**Comments on the IORP Directive**

The AAE published a Position Paper in November 2015 commenting on the European Commission's proposal for revision of the IORP Directive, which was published in March 2014, including references to the initial draft report by the ECON rapporteur.

ECON approved its proposal for amendments to the Directive in January 2016, and the trilogue discussions between Parliament, Council and the Commission is now in progress, under the Dutch Presidency.

In the November position paper, the AAE expressed its support for the Commission's objectives to:

- Protect pension scheme members and beneficiaries.
- Inform pension scheme members and beneficiaries.
- Remove obstacles for cross-border occupational pension funds.
- Allow long term investment in assets which are not traded on regulated markets

The AAE commented critically on some of the proposed amendments, particularly in relation to

- The need for a proper balance between harmonisation and Member State flexibility in, for example, specifying the detail of the Pension Benefit Statement
- The need for proportionality in relation to the key functions
- The qualifications needed to properly discharge the actuarial function
- The risk assessment should include a quantitative analysis of the risks being borne by the IORP and/or the members, although this should not drive capital requirements
- The obstacles to cross border activity i.e. retention of the fully funded at all times requirement and the proposed requirement for member approval to transfer

In this paper, the AAE considers how the key issues have been addressed in the proposals now being considered in the trilogue.

1. Subsidiarity

   This issue is recognised in Recital paragraph (2a) proposed by Council and ECON which states that this is a minimum harmonisation Directive. ECON emphasises this further in its proposed paragraph (2c)

   *"The Commission and ..EIOPA.. should take account of the various traditions of the Member States in their activities and should act without prejudice to national social and labour law in determining the organisation of institutions for occupational retirement provision."*

   There are references in the proposals of the two bodies to the member States and national competent authorities to have powers to decide on the detail of the content of the risk evaluation/assessment, the pension benefit statement and investment powers. The AAE is in favour of such powers being given to Member States where appropriate, subject to compliance with an overall set of high-level principles set out in the Directive. The AAE is further exploring the development of European Standards of Actuarial Practice with regard to the activities of the Actuarial Function and the risk evaluation/assessment, which aims to deliver a minimum consistency in the work of actuaries working in the Member States.

2. Proportionality

   The amendments proposed by Council and ECON explicitly refer to the proportionality objective in a number of areas, particularly in the section on governance. A particular example is the proposal that an individual or unit can fill more than one key function (other than internal audit), and may act for both IORP and sponsoring employer if there is no conflict of interests. The AAE is supportive of the approach adopted. In addition the AAE expects that further consolidation in the pension sector would contribute to further improving quality and at the same time reducing the costs per member or as percentage of assets under management.

3. Actuarial function
   As stated in our November paper, we are strongly of the view that the Directive should require that the actuarial function holder has the appropriate skills, experience and professional standards to discharge his/her responsibilities and are pleased to note the wording proposed by ECON in Recital 25
   *"The actuarial function should 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 activities of the institution for occupational retirement provision, and who are able to demonstrate their relevant experience with applicable professional and other standards."*
   We strongly recommend that similar wording be included in Article 28 to ensure transposition to Member State legislation.

4. Risk evaluation/assessment
   The Commission used the term "risk evaluation" whereas ECON have used "own risk assessment" which reflects the ORSA under Solvency II but without the "solvency" part. The AAE has no view on which term is more appropriate but consider the detail of what should be covered in the risk evaluation/assessment should be determined by the IORP, subject to the requirements of the national competent authority, which in turn will be required to comply with principles set out in the Directive. The objective should be to enable the IORP to identify, quantify (where possible) and manage the various risks to which they are subject, and to demonstrate how they would deal with adverse conditions e.g. perform their own stress test. The AAE is strongly of the view that the process should require a quantitative assessment in relation to some risks, recognising the need for proportionality and cost controls. The AAE agrees that the document should be produced at least every 3 years (or if there is a major change to the risks being taken by the IORP) and should be available on request to members.

