard to point (a) of the second subparagraph, the supervisory authorities shall require the undertaking concerned to disclose immediately the amount of non-compliance, together with an explanation of its origin and consequences, including any remedial measure taken. Where, in spite of a short-term finance scheme initially considered to be realistic, non-compliance with the Minimum Capital Requirement has not been resolved three months after its observation, it shall be disclosed at the end of that period, together with an explanation of its origin and consequences, including any remedial measures taken as well as any further remedial measures planned.

In regard to point (b) of the second subparagraph, the supervisory authorities shall require the undertaking concerned to disclose immediately the amount of non-compliance, together with an explanation of its origin and consequences, including any remedial measure taken. Where, in spite of the recovery plan initially considered to be realistic, a significant non-compliance with the Solvency Capital Requirement has not been resolved six months after its observation, it shall be disclosed at the end of that period, together with an explanation of its origin and consequences, including any remedial measures taken as well as any further remedial measures planned.

2. Insurance and reinsurance undertakings may disclose, on a voluntary basis, any information or explanation related to their solvency and financial condition which is not already required to be disclosed in accordance with Articles 51 and 53 and paragraph 1 of this Article.

#### Article 55

##### **Report on solvency and financial condition: policy and approval**

*1. Member States shall require insurance and reinsurance undertakings to have appropriate systems and structures in place to fulfil the requirements laid down in Articles 51 and 53 and Article 54(1), as well as to have a written policy ensuring the ongoing appropriateness of any information disclosed in accordance with Articles 51, 53 and 54.*

*2 The solvency and financial condition report shall be subject to approval by the administrative, management or supervisory body of the insurance or reinsurance undertaking and be published only after that approval.*

#### **Article 56**

#### **Solvency and financial condition report: implementing measures**

*The Commission shall adopt implementing measures further specifying the information which must be disclosed and the means by which this is to be achieved.*

*Those measures, designed to amend non-essential elements of this Directive by supplementing it, shall be adopted in accordance with the regulatory procedure with scrutiny referred to in Article 301(3).*

#### **EIOPA view**

29.3.69. In the solvency II framework, the disclosure to the public of financial and solvency conditions of insurance companies is a substantial element of the solvency regime (the so-called "third pillar"). The disclosure allows the market to assess the stability and the creditworthiness of a company, and to value the securities it issues (bonds, common stock). The market assessment works as a strong incentive for companies to keep healthy solvency conditions, reinforcing the discipline imposed by capital requirements (first pillar) and risk management and supervisory assessment (second pillar).

29.3.70. For pension funds, this mechanism is not going to work essentially because they do not issue securities, so there is no direct way in which the market may signal its assessment of a pension fund (a negative view could not be reflected in the price of any security). Therefore, markets, or the public at large, are not going to induce discipline. This makes disclosure to the public less important than for insurance companies, because for the latter having healthy solvency conditions means having better conditions when issuing securities.

29.3.71. This should not restrict employers' ability to learn appropriate information on the solvency conditions of IORPS in the case they may consider (or are called) to act as sponsors.

29.3.72. Moreover according to recital 38 of the Solvency II directive one reason for the disclosure rules in Art. 51 – 56 of the Solvency II directive is to guarantee transparency.

29.3.73. A high level of transparency regarding general solvency conditions might be needed if the consumer can choose between several products in order to find the one that fits his needs best. However, IORPs do not offer services to the public like insurance companies do. Often IORPs are connected with one

sponsoring undertaking and there is no choice for the employee to choose between several IORPs. Mostly, employees are automatically enrolled in the IORP when they sign their labour contract. As the membership with an IORP is connected with employment, a termination only of the IORP contract is often not possible nor a change to another IORP. For these reasons the competition between IORPs and insurance companies differs. Therefore the need for public disclosure regarding solvency conditions significantly differs between an IORP and an insurance company. There is no need to disclose a report on solvency and financial condition to the public, but it is more fruitful to disclose certain information about the solvency or financial condition of the IORPs to (future) members in the pre-enrolment phase and also as ongoing information.

- 29.3.74. It must also be borne in mind that the existing IORP directive already contains disclosure rules for members and beneficiaries regarding solvency conditions e.g. in Art. 9 and 11. These provisions contain largely the same information as the information required in Art. 51 of the Solvency II directive. For example the information required in Art. 51 (1) a) is already part of Art. 9 (1) c), f) of the IORP directive. The requirements of Art. 51 (1) b) - e) will probably become part of the annual report that has to be sent to the members and beneficiaries on request (Art. 11 (2) a)). So the members and beneficiaries can get the same information as required under Solvency II for the public. This information is also provided on a continuous basis.
- 29.3.75. Parts of the information in Art. 51 of the Solvency II directive are already part of the statement of investment policy principles (Art. 12 of the IORP directive) e.g. the information on assets. There would be no further advantage in duplicating this information.
- 29.3.76. Therefore EIOPA is of the opinion that the current directive and the information in the pre-enrolment phase and the ongoing information as discussed above are sufficient to fulfil members' needs as regards information.
- 29.2.1. What is more a solvency report is very complex. Hence, this report would not contribute to a better understanding for members of the functioning and the financial solidity of the IORP. The report does not only consist of one figure that makes a statement on the solvency of the IORP; rather, a lot of information has to be combined.
- 29.3.77. Moreover, the full solvency report is linked to the holistic balance sheet of the IORP which includes security and adjustment mechanisms (such as sponsor support) in the balance sheet and the calculation/coverage of the solvency requirements. Therefore it might also contain information on the financial situation of the sponsor. It would cause problems with regard to data protection laws if confidential financial information about the sponsor can be found in a public report.
- 29.3.78. For all these reasons, EIOPA believes that it is not appropriate to extend Articles 51-56 of Directive 2009/138/EC to IORPs. Still, EIOPA believes that it is important for members to have key information and a basic understanding of the financial solidity of the IORP. Therefore a slight redrafting of article 11.4.d would be useful. It should refer to the need for members to receive yearly information on the financial solidity of the IORP.

