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**CALL FOR ADVICE FROM THE EUROPEAN INSURANCE AND
OCCUPATIONAL PENSIONS AUTHORITY (EIOPA) FOR THE
REVIEW OF DIRECTIVE 2003/41/EC (IORP II)**

TABLE OF CONTENTS

1. INTRODUCTION.....	3
2. SCOPE OF THE IORP DIRECTIVE.....	5
3. FACILITATING CROSS-BORDER ACTIVITY	5
4. INTRODUCING RISK-BASED SUPERVISION FOR IORPS.....	6
5. SPECIFIC FEATURES FOR DC SCHEMES	9
6. QUANTITATIVE IMPACT STUDY AND DATA RELATED ISSUES.....	10
7. FURTHER GUIDANCE ON THE REPORTING MODALITIES AND DEADLINES.....	11

ANNEX

1. INTRODUCTION

- 1.1. Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (IORP Directive) has been adopted in 2003. The aim of the directive is to create an internal market for occupational retirement provision organised on a European scale. The directive enables an employer in one Member State to sponsor an IORP located in another Member State or, conversely, it enables an IORP located in one Member State to be sponsored by one or more employers in different Member States. The opening up of the borders has to be accompanied by common standards to protect members and beneficiaries of occupational pension schemes. The IORP Directive therefore also provides for prudential regulation, but based on minimum harmonisation and mutual recognition.
- 1.2. This Call for Advice (CfA) seeks to obtain advice from the European Insurance and Occupational Pensions Authority (EIOPA) on how to improve the IORP Directive. The Commission has foreseen a review of the IORP Directive for three main reasons. First, there are currently less than 80 IORPs operating across different Member States, which represents a very small proportion of the around 140,000 IORPs existing in the EU. The Commission intends to propose measures that simplify the legal, regulatory and administrative requirements for setting-up cross-border pension schemes. Employers, IORPs and employees should be able to reap the full benefits of the Single Market. Second, the recent economic and financial crisis has forcefully demonstrated the need for risk-based supervision. This is the case already for IORPs in some Member States, but not at the EU level. Building on the know-how and technology existing in Member States, the Commission intends to propose measures that would allow IORPs to benefit from the risk-mitigating security mechanisms at their disposal. Third, while not very prevalent at the time of adopting the IORP Directive in 2003, today nearly 60 million Europeans rely on a defined contribution (DC) scheme for an adequate retirement income. DC schemes shift the risks – in particular market risk, longevity risk or inflation risk – to individual households. International discussions have shown that this raises important new policy issues. The Commission therefore seeks advice on how to modernise prudential regulation for IORPs that operate DC schemes.
- 1.3. The Commission's proposal to review the IORP Directive will be accompanied by an impact assessment study. This impact assessment will take into account that supplementary occupational pension schemes are generally proposed by employers to their employees on a voluntary basis. The new supervisory system for IORPs should not undermine the supply or the cost-efficiency of occupational retirement provision in the EU.
- 1.4. This CfA builds on extensive public consultation of a wide range of stakeholders that the Commission carried out over the past years. The Commission Services conducted a public consultation on the solvency rules for IORPs in 2008 and 2009. A summary of this consultation was published

on 16 March 2009.¹ This was followed-up by a Public Hearing on 27 May 2009.²

- 1.5. Given the importance of pensions for the citizens in an ageing Europe, the Commission subsequently decided to integrate issues relating to the solvency rules for IORPs into the much broader consultation launched by the Commission's July 2010 Green Paper on pensions.³ This decision was taken to ensure that the regulation of the activities and the supervision of IORPs are consistent with the overall economic, fiscal and social policy. The main aim of public policy in the area of pensions is to ensure the sustainability of public finances and an adequate retirement income. The Green Paper consultation confirmed that completing the Single Market for occupational retirement provision can make a significant contribution towards these objectives. The Single Market can reduce the cost of financing pensions by allowing for further efficiency gains through scale economies, innovation and diversification. It can also enhance the safety of pension schemes through effective and intelligent regulation. The best way for the Single Market to support fiscal sustainability and pension adequacy is through the facilitation of cross-border activity and the development of risk-based supervision.
- 1.6. The European Parliament adopted its Report on the Green Paper on 16 February 2011. The Commission Services published a summary of all the responses on 7 March 2011.⁴
- 1.7. The EIOPA advice should cover all the types of schemes operated by IORPs, ranging from pure defined benefit (DB) schemes to pure defined contribution (DC) schemes. A description of this spectrum of pension schemes is contained in the EIOPA report on risk management.⁵ Pension schemes with a minimum guarantee for the contributions paid and/or of the investment returns are, depending on the Member States, considered to be DC, hybrid or DB schemes.
- 1.8. This CfA has been informed by the significant work undertaken by the EIOPA Occupational Pensions Committee (OPC) in support of supervisory convergence since its creation in February 2004.
- 1.9. Against this background – and following the consultation of the Member States through the European Insurance and Pensions Committee (EIOPC) in

