DWP Select Committee

Inquiry into EU pensions policy

Submission by National Association of Pension Funds

March 2012

Key points

- The NAPF welcomes certain aspects of the European Commission's plans to introduce much of the insurance industry's Solvency II regime into the EU pensions Directive (the 'IORP Directive'). There are some benefits to be gained from a Solvency II-style approach on issues such as pension scheme governance and member communications.

- The introduction of a Solvency II-style approach to pension scheme funding, however, represents the single biggest threat to UK defined benefit pension schemes.

- The EC argues that a new IORP Directive would help to promote the development of cross-border pension schemes. The NAPF does not detect a demand for such schemes. In any case, there are far more significant barriers to cross-border pension provision, such as differences between Member States' tax regimes. The NAPF does not accept the case for a new IORP Directive.

- If the EC insists on going ahead, then the new Directive should only cover governance and communications issues. Funding issues should be excluded.

- The EU pensions regulator, EIOPA, has advised the EC to build the new Directive around a requirement that pension schemes should draw up a 'holistic balance sheet'. NAPF research[1] shows that just one element of the proposal – the shift to using a risk-free discount rate in valuing liabilities' – would increase the liabilities of defined benefit pension schemes by *27%*. This would equate to a *£291 billion* increase in scheme funding requirements.

- The extra funding demands on sponsoring employers would increase their insolvency risk and undermine their credit ratings.

- Employers would be forced to reduce or cease providing pension benefits to their employees, resulting in less generous benefits for scheme members. There would be a further shift from defined benefit to defined contribution pensions, creating a system in which members would be more exposed to risks.

- If sponsoring employers were required to put more funds into their pension schemes, then there would be less money available for investment and innovation, with a concomitant impact on growth. So the new IORP Directive could have a significant negative impact on the EU economy, making it more difficult to achieve the EC's 'Europe 2020' targets on job creation and investment.

[1] *Impact of risk-free discount rate on pension scheme funding: cases studies from NAPF member pension schemes*, NAPF, December 2011

EU pensions policy – the key initiatives

1. The starting point for the EU's current initiatives on pensions issues was the European Commission Green Paper, *Towards Adequate, Sustainable and Safe European Pension Systems*, published in July 2010.

2. The Green Paper covered a wide range of issues, from state pension provision to responses to increasing longevity to changes in working patterns. It was developed as a joint project between three European Commissioners: László Andor (Employment and Social Affairs), Olli Rehn (Economic and Monetary Affairs) and Michel Barnier (Internal Market and Services).

3. The EC's activities on pensions have now been split into two distinct workstreams:

   i. A review of the main EU legislation on workplace pensions – the *Directive on Institutions for Occupational Retirement Provision ('IORP Directive')*, which the EC is looking to bring into line with the Solvency II legislation that now applies to insurers. This work is led by Commissioner Barnier.

   ii. A White Paper, *An Agenda for Adequate, Safe and Sustainable Pensions*, published in February 2012, which covers a far wider and less controversial range of issues. This project is led by Commissioner Andor.

4. Both initiatives are considered in this submission.

Review of 'IORP Directive' – the threat of Solvency II

5. The IORP Directive provides a high-level framework for workplace pensions across the EU. First introduced in 2003, it is now under review by the European Commission.

6. The EC's key justification for the review is that the current Directive has proven ineffective in increasing the number of cross-border pension schemes (there are currently 84, mostly between the UK and Republic of Ireland), so a more far-reaching IORP Directive is needed. The NAPF does not detect a demand for such schemes. In any case, the wide variety of tax and employment laws between Member States provide far greater obstacle to the development of cross-border pensions.

7. It appears likely that the real reason for the IORP Directive review is more closely connected with a drive for a more harmonised regulatory landscape across the EU following the financial crisis. In particular, there is pressure from some key players in the EU insurance industry, which is now subject to Solvency II, to make pension schemes subject to similar regulatory requirements.

EIOPA advice

8. The European Commission has now commissioned and received advice from the European Insurance and Occupational Pensions Authority (EIOPA) on the drafting of the new Directive. The Commission set EIOPA a narrow brief - to consider how elements of Solvency II could be introduced into the IORP Directive.

9. EIOPA's 515-page advice was delivered to the EC on 15 February. Although most attention has focused on the proposals on pension scheme funding ('Pillar I' of Solvency II), there are also proposals to incorporate many of Solvency II's provisions on governance ('Pillar II') and communications with scheme members ('Pillar III'). These aspects are far less controversial and enjoy a good degree of support across the industry.

