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EC calls for advice on review of IORP directive

In brief

- The EC has issued a Call for Advice to EIOPA in advance of its review of the IORP directive.
- The review could lead to new and possibly stronger requirements for defined benefit scheme funding.

Next steps

- No actions are needed at this stage, but it is an area in which to watch out for future developments.

In April 2011, the European Commission (EC) issued a Call for Advice from the European Insurance and Occupational Pensions Authority (EIOPA) to prepare for the Commission's planned review of the Institutions for Occupational Retirement Provision (IORP) directive.

Background

The IORP directive is the European legislation which provides a framework for the regulation of funded pensions in Europe, in order to create an internal market for pensions within European countries and enable cross-border pensions provision. The EC has initiated a review of the directive for three main reasons:

- Only a small number of cross-border schemes exist in the EU, and the EC would like to increase this number.
- The recent economic crisis has demonstrated the need for risk-based supervision. This already exists in some (but by no means all) member states, and there is no EU-level framework.
- Defined contribution (DC) schemes are now far more prevalent than when the IORP directive was first introduced, a trend that is likely to continue. DC schemes have a very different risk profile to defined benefit schemes.

To inform its review of the IORP Directive, the EC has asked for advice from EIOPA, which is presented in a formal 'Call for Advice' paper. (EIOPA is the new European supervisor for insurance and pension schemes, created in January 2011.)

So why is this of interest to us? The main answer lies in what it could mean for the funding of defined benefit pension schemes in the UK and whether it might result in a solvency-type funding regime, potentially similar to that imposed on insurance companies by the Solvency II directive.

This Call for Advice follows on from two other consultations by the EC in recent years: a consultation in 2008/2009 regarding solvency rules for certain types of pension schemes; and a Green Paper on pensions published in July 2010, which integrated the topic of solvency funding for pension schemes into a much broader discussion regarding pensions policy across Europe.

'Three pillar' approach

The EC intends to introduce a risk-based supervisory regime for pension schemes and proposes a 'three pillar' approach:

- **Pillar 1:** quantitative requirements covering the calculation of technical provisions and other security mechanisms.
- **Pillar 2:** qualitative requirements, comprising rules on governance and the supervisory review process.
- **Pillar 3:** transparency requirements, comprising rules on disclosure both to regulators and to members.

This 'three pillar' approach is consistent with the framework adopted for other financial sectors, and in particular the approach set out for the insurance industry in the Solvency II directive. Although the EC has stated that the IORP directive should be the starting point for any new pensions supervisory regime, it has also indicated that the resulting regime should be compatible with the approach and rules set out in the Solvency II directive. Indeed, many of the questions put to EIOPA in the Call for Advice relate to how parts of the Solvency II directive could be adjusted such that they would be appropriate for pension schemes.

Pillar 1 – funding requirements

In its Call for Advice, the EC states that the valuation of assets and technical provisions should be market-consistent. It is also looking at an increased level of harmonisation of technical provisions across the EU as a cornerstone of its new supervisory system. The calculation of technical provisions will involve taking a best estimate of cashflows and discounting at a risk-free rate, plus a risk margin. This would be likely to increase significantly the level of technical provisions for most UK schemes.

However, EIOPA is also asked to consider how allowance for contingent assets, sponsor covenant and pension guarantee schemes such as the UK's Pension Protection Fund (PPF) could be incorporated. One suggestion is that sponsor covenant could be allowed for using an approach similar to that used by insurers to incorporate the value of a reinsurance contract, with an appropriate allowance for counterparty default risk. Such allowance for sponsor covenant and the existence of the PPF could mitigate some of the impact of any increase in technical provisions.

The Call for Advice draws a clear distinction between schemes like those in the UK where the sponsor underwrites the pension scheme liability and 'regulatory own funds', schemes which have no sponsoring employer and hence where all risks are borne by the scheme itself (of which there are thought to be very few, if any, in the UK). Additional, more stringent requirements are proposed for such regulatory own funds, including a requirement to hold solvency capital. The Call for Advice makes clear that schemes underwritten by a sponsoring employer will not be required to hold additional solvency capital.

Under the IORP directive, technical provisions should be fully funded. Where this is not the case, a recovery plan must be established. The Call for Advice indicates that recovery periods should be consistent across member states. It seems likely that any move to harmonise recovery plans would lead to a reduction in the recovery periods that currently apply in the UK.

Pillars 2 & 3 – governance and disclosure

Pillar 2 will require robust governance and risk management systems to be in place.

Increased transparency under pillar 3 is intended to reinforce the provisions of pillars 1 and 2. The Call for Advice indicates that disclosure of information both to supervisory authorities and to members should be reviewed. Requirements to disclose information to members should be compatible with those in other financial sectors, where possible.

However, in the UK, we would not expect pillars 2 and 3 to result in too many changes, given the risk-based regulatory regime that is already in place and the active role of the Pensions Regulator.

DC schemes

There is, in addition, a strong focus on DC schemes given their increased prevalence across Europe. The Call for Advice asks EIOPA to consider whether and how the IORP directive should be adjusted to better allow for the specific needs for the regulation of DC schemes, with a particular focus on several areas, including governance, investment rules (e.g. lifestyling approaches and default funds) and costs and fees. This is an area that the Pensions Regulator is already looking at in the UK.

Comment

Of the three pillars proposed, it is pillar 1 where any new requirements would be most keenly felt in the UK. Whilst it is reassuring that schemes with an ongoing sponsor commitment would not be liable to a solvency capital requirement, any move to a risk-free discount rate plus a risk margin would be likely to lead to a considerable increase in technical provisions, although this might be mitigated if allowance could be made for sponsor covenant and the PPF. Any increase in funding requirements would have serious ramifications for schemes and their members, sponsoring employers and the economy as a whole. We will, however, need to wait until at least December (when EIOPA is expected to deliver its advice to the EC) for the next development.

Where can I get further information?

For specific advice, please get in touch with Jane Beverley on 020 7839 8600 or by email to jane.beverley@puntersouthall.com. Alternatively, speak to your usual Punter Southall contact.

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