5. Obstacles to cross border activity

   The AAE agrees that obstacles to cross border activity should be removed, provided the interests of members and beneficiaries are properly protected. The Directive sets out a

process involving the IORP, the home state competent authority and the host state competent authority which is designed to ensure that members' interests are protected, both by prudential supervision and social and labour law. This process should be as efficient as possible i.e. each of the bodies involved should have clear responsibilities to be discharged within a reasonable timescale, and should be required to give a reasoned decision if they are unable to do so.

There are three aspects on which the AAE would comment:

a) The AAE considers that the "fully funded at all times" requirement is a material obstacle to cross border transfers and supports the ECON proposal that Article 15(3) be amended to remove the requirement i.e. to have the same option of a recovery period as in a single country IORP "*provided that the interests of members and beneficiaries are fully protected".* The AAE agrees that it is paramount that the interests of members and beneficiaries are protected to the extent required by national social and labour law, but the Directive should not require that a higher level of security applies in a cross border transfer. The AAE suggests that consideration be given to adopting an alternative approach to ensuring this which would make it easier for companies to establish cross border IORPs in line with the objectives of the Directive.

*b)* We note that the ECON proposal also includes text in Article 13(1) which appears to contradict their proposal to remove the fully funded requirement in the case of the transfer of part of a scheme:

> *"In the event of a transfer of part of a pension scheme, Member States shall require the transferring and the receiving institution to have sufficient and appropriate assets to cover the technical provisions for the transferred part and the remaining part of the scheme, in accordance with Article 15(1)."*

The Council proposal has a less prescriptive approach to safeguarding the members' interests, stating that in the case of a partial transfer the home state of the transferring IORP must "*verify the viability of both the transferred and the remaining part of the pension scheme."* This seems to be a more flexible approach, although it would seem more appropriate for the "viability" of the transferred part to be verified by the home state of the receiving IORP. We do not think that it is necessary to require home state approval of the transfer, which is not currently required under the Directive and would create another hurdle to cross border activity.

c) The requirement (unless disapplied by social and labour law) for approval of a cross-border transfer by members and beneficiaries, or their representatives, as proposed by the Commission in Article 13 is impractical if it means that all members and beneficiaries must give their consent, as this will never be possible in an IORP with many members. The ECON proposal amends this to provide that a majority of members and a majority of beneficiaries, or a majority of their representatives, must approve a transfer, and Recital paragraph 24 notes that "representatives" can be taken to include trustees in a trust based IORP (e.g. as in UK and Ireland). The AAE considers this to be a better approach as

- The trustees are required to consider the best interests of all of the members and beneficiaries and hence can safeguard members of smaller groups who might be disadvantaged by a majority vote of members

- The trustees can take advice (legal, actuarial etc), and engage on a detailed level with the sponsor, to enable them to evaluate the proposal and if appropriate seek some amendments

It would be preferable if the term "representatives" was defined in the Articles as including trustees or others who have a fiduciary responsibility in relation to the members of the transferring scheme.

In addition, it might be considered reasonable that individual members could be given the right to to "opt out" of a cross-border transfer. This would then mean that after the procedure of collective decision-making, individuals could have the option not to transfer and to stay behind in the national scheme, if this is continuing in existence, or to transfer to a personal pension arrangement.

d) ECON propose a new Article 3a entitled "Duty of Care" which gives the competent authorities of the home state of a DB IORP in respect of which it is proposed to make a cross-border transfer, which has been approved by the members and beneficiaries or their representatives, the power to refer the proposal to EIOPA "*to assess whether there could be any systemic risk to the EU financial system arising from the transfer and whether the long-term interests of members and beneficiaries are negatively affected if the transfer were to proceed.*"

   In addition, ECON propose a power under Article 15 to refer to EIOPA any issues on which the competent authorities do not agree.

   The AAE considers the proposed Article 3a to be unnecessary as it is difficult to see why a transfer would give rise to systemic risk, and the members' interests are protected by the prudential supervision of the home state of the receiving scheme, which by definition will meet the requirements of the Directive. However, if such a power existed, competent authorities of Member States might feel that they should refer cases to EIOPA to protect their own position, and this would create another obstacle to cross-border activity.

