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DRAFT CONSULTATIVE DOCUMENT

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

1. INTRODUCTION

The pension system in most EU Member States rests largely on three pillars: the state, occupational and personal pillars. The occupational pension pillar relies on the contributions made by employers towards future pension entitlements of their employees. Occupational pension schemes are a form of deferred compensation for labour supplied today. There are a wide variety of methods in EU Member States to finance these schemes. The employer could, for example, choose to set up and make contributions to a pension fund, which is a financial institution in the sense that it bears the risk relating to the commitments made to pension beneficiaries. Alternatively, in a number of Member States occupational pensions are organised on a pay-as-you-go basis, which do not hold assets to meet future liabilities and which therefore are reliant upon benign demographic trends remaining in place. In other Member States occupational pension arrangements require the employer to set aside assets towards future pension liabilities and to absorb risks relating to the pension commitments.

In the EU, occupational pension funds are regulated by the IORP Directive adopted in 2003.¹ This Directive aims at *inter alia* introducing a qualitative approach to investment management, ensure a level playing field between service providers that operate on the market for occupational pensions, facilitating cross-border business of IORPs and achieve a certain level of prudential harmonisation with respect to cross-border activities.² Moreover, the IORP Directive respects that, in accordance with the principle of subsidiarity, 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.

The prudential rules in the IORP Directive "are intended both to guarantee a high degree of security for future pensioners [...], and to clear the way for the efficient management of occupational pension schemes" (see recital 7). As part of the overall supervisory framework, the IORP Directive contains rules for calculating technical provisions, including a margin for adverse deviation (Article 15), the funding of these technical provisions (Article 16) and regulatory own funds (Article 17).

The IORP Directive has been implemented by all Member States only last year and time is still needed for its full effects to unfold. Meanwhile, three important developments that relate to the solvency rules for IORPs have taken place over recent years.

First, there is an emerging best practice at international level towards more risk-sensitive and more transparent prudential supervision of occupational pension funds. For example, the OECD has recently issued "guidelines on funding and benefit security in occupational pension plans".

¹ Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision.

² Explanatory Memorandum to the Commission's Proposal for a Directive of the European Parliament and Council on the activities of institutions for occupational retirement provision [COM(2000) 507 final.]

Second, these international developments build to some extent on a similar development that originated in other financial sectors. In particular, the solvency rules for insurance undertakings are currently being overhauled by the Solvency II Directive proposal of 10 July 2007. This is of relevance for the IORP Directive only in those cases where the IORP itself, and not the sponsoring undertaking, underwrites the liability to cover against biometric risks, or guarantees a given investment performance or a given level of benefits. In those cases, as specified in Article 17, the IORP is required to hold on a permanent basis additional assets above the technical provisions to serve as a buffer. This is because IORPs subject to Article 17 are financial institutions in the sense that they bear the risk of the commitments made to pension beneficiaries and as a result are potentially comparable to an insurance undertaking. Accordingly, Article 17 of the IORP Directive states that for IORPs to which this article applies, the rules to calculate the amount of regulatory own funds are linked to the solvency rules prevailing at present for life assurance undertakings, as specified in the consolidated life assurance Directive (i.e. Solvency I)³.

During the preparation of the Solvency II proposal, it was decided to “carve out” IORPs from the scope of Solvency II because of a lack of solid evidence about the potential implications that these new solvency rules could have on IORPs subject to Article 17. Moreover, because of differences between IORPs subject to Article 17 and insurance undertakings, further work was required to determine whether or not the new solvency regime developed for insurance undertakings would be suitable for IORPs subject to Article 17.

Third, from a cross-border perspective, the IORP Directive "represents a first step on the way to an internal market for occupational retirement provision organised on a European scale" (recital 6) and it has achieved some progress through convergence of prudential regulation across the EU. In a few areas Member States are given the possibility, however, to go beyond the common provisions of the IORP Directive and, as a result, the prudential rules in the Member States continue to differ in part considerably. This raises potential concerns where cross-border activity is taking place.

