Comments on the IORP Directive

Introduction

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

Purpose

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

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 considering the development of Educational Notes with regard to the activities of the Actuarial Function and the risk evaluation/assessment. These Notes may later evolve into European Standards of Actuarial Practice.

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.

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, which would provide greater comfort for members, sponsoring employers and supervisors that the IORP will be appropriately financed. We 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.

The AAE believes that an actuary can also play an important role in the governance in IORPs where members bear all the risks (i.e. "pure DC" IORPs) by contributing to the effective implementation of the risk management system (as provided under Article 28(2) (f) but only for IORPs where members do not bear all the risks). In addition, the proposed requirement in Art 40a that members should be provided with projected pensions based on assumptions about future investment returns, inflation and longevity requires actuarial expertise.

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.

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 two 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) 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.

The AAE also takes this opportunity to comment on four 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.

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 Commission proposal that key function holders should have the power to report to the competent authority in circumstances where the IORP Board has not dealt with an issue that has been reported to them, if they believe that an action or failure to act will lead to the material detriment of members and beneficiaries of the IORP. The AAE considers that the circumstances in which reporting is required should be clearly defined (i.e. not just "*could have a significant impact"* as proposed by ECON) and that it is essential that a key function holder who makes a report to the competent authority in good faith benefits from statutory protection.

Pension Benefit Statement

The ECON proposal [Art 40a (5) (e)] provides that members of DC Schemes should receive key information which includes
"information on the investment profile, including a clear indication of the risks borne by the member under a best estimate scenario and an extreme but plausible worst case scenario, taking into consideration the specific nature of the pension scheme;"

We presume that this is specifically intended to refer to DC schemes where members bear all the financial risks. In some DB schemes, for example in the Netherlands, some of these risks are borne by the members as well. It is important that members and beneficiaries are aware whether or not they bear any risks, and if they bear no risks i.e. there is a guarantee of the level of benefits payable, this should be stated, and in such cases the amount of information provided to members on risks can be much less. We agree that members of IORPs should be provided with projections of their benefits based on an estimate of expected returns, net of costs and charges, reflecting the investment profile, and in today's money terms i.e. having taken out the effect of future expected inflation.

We also agree that members should be given alternative projections of the possible outcome, as this will help to make it clear that the figures quoted are not guaranteed, and will give an indication of the extent of the risk being taken by the member. However, we strongly recommend that the term "worst case scenario" should not be used, and that figures are also provided on which are higher than the "best estimate" figures as highlighting the downside may discourage individuals from saving for retirement at all. We believe that there may also be some confusion about the term "best estimate" – we suggest that this be taken as the median expected return (the return above which 50% of possible outcomes lie, and below which 50% lie) and that two alternative scenarios are shown which reflect the 5^{th} and 95^{th} percentiles of the distribution of expected outcomes i.e. the returns which only 5% of outcomes lie above or below. These two alternative projections could be described as "favourable/unfavourable", "optimistic/pessimistic" or "good weather/bad weather" scenarios.

11 May 2016