¹http://ec.europa.eu/internal_market/consultations/docs/occupational_retirement_provision/feedback_statement_en.pdf

²

http://ec.europa.eu/internal_market/pensions/docs/hearing052009/summary_IORP_public_hearing_en.pdf

³ Green Paper - towards adequate, sustainable and safe European pension systems (COM(2010)365 final), 7.7.2010

⁴ <http://ec.europa.eu/social/main.jsp?catId=700&langId=en&consultId=3&visib=0&furtherConsult=yes>

⁵ Report on risk management rules applicable to IORPs (CEIOPS-OP-22-09), 6.11.2009.

March 2011 - the Commission Services request EIOPA to advise on the further development of EU legislation for the activities and supervision of IORPs, in line with the mandate set out in this CfA. The remainder of this CfA is structured as follows. Section 2 relates to the scope of the IORP Directive. Section 3 focuses on the facilitation of cross-border activity. Section 4 provides guidance for the main features for the risk-based supervision of pension funds. Section 5 outlines specific features to manage and supervise risks in pure DC schemes. Section 6 provides guidance for a quantitative impact study and data related issues. Finally, Section 7 provides further guidance on the reporting modalities and the deadline.

- 1.10. The Annex of this CfA sets out more detailed guidance and specific instructions. It seeks to contribute to the EIOPA advice in two ways. First, it provides for each topic detailed information about the current provisions in the IORP Directive and, where relevant, the corresponding articles in Directive 2009/138/EC (Solvency II). Second, it makes reference to the main reports prepared by the EIOPA Occupational Pensions Committee (OPC) over the past years.

2. SCOPE OF THE IORP DIRECTIVE

- 2.1. The IORP Directive deals only with occupational retirement provision. However, not all occupational pension schemes are covered. Occupational retirement provision, operating on a funded basis, is delivered through different financing vehicles and under different legal regimes in Member States. As regards book reserve schemes, it should be noted that Article 8 of Directive 2008/94/EC requires Member States to protect employees' rights, in particular outstanding supplementary occupational pension claims, in the event of the insolvency of their employer. Following the Green Paper consultation, the Commission is currently assessing the need to review this directive.
- 2.2. DC schemes existing in some Member States either do not fall under any EU prudential regulation or Member States have chosen to subject them to national legislation that is inspired from the provisions of EU prudential regulation for similar financial products (e.g. the IORP Directive itself or the UCITS Directive). The advice should include an assessment of the provisions in the IORP Directive that could be extended to occupational DC schemes that are currently not covered.

3. FACILITATING CROSS-BORDER ACTIVITY

- 3.1. The main purpose of the IORP Directive is to enable an employer in one Member State to sponsor an IORP located in another Member State. The legal definition of **cross-border activity** should be clear in this respect.
- 3.2. The IORP Directive provides that, in general terms, IORPs are subject to the **prudential supervision** of the competent authorities from the home Member State, while the social and labour law (SLL) of the host Member State is applicable in this respect. The distinction between prudential legislation and SLL should be clear and as consistent as possible across Member States.

- 3.3. Even though the IORP Directive does not contain a definition of the term **ring-fencing**, it refers to this concept at various instances. Legal clarity of the concept at the EU level may enhance the effectiveness of ring-fencing measures in protecting pension benefits in the case of cross-border activity of IORPs and in stressed situations.