Scope of the consultation

These three developments – risk-based supervision, Solvency II for life assurance undertakings and differences in national solvency rules for IORPs – are the main drivers determining the scope of this consultative document.

The focus of this consultation is on IORPs subject to Article 17 because they underwrite liabilities to cover against biometric risks, or provide guarantees of a given investment performance or a given level of benefits. As mentioned above, there is in these cases a direct connection with Solvency II because the own funds requirements for IORPs are linked to the prevailing life assurance undertakings (i.e. Solvency I). Therefore, for IORPs that underwrite liabilities / provide guarantees the question arises whether or not the current solvency rules should be amended in the light of Solvency II to maintain a level playing field with insurance undertakings

³ Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance.

and support fair competition in terms of capital requirements for retirement products that expose the financial institutions to similar risks.

Beyond IORPs subject to Article 17, the only other area within the scope of this consultation is IORPs that undertake cross-border activity. This is a crucial part of the consultation because of the need to ascertain whether different approaches to IORPs operating on a cross-border basis have given rise to regulatory arbitrage which can be shown to have harmed the interests of pension beneficiaries. Those IORPs which do not operate on a cross-border basis and where a sponsoring employer underwrites the liability / provides the guarantee fall outside the scope of this consultation. In accordance with the principle of subsidiarity recognised by the IORP Directive, Member States retain the right to organise their pension arrangement in this way.

Purpose of the consultation

The purpose of this broad consultation is to collect the views from all stakeholders concerned whether they believe that, from an internal market perspective, a further harmonisation of the solvency regime for IORPs covered by Article 17 of the IORP Directive and IORPs operating on a cross-border basis is desirable or not and what the reasons are for expressing that view. The consultation intends to review neither the scope of the IORP Directive as a whole⁴, nor the scope of Article 17 which determines that an IORP should only be required to hold regulatory own funds in cases where the IORP itself underwrites liabilities and/or guarantees a given investment performance or level of benefits.

The consultation aims to ensure that all parties concerned have a chance to voice their opinion. It is stressed that the Commission has no pre-conceived ideas on the way forward at this stage and there will be no automatic extension of the Solvency II Directive proposal to IORPs subject to Article 17. Suggestions for possible changes to the current EU solvency rules for IORPs subject to Article 17, if any, need to be based on a solid business case and a rigorous analysis of the costs and benefits of such changes, in line with the Commission's Better Regulation agenda. The Commission will be particularly concerned that a careful balance is struck between the protection of future pensioners and the cost of providing occupational retirement benefits to the sponsoring undertaking.

In order to map out the current situation across the EU, the Commission asked CEIOPS in mid-2007 to make an inventory of the methods for the calculation of pension liabilities (technical provisions), funding rules and other security mechanisms for IORPs existing in EU Member States today. The result of this work is contained in the attached CEIOPS survey on "fully funded, technical provisions and security mechanisms in the European occupational pension sector" published on

⁴ The scope of the IORP Directive is mentioned in Article 2. The Directive covers all IORPs, which operate on a funded basis and are outside the social security system. The few IORPs which operate on a pay-as-you go basis are not covered by the Directive. Moreover, firms which establish book-reserves in order to provide retirement benefits to their employees are also not covered by this Directive. In this latter case, as may have become the situation for certain IORPs, the risk of the sponsor's insolvency is covered by a guarantee fund, generally replacing any prudential rules.

7 April 2008.⁵ Accordingly, the questions posed in this consultation document were elaborated based on technical advice from CEIOPS.

Structure of this document

This document will first focus on the objectives of solvency rules for IORPs subject to Article 17 and on the experience with existing solvency regimes for these IORPs to date (section 2). The section will also outline a set of common principles for the prudential supervision of IORPs subject to Article 17 to explore the extent to which existing solvency regimes already meet these principles.

