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Executive summary

In March 2014, the European Commission (EC) published a proposed Directive on “the activities and supervision of institutions for occupational retirement provision (IORPs)” – in other words, IORP II. The Italian presidency of the European Union (EU) (which started on 1 July 2014) will have the revision of this Directive as an important item of its legislative agenda, so it seems appropriate to consider the proposal and next steps.

The proposed Directive, which is an overhaul of the existing 2003 Directive, has a number of important features, which are summarised here.

- **Cross-border transfers**: These will be simplified, with only the country receiving the pension scheme having to give permission for any transfer to take place. This could lead to regulatory arbitrage – in other words, employers may move their pension schemes to countries with preferable regulatory regimes; however, a requirement that any transferring liabilities are fully funded remains.

- **Capital requirements**: The proposed Directive does not seek to add any capital requirements to pension schemes, although it does seek to add a timescale of four years for the review of this stance. As such, it is important that views on this issue continue to be communicated to both the EC and the European Parliament.

- **Governance**: A number of obligations are added, and whilst most are sensible, they could be onerous for smaller schemes. This could encourage scheme mergers.

- **Communications**: Significantly greater communication requirements are proposed, particularly for members of defined contribution (DC) pension schemes. There are good suggestions here, but there is a risk that the volume of information will be too great to make an impact.

- **Long-term investment**: This is heralded as one of the key drivers for this legislation; however, only a passing reference, requiring countries to allow pension scheme investment in long-term illiquid assets, is made.
Introduction

On 1 July 2014, Italy took over the presidency of the Council of the EU. Its six-month tenure marks the start of a new 18-month presidency trio. On the trio’s agenda is likely to be the long-discussed revisions to the IORP Directive, known as IORP II. The discussions around IORP II began in 2011, when the EC issued a call for advice\(^1\) on potential changes to the 2003 Pensions Directive. At an early stage, the proposed Directive was referred to as “Solvency II for Pensions”, reflecting its similarity to the insurance Directive of the same name. Solvency II divides the supervisory process into three “pillars”, as summarised in Exhibit 1.

Of these three pillars, the application of the first pillar to pension schemes caused the most concern. There was a real risk that excessively market-based solvency requirements could force higher levels of funding than should realistically be necessary. That risk seems to have been avoided—for now at least—but the obligations that the new Directive would impose are not trivial. Furthermore, the proposed Directive contains a revision clause that would ensure that the quantitative requirements could not be revisited until four years after this Directive had itself been implemented. However, whilst this would remove the immediate risk of new capital requirements for pension schemes, it would still leave the door open for a subsequent move in this direction - the arguments are not yet over.

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The proposed Directive

The Directive is presented as a marked-up version of the 2003 Directive. As such, it is easy to see which parts of the proposed Directive are new. One bigger change is the division of the document into six main sections or Titles:

- General provisions
- Quantitative requirements
- Conditions governing activities
- Information to be given to prospective members, members and beneficiaries
- Prudential supervision
- Final provisions

General and final provisions

The main changes to these sections cover cross-border transfers of pensions. They essentially provide for pensions to be transferred to and regulated by another country in the EU. Indeed, it requires member states to allow such transfers, with only the regulator in the receiving country having to give approval. The only other requirement is that the scheme members concerned must also consent to such a transfer.

This is important as it allows for regulatory arbitrage. An employer that feels that its domestic pension regulations are too onerous could transfer the assets and liabilities of its pension scheme to a country where the rules were more accommodating. In principle, the members could object to such a transfer, and if most of the members were former rather than current employees then such an objection could well be raised. However, current employees might be prepared to forgo some of the guarantees on their pensions if this were to allow them to continue earning benefits – in other words, an employer could make future defined benefit (DB) pension provision contingent on the transfer of the scheme to another regulatory environment. This is an important development, and if it improves the chances that DB pension schemes will continue, we believe it is desirable.

There is, though, an important point to note that relates to a part of the proposed Directive that remains unchanged. This requires any liabilities that are transferred to another country to be fully funded. In other words, if liabilities were to be transferred overseas, there would need to be at least the same value of assets going with them. This could discourage the transfer of accrued benefits, as it could mean additional contributions being needed.

However, the funding of future benefits would not be subject to any requirements other than the funding regime of the country in which the scheme was based. As such, cross-border pensions are likely to be more attractive for future accrual, at least in terms of regulatory arbitrage.