## **Specific sub-CfA 23.4**

### **Specific Call for Advice**

- Other requirements for IORPs, if any: e.g. specific reporting requirements for DB, DC and hybrid schemes.

29.3.79. Some specific requirements are incorporated in the discussion on CfA 23.1, 23.2 and 23.3. In addition, EIOPA wants to emphasise the following item.

#### **Encourage digital information provision**

29.3.80. Another general criterion that should be introduced as a trend to be encouraged is providing information also through digital means (this is also mentioned in the context of the Green Paper on pensions). The revised Directive should bring the potential of digital information disclosure to the foreground. IORP websites could become a widespread way to make available all the information documents duly updated, together with calculation tools that would help people to discover what pension outcomes they can expect at what age, what are the risks involved, and what would be the benefits of working and saving longer. Digital information would also help prevent members from being overloaded with information – they should receive the essential information and new opportunities of digital information provide easy access to more detailed information.

29.3.81. It should be left to Member States to decide if information is provided to members and beneficiaries in paper form or digitally. Member states can leave the decision to the IORP. In any case, members should keep the right to receive documents on paper at their request; in respect of small schemes, according to the principle of proportionality, paper delivery and the use of emails should still be permitted as valid alternatives to websites and company intranet.

## **29.4. Impact assessment**

29.4.1. Compared with the current position, the EIOPA advice on information requirements would have a substantial impact only for DC schemes, where members bear the investment risk and are asked to make choices. For DB funds, the impact would be in principle minimal, as no compulsory additional requirement would be introduced.

29.4.2. However, also for DC schemes, the requirements that would be introduced are already part of the national regulation in many member states and/or good practices that many DC IORPs follow anyway. The introduction of a EU requirement would indeed imply additional compliance costs for IORPs and additional supervisory costs for supervisory authorities; however, these costs are considered clearly less significant than the benefits in terms of protection of members. In addition, the functioning of the market for pension provision would benefit from enhanced comparability and competition.

- 29.4.3. The need for additional protection for members of DC pension schemes through increased information has been made all the more clear since the financial crisis in 2008. In a situation where members are exposed to substantial investment risks, it is clear that they deserve increased protection at least in terms of information and help in taking informed decisions.
- 29.4.4. However, in the advice care has been used in order to recognise pension specificities and avoid recommending that information be supplied in the same way as for pure investment instruments. In particular, the longer-term view of pension funds and the links with first pillar pensions should be recognised appropriately. This may lead to some additional costs in terms of defining the regulation both as regards the EU level 2 measures and at the level of individual member states.

## 29.5. EIOPA advice

Information requirements to the members and beneficiaries to be included in the revised IORP Directive should build on the text of the current IORP Directive with modifications inspired by the following principles:

1. Information should be provided to members/beneficiaries in all phases of their participation in the pension scheme, proportionally to the choices to be made.
2. Information should be 1) correct, 2) understandable and 3) not misleading. 'Correct' implies that the information provided should be regularly updated, in particular after substantial changes to the scheme. 'Understandable' implies that all information documents are written in a way and have been given a lay-out that have proved to be clear and understandable and hence useful for people. 'Not misleading' implies that members should not receive information which gives them an unjust impression of the functioning of the pension scheme.
3. Information overload should be avoided. Information to be mandatorily delivered to members should be concise and kept as simple and straightforward as possible; relevant additional information should be easily available to members, beneficiaries and stakeholders;
4. Information to members and beneficiaries has to make clear the risks to which they are exposed. EIOPA recognizes the wide diversity of ways across Europe in which risk is allocated between members/beneficiaries, the IORP, the employer(s) and possibly other entities. Nevertheless, EIOPA believes that the DB/DC distinction is still useful on practical grounds. In particular, with respect to the requirements of the current IORP directive, information has to be improved in the case of DC schemes where members bear the investment risk and are asked or have the right to make choices at individual level.
5. In the case of DB schemes, the contents of information requirements under the current Directive are still appropriate. Anyway, it should be made clear that any adjustment benefit mechanisms (see response to CfA 5 and 6) should be part of the description of the risk-sharing mechanisms in place (a description that is already part of the mandatory information requirements).