The next two sections address questions related to potential EU harmonisation in more detail first for IORPs subject to Article 17 and then on IORPs operating on a cross-border basis. Given that this consultation focuses on IORPs that underwrite liabilities / make guarantees, section 3 addresses regulatory own fund requirements and funding rules, in the light of Solvency II. The final section considers technical provisions and solvency rules for IORPs operating on in a cross-border basis to address explicitly the question of potential regulatory arbitrage (section 4).

Consultation Process

All interested parties – in particular representatives from the pension fund industry, other financial industries, employers, employees, beneficiaries, prudential supervisors and Member States - are invited to respond to the questions posed in this consultation document. In addressing these questions, it is important to be as specific as possible in identifying the nature and size of any costs and benefits (to pension scheme members, employers, providers of insurance products and/or shareholders) related to either making changes to the present EU solvency regime for pension funds, or leaving the rules unchanged.

An on-line electronic tool will be used to collect the responses. The comments received will be used in accordance with the privacy statement. The deadline for submitting responses is [**31 October 2008**]. Comments received after that deadline will be processed on a best effort basis.

Questions

Questions and comments regarding the consultation process should be addressed to:

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⁵ The CEIOPS survey is available from http://www.ceiops.eu/media/docman/public_files/publications/submissionstotheec/ReportonFundSecMech.pdf.

2. OBJECTIVES AND PRINCIPLES OF SOLVENCY RULES FOR IORPs SUBJECT TO ARTICLE 17 OF THE IORP DIRECTIVE

1. Solvency rules for IORPs subject to Article 17 should aim at guaranteeing a high degree of security for future pensioners, at a reasonable cost for the sponsoring undertakings, in the context of sustainable pension systems that are decided by the Member States.

Question What do you consider the overall objective of solvency rules for these IORPs ?

2. Beneficiaries and sponsors seek to secure pension rights that maintain standards of living after retirement. These rights are subject to risks related to future mortality rates, financial returns on assets, future inflation, future participation and contribution rates and to the solvency of IORPs subject to Article 17. The CEIOPS survey shows that there are wide differences between Member States in their approach to these and other risks.

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

Question b) What have been the main shortcomings of prevailing solvency rules for IORPs subject to Article 17, and what are the main challenges lying ahead?

Question c) Is there evidence at the supervisory or IORP level of how specific solvency regimes proactively deal with different risks and improve risk management techniques?

Question d) To what extent do mandatory versus voluntary arrangements have a different impact on the overall outcome of solvency rules and in which case(s) are problems likely to arise in the future?

Question e) To what extent does the existence of single-employer or multi-employer IORPs subject to Article 17 shape the solvency rules prevailing today in the different Member States?

3. The CEIOPS survey outlines four common overarching principles, as part of emerging best practices underpinning the supervisory framework which are relevant to this consultation on IORPs subject to Article 17. First, a forward-looking risk-based approach to pension supervision, that weighs the potential risks faced by an IORP, as well as risk mitigants, and tailors the scope and intensity of supervision to this appraisal. Second, the principle of market-consistency in the valuation of an IORP's assets and liabilities for supervisory purposes. Third, the principle of transparency, which 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 and adjustment instruments, are made explicit to the supervisor. Fourth, the principle of proportionality, implying that supervisory requirements are applied in a manner proportionate to the nature, complexity and scale of the IORP's inherent risks.

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

Question b) Are there any other overarching principles that you consider relevant?

Question c) Do you see a case for a different supervisory approach of IORPs subject to Article 17 depending on their size?

Question d) To what extent do you consider that the supervisory frameworks existing today already meet the common principles emerging out of international best practice?

3. REGULATORY OWN FUNDS AND FUNDING RULES FOR IORPs SUBJECT TO ARTICLE 17 OF THE IORP DIRECTIVE

4. In cases where the IORP 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, the IORP is required to hold additional assets in the form of regulatory own funds according to the rules currently prevailing for life assurance undertakings (Solvency I). As from 2012, it is expected that new solvency rules will apply to life insurance undertakings (Solvency II). This would mean that from a solvency perspective, different rules will apply to IORPs subject to Article 17 and life insurance undertakings offering similar products.