   The proposed Article 15 provides a way to resolve differences of interpretation between competent authorities to EIOPA for resolution and the AAE considers this to be beneficial. An alternative approach would be to revise the Budapest Protocol which sets out in detail the procedures to be followed in relation to the establishment of a cross-border IORP.

The AAE also takes this opportunity to comment on three further aspects of the proposals to amend the Directive:

**Environmental, social and governance risks (ESG)**

The Commission proposal required that the risk evaluation for pensions included

*a qualitative assessment of new or emerging risks relating to climate change, use of resources and the environment.*

ECON have expanded this reference to "*climate change, use of resources and the environment**,** social risks and risks related to the depreciation of assets due to regulatory change*." The Recital clarifies that the final reference relates to "stranded assets" e.g. fossil fuel reserves which become unviable. ECON have also explicitly referenced ESG in Articles 20 (Investment rules),

*the 'prudent person' rule shall not prevent institutions from taking into account the potential long-term impact of investment decisions on environmental, social, governance or ethical factors**;***

22 (Common principles of governance), 26 (Risk management), 32 (Statement of investment policy principles) and 55 (member disclosures).

The AAE agrees that such risks should be considered as part of the risk management framework but considers that it should be left to employers and employees to discuss these matters and agree how they should be taken into account in the management and investment strategy of the IORP.

Those principles would have to be documented and implemented in the management of the IORP.

**Intergenerational balance**

A number of references to intergenerational balance have been included in the ECON draft: this is introduced in their text for Recital 3:

*Member States should take into account the objective for all institutions of ensuring the intergenerational balance of occupational pension schemes, by aiming to have an equitable spread of risks and benefits between generations*.

There are also specific references to the "intergenerational balance" in Articles 20 (Investment Rules), 29 (Risk assessment) and 60 (Prudential Supervision).

The AAE would point out that intergenerational balance is not applicable in circumstances where each member bears all of his/her own risks, with no guarantees being provided by the IORP or any other party.

The primary objective of a defined benefit IORP is to pay all benefits to members and beneficiaries as they fall due. It may be the case that different cohorts of members have different benefit entitlements, due to changes over time in employment terms or in legislative provisions, so that there may not be "an equitable spread of benefits between generations", and the IORP should not have an objective of providing intergenerational balance where this is not intended. However, an unintended shift in the intergenerational balance might arise e.g. in the Netherlands, adopting a higher discount rate would increase the possibility to grant indexation. This would benefit the older members/beneficiaries most. Such indexation will be "paid" by the younger members, especially if this would not be "compensated" by some additional sponsor requirements to pay in additional money, as there will be less money left over for them.

In relation to risk, it is likely that the risks being borne by members who will not receive benefit payments for many years are higher than those being borne by retirees currently in receipt of pension payments, and it would be impractical, and not desirable, to attempt to provide intergenerational balance in this context.

The AAE supports the concept of intergenerational balance, insofar as this can be achieved, in relation to actions taken by the IORP e.g. the reduction of benefits in the event of a funding shortfall, or the increase in benefits if a surplus is to be distributed. It could also be argued that the IORP should have regard to indirect intergenerational balance in its dealings with the sponsoring employer i.e. is it appropriate to insist on accelerated funding if this is likely to damage the viability of the employer into the future, putting jobs at risk?

The AAE considers that clarity is essential i.e. where a change is stated to have "overall" no significant impact, or perhaps is state as being a better deal than the current situation, there could still be a very different balance between cohorts of members before and after the change, and this should be made clear to all parties.

**Reporting to the competent authority ("whistleblowing")**

Article 25(6) of the Commission proposal required that *"the risk management, internal audit and, where applicable, actuarial functions shall inform the competent authority of the institution if the administrative, management or supervisory body of the institution does not take appropriate and timely remedial action"* in specified circumstances. The Council text has deleted this requirement but ECON have included a more general "whistleblowing" requirement *"The holder of a key function shall inform the competent authority of the institution of any finding that could have a significant impact on the interests of members and beneficiaries"***.**
The AAE is supportive of the imposition of a duty on key function holders and others to report to the competent authority if they have reason to believe that an action or failure to act will lead to the material detriment of members and beneficiaries of the IORP.

**27 March 2016**