6. The potential of digital devices in delivering and making available information efficiently and effectively should be duly taken into account.

The following EIOPA advice refers to specific sub-items.

*23.1 The extent to which the KII Document can be used for IORPs as regard pre-contractual information disclosure. This includes advice on the material elements of Articles 78-82 of Directive 2009/65/EC that should be amended or removed to adequately address the specificities of IORPs with a view to replacing Article 9c and 9f of Directive 2003/41/EC*

Regarding CfA 23.1, EIOPA has the view that the introduction of the requirement of a pre-enrolment information document similar to the KIID is useful for DC schemes where members bear the investment risk and are asked to make choices at individual level.

The contents of a KIID-like document cannot be presented in accordance with the exact provisions of the UCITs Directive and its implementation measures; rather, they should be made relevant to pension schemes and should extend to aspects beyond investment (that may lead to a name such as KID, or Key Information Document).

In particular, such a KID could contain the following elements, that, where relevant, should be provided for the relevant investment options that are offered:

1. the identification of the IORP;
2. a brief description of the objectives and investment policies;
3. information on performance (either in terms of past performance and/or of performance scenarios);
4. costs/charges;
5. a risk/reward profile and/or the time horizon adopted for the investment policy (see explanatory text);
6. contribution arrangements and in particular contribution commitments of the employer and the employee as a percentage of the salary;
7. practical information, allowing Member States to add country-specific information;
8. cross-references to the relevant other documents that are also available to members.

EIOPA believes that certain technical aspects of the way to convey this information are better dealt with by implementation measures at EU level, as provided for in the UCITS Directive; anyway, room should be left to country-specific information (see below comment on art. 20.7 of current IORP directive).

It should be made clear that, at least in general, the KID is only an information document and not a source of legal commitments with respect to members. The documents that are the legal source of commitments should be clearly identified and made available. The regulation should also make clear the different function of the KID and the SIPP (Statement of Investment Policy Principles) as set out by art.12 of the current IORP Directive, with the latter being primarily an internal governance document and not a document to inform members (see also comments with respect to CfA 7 (Investment) and CfA15 (Risk management)).

A pre-enrolment document, but with a different lay-out than the KID, could be useful also for DB pension schemes. For this document, the contents specified in articles 9

and 11 of the current IORP Directive could be appropriate. Yet, it needs to be written concisely and needs to be understandable for members. Member States should be asked to consider such a document as an option and should be allowed to set more detailed rules.

*23.2 The content, format and timing of ongoing information disclosures to strengthen and make more consistent the current provisions of Article 11a and 11c. This should also include advice on the possibility to delete Article 20(7) of Directive 2003/41/EC.*

Ongoing information requirements should provide for a personalised annual statement to be delivered to each member. In the case of DC schemes, the annual statement should include the individual member's accrued balance and a summary of inflows and outflows, with particular reference to employer's and employee's contributions; the statement may also include additional information, such as the charges actually levied and the performance in that particular year. The details of the contents need implementation measures. Anyway, room should be left to country-specific information.

When the employers or the IORP bears the investment risk, a simplified information notice with brief particulars of the situation of the institution, the individual member's accrued entitlements and their level of financing (as of art. 11.4.d of the current IORP directive) would suffice.

Information requirements for DC schemes should also include the possibility for individual members to obtain (e.g. through electronic devices) personalized pension projections, based on the accumulated individual position, the flow of contributions and a set of macroeconomic assumptions in order to estimate future returns; the assumptions to be used may require implementation measures; anyway, room should be left to country specificities.

Article 20.7 and host country competence should be maintained, as information requirements are contiguous to SLL and maximum harmonization would likely result in lower disclosure standards in many countries; however, certain aspects of information requirements for DC schemes, consistently with the discussion made above, can be harmonized, still leaving the option to host member states to introduce additional information requirements. Therefore, EIOPA recommends for the time being minimum harmonization of content but no required common format at EU level for the pre-enrolment document and the annual statement. For DC schemes EIOPA will explore best practices in respect of the format of these documents with a view to possible future minimum harmonisation.

*23.3. The extent to which Articles 51-56 of Directive 2009/138/EC can be used for IORPs as regards public disclosure through the report on solvency and financial condition.*

EIOPA believes that it is not appropriate to use Articles 51-56 of Directive 2009/138/EC for IORPs as regards public disclosure through the report on solvency and financial condition. However, Article 11.4.d) should be modified. It should refer to the need for members to receive yearly information on the financial solidity of the IORP.

*23.4. Other requirements for IORPs, if any: e.g. specific reporting requirements for DB, DC and hybrid schemes.*

The revised Directive should bring the potential of digital information disclosure to the foreground. IORP websites could become a way to make available all the information documents duly updated, together with calculation tools that would help people to better understand what pension outcomes they can reasonably expect at what age, what are the risks involved, and what would be the benefits of working and saving longer. EIOPA recommends that the question of whether to provide information digitally should be for the member states to decide. IORP members should keep the right to receive documents on paper.