4. INTRODUCING RISK-BASED SUPERVISION FOR IORPs

- 4.1. The supervisory system should provide supervisors with the appropriate tools and powers to assess the overall financial position of an IORP based on an **economic risk-based approach**. The aim is to reflect the true risk position of the IORP. The supervisory system should not only consist of quantitative elements, but also cover qualitative aspects that influence the risk-standing of the institution (managerial capacity, internal risk control and risk monitoring processes, etc.).
- 4.2. The supervisory system should be designed in a way that encourages and gives an **incentive** to the supervised institutions to measure and properly **manage their risks**. In this regard, common EU principles on risk management and supervisory review should be developed. Furthermore, the supervisory requirements should cover the quantifiable risks to which a supervised institution is exposed.
- 4.3. The supervisory system should be able to allow for interactions between quantitative and qualitative supervision, as well as with the role of disclosure. It should therefore be based on **three pillars**:
- The first pillar consists of quantitative requirements comprising of rules for the calculation of technical provisions and other security mechanisms. Where the IORP itself rather than the sponsoring undertaking covers risk, the own fund requirements should reflect economic capital: a Solvency Capital Requirement (SCR) and a Minimum Capital Requirement (MCR). As a particular treatment of this, a similar approach should be adopted for pension schemes where the risk is covered by the IORP and the sponsoring undertaking. Where the risk is covered by the sponsoring undertaking (not the IORP), it should be possible to restate the value of assets in the IORP and the liabilities of the sponsoring undertaking into a single balance sheet, including the possibility to recognise sponsor covenants and claims in pension protection schemes as an asset similar to reinsurance. Irrespective of the security mechanisms used, the level of protection of the scheme members and beneficiaries should be similar.
 - The second pillar consists of qualitative requirements, comprising of rules on governance and the supervisory review process.
 - The third pillar consists of transparency requirements, comprising of rules on information disclosure to supervisory authorities and to members/beneficiaries.
- 4.4. EIOPA's advice on the future regulation for IORPs should be provided on the basis of the particular characteristics of occupational pension schemes in the EU. The aim of the Commission is to develop a *sui generis* risk-based

supervisory system for IORPs. EIOPA should therefore **take the IORP Directive as the starting point** for the development of its advice. This notwithstanding, the EIOPA advice should also endeavour to maintain consistency across financial sectors. Pension schemes and pension products containing similar risks should be subject to similar regulatory requirements. The new supervisory system for IORPs should be constructed in a way that avoids regulatory arbitrage between and within financial sectors. Accordingly, the general layout of the supervisory system should, to the extent necessary and possible, be compatible with the approach and rules used for the supervision of life assurance undertakings subject to Directive 2009/138/EC (Solvency II). When reference is made to this directive, the EIOPA advice should however carefully take into account lessons learnt from the European regulatory discussions that took place after the adoption of this directive in 2009. This relates, in particular, to the illiquidity risk premium in the discount rate, to the need to better reflect long-term guarantees and to possible simplifications.

4.5. The main **features of Pillar 1** are the following:

- (a) The **valuation** of assets, technical provisions and other liabilities of the IORP should be **market-consistent** and based on sound economic principles.
- (b) **Technical provisions** need to be established in order for the IORP to fulfil its obligations towards members and beneficiaries. An increased level of harmonisation for technical provisions is a cornerstone of the new supervisory system. In the case of non-hedgeable risks, the calculation of technical provisions comprises of a best estimate of future cash flows, discounted at a risk-free rate of interest, plus a risk margin.
- (c) In addition, **Article 15(6)** of the IORP Directive provides that "[w]ith 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, drawing on advice from EIOPA, shall, every 2 years or at the request of a Member State, **issue a report** on the situation concerning the development in cross-border activities." The advice from EIOPA should therefore also support the Commission in its assessment as to whether it "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."
- (d) An IORP that 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, remains subject to **own fund requirements**. The new supervisory system should provide for a Solvency Capital Requirement (SCR) and a Minimum Capital Requirement (MCR).