Quantitative requirements

The question of more and less onerous regimes could have been ignored completely if the draft Directive had taken its original course, and standardised quantitative requirements. However, this has not happened, as can be seen in the virtually unchanged section on this topic. In fact, rather than adding text here, some provisions have been removed – most notably, a paragraph which concerned the potential further harmonisation of rules regarding the calculation of pension liabilities. For the time being, then, the concept of Solvency II for Pensions has been put to rest.
However, some see this as a postponement rather than a definitive rejection, not least because there is a provision later in the draft for this aspect of the Directive to be reviewed in four years’ time. There is always the chance that this part of the proposal will not make its way into the final legislation, but it should not be assumed that Solvency II for Pensions is dead, particularly as the European Insurance and Occupational Pensions Authority (EIOPA) is continuing its work on the “Holistic Balance Sheet” (HBS).

One of the few additions in the section on Quantitative Requirements is a paragraph that requires Member States to allow pension schemes to invest in long-term illiquid assets. Despite the presentation of this Directive as something which will promote long term investment, these few lines appear to be the only part of the document promoting such a strategy. As such, these sentiments appear to be largely political. If there had been a genuine desire to promote investment in illiquid assets, then the proposed Directive might have included a requirement for national regulators to allow for an illiquidity premium in discount rates. Beyond this, EIOPA could be exploring cash flow based valuation approaches that reflect the income characteristics of illiquid assets in a way that the HBS cannot.

### Conditions governing activities

This is an entirely new section that covers governance, outsourcing, and depositaries.

#### Governance

Many of the requirements around governance seem sensible, even to the extent that some pension schemes might notice little change. For example, schemes would be required to have written policies in relation to risk management, internal audit, actuaries and outsourcing, these policies being reviewable annually. An effective internal controls system is also required. There are also requirements around remuneration policies, and a proposal that those who “run” an institution or have a key function should be “fit and proper” - that is, they should be sufficiently qualified or experienced and of good repute. It is not clear who this requirement would cover and how onerous it would be. The risk management, internal audit and actuarial functions will certainly be covered, but in the UK it could also encompass pension scheme trustees. How many trustees could pass these new requirements? And how many would want to subject themselves to such scrutiny? Furthermore, could the regulator cope with the huge number of applications that this would generate if formal approval were required? The practicalities of this proposal should not be underestimated.

It is also important to recognise that in the world of DC, additional obligations on trustees could further encourage employers to pursue contract- rather than trust-based pension solutions, thus limiting the degree to which they can follow a paternalistic approach to retirement. However, it is difficult to argue against a system that ensures that the pension schemes are run by the right people.

Also in this section is the requirement for each pension scheme to have an effective risk management system, and to have risk management, internal audit and actuarial functions. In practice, these functions should exist already, particularly as the risk management and actuarial functions can be combined and outsourced.

However, there is a potential complication for any scheme that currently uses the internal audit functions of its sponsor. The proposed Directive specifically prohibits a person or operational unit from carrying out one of these three key functions for both the pension scheme and the sponsor. As such, any scheme that had contracted with its sponsor’s internal audit function to cover this role would need to make other arrangements.

In addition, there is a proposed requirement for a document entitled “risk evaluation for pensions”. This covers a number of key areas for pension schemes, ranging from the effectiveness of the risk management system to the quality of sponsor support. Practically all of the questions proposed are questions that pension schemes should already be asking themselves, and formalising the answers in a document makes eminent sense.

#### Outsourcing

The text around outsourcing essentially says that outsourcing a function does not mean that the responsibility has been outsourced. Again, this should not be contentious. However, it is important that these proposals are not implemented in such a way as to make outsourcing impractical. Many schemes, large and small, rely on external providers for a range of services - there should be no excessive bureaucracy introduced to these relationships. It is also important that non-essential outsourcing is not caught up in this bureaucracy - as it is worded, there is a risk that the proposed Directive would require schemes to obtain written agreements for all outsourcing arrangements, even down to travel and catering.
Depositaries
Finally in this section, there is the requirement for each DC scheme to appoint a depositary, a requirement that individual countries might extend to DB arrangements. This text is adapted from the previous Directive which refers instead to custodians. However, the text of this section is hugely expanded, placing a range of new obligations on these institutions, not least in relation to oversight duties.

Information for prospective members, members and beneficiaries
The bulk of this section covers the Pension Benefit Statement (PBS), a new feature in this proposed Directive. This could be regarded as the third pillar of pension regulation (disclosure). However, as we argued in our 2012 paper, the third pillar is less relevant for pension schemes than for insurers (under Solvency II) or banks (under the Basel accords). The reason for this is that under Solvency II and Basel II, disclosure is intended to encourage good risk management, acting to reinforce the impact of capital requirements and governance. It is intended to do this because the disclosures relate to the extent to which risk is well managed, allowing providers of capital to adjust the cost of capital accordingly. As such, there is an incentive to manage risk better if disclosing this fact will reduce a firm’s funding costs.