Question a) Do you anticipate competitive distortions emanating from the application of different solvency regimes between insurance companies and IORPs subject to Article 17 in a cross-border perspective? Please specify.

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

Question c) What would be the likely impact of applying Solvency II (or a similar solvency rules) to IORPs subject to Article 17? What would be the impact on the future provision of defined benefit schemes and the risk of closing down existing schemes? What would be costs and benefits of this? Please provide quantitative information, where available.

Question d) In case a Solvency II-type regime were to be applied to IORPs subject to Article 17, which elements would need to be adjusted to take account of the specificities of the institutional set-up in which that IORP

operates (e.g. recovery plans, additional contributions, flexibility of benefits, etc.)?

5. The IORP Directive requires IORPs subject to Article 17 to hold assets to fund their technical provisions at all times. In the event of underfunding, the IORP is required to establish a recovery plan.

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

4. TECHNICAL PROVISIONS AND SOLVENCY RULES IN THE CONTEXT OF CROSS BORDER ACTIVITY

6. The CEIOPS survey shows that, in practice, Member States use different methods and assumptions to determine their technical provisions. Current practices vary from applying best estimates to including extra safety margins in the underlying assumptions and incorporating prudence in different components of the technical provisions. Discount rates applied to the valuation of the technical provisions for example vary considerably. Moreover the treatment of mortality tables is rather diverse, as mortality rates, elements of prudence or incorporation of a trend component to reflect improvements in life expectancy are differently applied. This diversity can result in significant variations in the size of technical provisions across countries for comparable defined benefit commitments, and hence to differences in the level of liabilities to be funded.

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

Question b) Do you see any elements in Social and Labour Law (SLL) that have a bearing on prudential requirements? Should prudential requirements be considered separately from SLL?

7. The CEIOPS survey shows that in practice, Member States differ markedly in their approaches to inflation protection of the benefits promised. In some Member States they are conditional, in which case inflation risk is left with the beneficiaries, while in others they are unconditional.

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

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

8. The IORP Directive has created opportunities for the provision of cross-border pension services, as a first step towards an internal market for occupational pensions. Take-up so far has been rather slow, as full implementation of the Directive was achieved only in 2007. More time is therefore needed for the full effects of the Directive to unfold.

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

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

9. The IORP Directive lays down only minimal solvency requirements for IORPs. The CEIOPS survey suggests that material variations in regulatory requirements may spur regulatory arbitrage by IORPs operating on a cross-border basis and supervisory competition between Member States.

Question a) Is there any evidence of regulatory arbitrage by IORPs operating on a cross-border basis and/or supervisory competition between Member States? If so, please give examples. Do you expect this to occur in the future, and what evidence do you have to support your belief?

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

Question c) Do you feel that the present EU solvency rules for IORPs operating on a cross-border basis are sufficiently risk-oriented?

Question d) Do you think the quality of the governance should have implications for the solvency requirements?

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

10. The CEIOPS survey shows that the existing solvency regimes for IORPs operating on the cross-border basis are very diverse. This is reflected in different valuation methods for technical provisions and in the variety of security mechanisms. But, this does not necessarily imply substantially different security levels provided to beneficiaries between Member States. In practice, the different security mechanisms are linked to one another and may operate simultaneously. By implication, as different approaches can be used to secure pension benefits, national pension supervision frameworks do not

necessarily have to be identical. In practice, there may be several degrees of harmonisation, or harmonisation only of some elements.

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

Question b) Is there scope to separate out different types of IORPs operating on a cross-border basis in this harmonisation? Please explain that view.

Question c) Do you see any problems relating to a harmonised approach and would this be in the interests of the beneficiaries or sponsors?

Question d) Do you think that in some parts or elements of the solvency framework there is scope for harmonisation? If so, for which parts or elements?

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