- (e) The amount of **own funds eligible** to cover the SCR and MCR should be determined on the basis of three criteria: availability, classification and eligibility.
- (f) The **SCR** reflects a level of capital that enables an institution to absorb significant unforeseen losses and that gives reasonable assurance to members/beneficiaries. The SCR should be calculated in such a way that the quantifiable risks to which an institution is exposed are taken into account and based on the amount of economic capital corresponding to a specific ruin probability and time horizon. The appropriate ruin probability and time horizon to be used and the implications for the calculation of the SCR on a going-concern basis require analysis. The EIOPA advice should consider a suitable calibration, including a Value at Risk measure with a 99.5% confidence level over a one year period, that is consistent with the nature of IORPs.
- (g) The technical provisions and/or own fund requirements should take into account additional **risk-mitigating security mechanisms** for pension schemes. In particular, on the liabilities side, pension funds may have the possibility to call on additional contributions from members and/or sponsors, reduce or suppress the indexation of pension rights or reduce the pension liabilities (i.e. the technical provisions themselves) in going concern. On the asset side pension funds may have recourse to sponsor covenants, contingent assets outside the balance sheet of the IORP, or to reinsurance from a pension guarantee fund.
- (h) The risks addressed in the capital requirements should include at least **underwriting risk, market risk, counterparty default risk and operational risk**. To the extent that these risks are not quantifiable they will be taken into account in Pillar 2.
- (i) The **standard approach** to calculate the SCR shall be to add the following three items: a basic SCR, a capital requirement for operational risk and an adjustment for the loss-absorbing capacity of technical provisions and deferred taxes.
- (j) The risk-based approach implies the recognition of **internal models** (either partial or full) provided these improve the institution's risk management, better reflect its true risk profile than under the standard approach. Institutions' internal models may be used to replace the standard approach to the SCR if the internal model has been validated for this purpose. The validation criteria and the validation process should be developed and harmonised. The possibility to extend this option to group-wide internal models requires analysis.
- (k) The **MCR** reflects a level of capital below which ultimate supervisory action would be triggered. It is calculated in a more simple and robust manner than the SCR as this kind of action may need authorisation by national courts. The MCR shall be contained within an interval of 25% to 45% of the institution's SCR.

- (l) Technical provisions should be fully funded. When the amount of assets no longer covers the amount of technical provisions, or when the own fund requirements are no longer met, IORPs should set up concrete and realisable recovery plans. The recovery periods should be consistent across Member States and prudentially sound.

4.6. The main **features of Pillar 2** are the following:

- (a) Robust governance and risk management requirements are a prerequisite for an efficient risk-based supervisory system.
- (b) The supervisory review process should increase the level of harmonisation of supervisory methods, tools and processes. In particular, it should aim to identify institutions with financial, organisational or other features susceptible to producing a higher risk profile. Such institutions require funding or a higher capital than under the SCR.

4.7. The main **features of Pillar 3** are the following:

- (a) Transparency enhances discipline and hence reinforces the provisions in Pillars 1 and 2. There is a need to revisit the requirements to disclose information to supervisory authorities and to the members/beneficiaries of occupational pension schemes.
- (b) Requirements to disclose to members/beneficiaries should, to the extent possible, be compatible with requirements in other financial sectors, in particular the UCITS IV Key Investor Information Document (KIID) in the case of DC schemes.

5. SPECIFIC FEATURES FOR DC SCHEMES

- 5.1. Specific attention should be paid to defined contribution (DC) schemes that do not offer a principal and/or investment guarantee. These schemes have become much more prevalent in the EU since the adoption of the IORP Directive in 2003. 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.
- 5.2. The main focus should be on the accumulation phase of DC schemes, although where necessary advice concerning the decumulation phase should also be considered.
- 5.3. Although relevant to all types of pension schemes, the areas where DC schemes may require particular attention include at least the following:
 - Governance: see general governance, fit and proper, risk management and outsourcing in the Annex;
 - Investment rules: supervision of asset allocations in multi-funds, life-cycling investment approaches and default funds (see investment rules in the Annex);

- A comprehensive statement of investment principles: see reporting to supervisors and information to members/beneficiaries in the Annex;
- 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);
- Costs: Regulation should ensure that costs and fees are disclosed fully and transparently (see information to members/beneficiaries in the Annex). Other possible approaches to deal with high costs include an "unreasonable test", capping fees, requiring competitive bidding and centralisation (clearinghouses).
- Managing transition from accumulation to decumulation: annuitisation, timing, programmed withdrawals. Regulation should ensure that supervision can oversee how information is provided and how competition is working during the transition (e.g. comparison of annuity prices); see information to members/beneficiaries in the Annex.