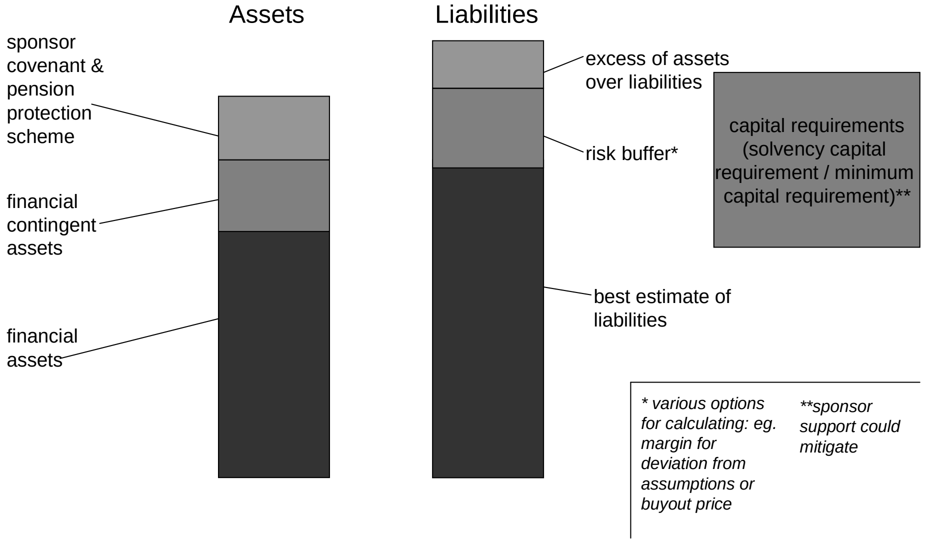
'Holistic balance sheet'

10. At the heart of EIOPA's advice is a variant on the Solvency II model applied to insurers. Instead of requiring pension schemes to hold extra Solvency II-style capital buffers, the EU would instead ask them to draw up 'holistic balance sheets'. The argument is that this would ensure consistent measurement of schemes' obligations and resources, while still allowing Member States to define the benefits that should be provided.

11. The components of the 'holistic balance sheet' on the assets side would be:

- the scheme's *financial assets* (at market value);
- any *contingent assets*;
- an extra 'component' that represents the 'value' of the *sponsor covenant* (the employer's support for the scheme) and the protection provided by any *pension protection scheme* (such as the UK's Pension Protection Scheme).

Holistic balance sheet



12. **Liabilities.** The liabilities side of the holistic balance sheet would include:

- *'technical provisions'* (the assets that a scheme needs to hold in order to meet its liabilities) - likely to be calculated using a 'best estimate' of future cash flows, discounted using a *risk-free discount rate*;
- a *'risk buffer'* (potentially based on buyout price) – a component directly imported from Solvency II; and
- depending on the nature of the scheme – a *solvency capital requirement.*

Damaging impact on pension schemes

13. Research across a sample of NAPF members shows that just one of the innovations envisaged by the 'holistic balance sheet' – the shift to using a risk-free discount rate in order to obtain the 'best estimate of liabilities' – would increase the liabilities of defined benefit pension schemes in the UK by *27%*. This would equate to a *£291 billion* increase in scheme funding requirements.

14. The extra funding demands on sponsoring employers would weaken these companies, increasing their insolvency risk and undermining their credit ratings. The 'sponsor covenant' (the employer's support for the pension scheme) would be weaker.

15. Employers would be forced to reduce or cease providing pension benefits to their employees, resulting in less generous benefits for scheme members. We would see a further shift from

defined benefit to defined contribution pensions, creating a system in which members would be more exposed to risks.

Negative impact on the economy

16. In addition to threatening the existence of defined benefit pension schemes, the new IORP Directive could also have a significant contractionary impact on the EU economy, making it more difficult to achieve the EC's 'Europe 2020' targets on job creation and investment.

17. If sponsoring employers were required to put more money into their pension schemes, then there would be less money available for investment and innovation.

18. Pension schemes seek to match their assets to their liabilities. If liabilities were to be valued on a risk-free basis, then this would prompt a further shift from equities to bonds – again reducing investment in the most productive areas of the economy.

Solvency II-based approach inappropriate for pensions

19. Pensions are fundamentally different from insurance and, therefore, require a different regulatory regime.

    - Unlike insurance products, pensions are paid over the long term in a relatively predictable manner.