For a pension scheme, this argument does not hold true. Disclosures relating to members’ benefits will do little to improve risk management. However, stronger requirements around disclosure can be desirable from a consumer perspective, and there is much to admire in this part of the proposed Directive. The key requirements are summarised below:

• **Cost**: A key characteristic of the PBS is that it should be free of charge. It is clear why this is the case – if members had to pay for statements, they might be less likely to request them. However, it is important to recognise that even if such statements were free of charge, they would not be costless to produce. To put it another way, if members are not paying for these statements explicitly, it is important to understand where they are allowed for in the fees being charged.

• **Standalone nature**: Another requirement is that the PBS should be comprehensible without reference to other documents. This is a sensible precaution to ensure that a short statement is not short because it can only be deciphered with the help of another larger document; and comprehensibility is a virtue in itself.

• **Length**: The PBS should also be no longer than two pages of A4 paper, using a readable font size. Whilst “readable” is a subjective term, the point about font size is clearly designed to avoid small print. However, without small print it could be challenging to fit the information required into the space available.

• **Content**: Apart from personal details, and information about the scheme itself, text is required on guarantees, contributions and costs incurred – although if these costs include those borne by the sponsoring employer, it is unclear how useful the information will be to the member.

• **Pension projections**: Information is also required on pension projections. The pension projection for a DC scheme would require the expected fund value not only at the expected date of retirement, but also at both two years before and two years after this time. Furthermore, these amounts would need to be expressed as an amount of benefit per month. This information is, in fact, very useful – even if it is not clear how it would be calculated in an objective manner. To encourage members of DC schemes to focus on the income they might receive rather than the value of their fund means that the information they receive will be relevant; to also show the impact of retiring early or late makes this information even more powerful.

• **Other investment information**: This detail must also share space with a raft of information on investments, including risk/return charts for the various investment options, information on past performance, and descriptions of up to five different choices.

As well as the challenge of fitting the information onto two pages, the administrative challenge of producing this information must also be recognised. It has already been mentioned that the PBS would be provided free of charge. If the cost of producing it is significant, this must be borne by one of the parties. As such, it could also pose a challenge for UK DC schemes in the context of the charge cap.

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The section on disclosure also considers information to be given to members in the run up to retirement, as well as in the pay-out phase. This could be particularly relevant in the UK, where the obligation to buy an annuity at retirement has just been abolished. In particular, the proposed Directive requires that members are given information about the advantages and disadvantages of the various options “in a way which supports them in choosing the option most appropriate to their circumstances”. Whilst this could be thought of as being similar to the free at-retirement guidance promised by the UK government, the proposed Directive appears to go further. How much support is envisaged? And to what extent will this support need to allow for all aspects of an individual’s circumstances? In the extreme, this could even act as a deterrent to providing workplace pensions, in those countries where this is an option.

Prudential supervision

The section on prudential supervision covers the way in which regulators should supervise pension schemes. Whilst the supervisory process is discussed, much of the text is around secrecy and the exchange of information between pension schemes, regulators, central banks and governments. The main purpose seems to be to allow the transfer of information, despite any professional requirements for confidentiality, to ensure that firms are properly regulated.
What next?

Greece held the six-month rotating presidency of the EU up until the end of June 2014, and it had already proposed a number of changes to the draft Directive. Most of these were minor or technical. The Greek presidency has also produced a draft example PBS, showing how such a document might look. Whilst it could be argued that the hypothetical scheme underlying this document is unduly simplistic, it is at least a starting point.

During its presidency, Italy will be responsible for brokering a compromise on this proposed Directive between the 28 member states of the Council of the EU (as well as on other EU legislative proposals). The discussions between member states are only one side of the equation. Whatever text is agreed between EU countries must be reconciled with the position adopted by the European Parliament.

Due to recent elections, the European Parliament has not commenced work on IORP and we do not expect this to begin until September or October. The Parliament’s Economic & Monetary Affairs (ECON) Committee will lead work on IORP. First a lead member of the ECON Committee or rapporteur must be appointed by the European Parliament, to marshal the progress of this legislation. The rapporteur will debate the rules with members of other political parties before agreeing a final compromise.

When both Council and Parliament have agreed their respective positions, the three institutions, the Council (represented by the presidency), the Parliament and the European Commission convene in a series of meetings called ‘Trialogues’ to agree on a final compromise text. It is also worth noting that Jean-Claude Juncker takes over the presidency of the European Commission in November of this year, and the person he chooses to head the Directorate-General for Internal Market and Services – in other words, to replace Commissioner Michel Barnier - will also have an impact on the direction this Directive takes.
Conclusion

The proposed IORP Directive avoids imposing additional capital requirements on pension schemes - for now. However, it does put forward a number of proposed changes, which could cause significant additional work for pension schemes. Many of these changes are sensible, but there is still much to discuss on IORP II.
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