6. QUANTITATIVE IMPACT STUDY AND DATA RELATED ISSUES

- 6.1. EIOPA is also requested to run a Quantitative Impact Study (QIS) and provide related data with a view to informing the impact assessment analysis that will accompany the Commission's proposals to review the IORP Directive.
- 6.2. The timetable for the QIS exercise is challenging. EIOPA may therefore wish to focus on the impact of its advice on particular Member States and use, as far as possible, approximations based on existing data. Simplifications should be used when they are possible. EIOPA is also encouraged to work with other stakeholders.
- 6.3. The aim of the QIS exercise is twofold. First, to provide all stakeholders with detailed information on the quantitative impact of EIOPA's advice on the prudential balance sheet of IORPs in comparison with the current situation. The current situation is reflected in the requirements and practices existing already both at the national and institution level (baseline scenario), including legal obligations that stem directly from the existing IORP Directive, obligations imposed through national laws or by supervisors, as well as practices institutions voluntarily abide by for both internal and

external purposes ("business as usual" practices). Second, to collect quantitative and qualitative data to support the analysis of different policy options in the impact assessment of the Commission.

6.4. EIOPA should address at least the following main questions:

- Which items on the prudential balance sheet are impacted the most?
- What is the effect on IORPs of the possible restatement of the value of both assets and liabilities under the envisaged supervisory framework?
- What is the relationship between the explicit requirements in the envisaged supervisory system and the current explicit and implicit requirements as regards technical provisions, own funds and/or prudent valuation of assets and liabilities?
- Which elements are the most important sources of own funds for IORPs?
- What is the impact on the funding level or capital surplus (capital available on top of the regulatory requirement)?
- Where own funds are required, what is the impact on the solvency ratio (coverage of SCR and MCR)?
- Will IORPs need to raise their funding level or raise additional capital?
- Are internal models used by IORPs and can they reduce the required level of funding or capital?
- How practical are the calculations involved?

6.5. EIOPA should also seek to provide an indication of the impact of its advice on administrative costs, using as far as possible the approach set out in the EU Standard Cost Model.

7. FURTHER GUIDANCE ON THE REPORTING MODALITIES AND DEADLINES

7.1. The aim is to attain a level of **harmonisation** where EU legislation does not need additional requirements at the national level. The Commission Services intend to use the Lamfalussy approach to financial legislation, i.e. recast the existing IORP Directive into a Level 1 Framework Directive and develop, at a later stage, Level 2 implementing measures. This CfA only concerns advice in relation to the Level 1 Framework Directive.

7.2. EIOPA should also consider whether its advice needs to be formulated in the form of several **policy options** with an explanation of their respective merits.

- 7.3. EIOPA should consider how the envisaged rules can be applied in a manner that is **proportionate** to the nature, scale and complexity of the IORP. Simplifications should be used whenever possible.
- 7.4. The EIOPA advice should incorporate - as far as possible - the principles and guidelines on private pension funds developed by the OECD, the International Organisation of Pension Supervisors (IOPS) and the Groupe Consultatif Actuariel Européen / International Association of Actuaries (IAA).
- 7.5. EIOPA is encouraged to **consult stakeholders** before submitting its advice to the Commission. Given the tight timetable EIOPA should however take into account that a number of aspects of the envisaged supervisory system have already been consulted on by the Commission Services in 2008/2009 and in the 2010 Green Paper on pensions. References to the latter consultation have been made in the Annex.
- 7.6. EIOPA should provide the Commission with its final advice by Friday, **16 December 2011**. EIOPA may wish to deliver its advice, including interim reports if necessary, in regular stages.
- 7.7. In the interests of transparency, the Commission will publish this Call for advice on its website.