    - Workplace pension funds have weathered the financial storm well and have proved to be resilient. Security should not be seen as being synonymous only with solvency; governance also has a crucial role to play.

    - The UK already has a strong system of protection for members' benefits. The employer covenant, the work of the Pension Regulator and the Pension Protection Fund provide a high degree of security.

    - Unlike insurance companies, pension schemes are run on a not-for-profit basis.

Concerted opposition to Solvency II

20. Recent weeks have seen strong and concerted opposition to a Solvency II-based pension funding regime.

    - The NAPF, CBI and TUC wrote jointly to President Barroso and Commissioners Barnier, Rehn and Andor, stating their strong concerns and calling for a review of the EC's approach.

- The European Federation for Retirement Provision (EFRP – the NAPF is the British member) was a co-signatory of a similar joint statement from the ETUC, Business-Europe and other EU-level employer and employee organisations.

21. The EC has indicated that it is 'reflecting' on the concerns raised. The NAPF will continue to press the Commission to revise its plans.

Positive aspects – governance and communications

22. The Solvency II Directive is divided into three 'pillars':
    - Pillar I on quantitative or funding issues;
    - Pillar II on governance; and
    - Pillar III on communications.

23. As explained above, the NAPF is very concerned by the prospect of importing much of Pillar I on funding into the IORP Directive. However, the NAPF recognises that there are potential benefits from importing aspects of Pillars II and III on governance and communications respectively.

24. Examples from the proposals in EIOPA's advice include:

    - proposals to strengthen the governance of defined contribution schemes in order to ensure that members' interests are well protected;

    - proposals to improve communication to members – in both defined contribution and defined benefit schemes, such as the introduction of a Key Investor Information Document ('KIID');

    - proposals to strengthen the IORP Directive with general principles on the supervision of pension schemes; and

    - use of the Solvency II-style Own Risk and Solvency Assessment (ORSA) to improve qualitative assessment of governance standards and procedures.

25. If the EC insists on going ahead with a new IORP Directive, then it should be limited to Pillars II (governance) and III (communications) issues. Pillar I (funding) should be excluded.

Next steps – impact assessments and draft Directive

26. The next few months will be dominated by impact assessment.

    - The EC will shortly publish terms of reference for a Quantitative Impact Study (QIS) to be carried out by EIOPA. This will be a technical piece of work examining the impact on schemes. EIOPA aim to publish this in the third quarter of 2012. The QIS will look particularly at the impact on the UK, Netherlands, Germany, Ireland, Sweden, Belgium and Portugal.

- The EC is embarking on a wider impact assessment, which will cover macro-economic effects.

27. Importantly, the funding sections of EIOPA's advice have been made *conditional* on the outcome of the QIS. EIOPA are keeping open the option of revising this very sensitive section of their advice should the QIS show a potentially negative impact on pension scheme funding.

28. The EC impact assessment will be published alongside the draft Directive at the end of 2012 or (more likely) in early 2013.

EC pensions White Paper

29. The European Commissioner for Employment, László Andor, published the Commission's long-awaited White Paper *An Agenda for Adequate, Safe and Sustainable Pensions* on 16 February.

30. The paper sets out 20 action points for the EU and Member States, many of which are based on using the EU institutions to share best practice in responding to increasing longevity and changes in working patterns.

31. The NAPF has given the White Paper a broadly positive welcome. The NAPF supported the Commission's proposal to promote the sharing of best practice in responding to increasing longevity and changes in working patterns. The EU can also make a useful contribution in other areas, for example, by encouraging workplace pensions saving and by joining up national level pensions tracing services.

Key points in the White Paper

32. Some of the White Paper's 20 recommendations are in areas where the UK has already made good progress. These include equalising pension ages for men and women and revising 'unwarranted' mandatory retirement ages.

33. Other action points, such as providing better information to pension scheme members, reflect the NAPF's own priorities as demonstrated through initiatives such as the NAPF's Pension Quality Mark.

34. Key measures in the White Paper include:

- a renewed attempt to bring forward a Portability Directive, to make it easier to move pensions across EU borders;

- a revised Insolvency Directive;

- inviting the 'pension industry' to participate in the development of a 'code of good practice for occupational pension schemes'; and

- joining up national-level pension tracing services.

35. The review of the IORP Directive forms the least helpful of the White Paper's 20 recommendations. The addition of a reference to maintaining '*a level playing field with Solvency II'* – a phrase not included in earlier drafts, has been seen as a clear political signal of the Commission's intent in this area.

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