

# PEER REVIEW ON SUPERVISORY PRACTICES WITH RESPECT TO THE APPLICATION OF THE PRUDENT PERSON RULE FOR IORPS

EXECUTIVE SUMMARY

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European Insurance and  
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# **PEER REVIEW ON SUPERVISORY PRACTICES WITH RESPECT TO THE APPLICATION OF THE PRUDENT PERSON RULE FOR IORPS**

**EXECUTIVE SUMMARY**



## EXECUTIVE SUMMARY

In the context of its oversight activities, the European Insurance and Occupational Pensions Authority (EIOPA) regularly conducts peer reviews, with experts from national supervisory authorities acting as reviewers in coordination with EIOPA. Peer reviews strengthen consistency in supervisory actions, helping to build a common supervisory culture among European supervisors.

In line with EIOPA's founding Regulation, the outcomes of peer reviews, including identified best practices, are made public with the agreement of the NCAs that have been subject to the peer review.

### BACKGROUND AND OBJECTIVES

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Institutions for occupational retirement provision (IORPs) should invest their capital in the best interest of their members and beneficiaries, i.e. prudently. Therefore, the IORP Directive<sup>1</sup> requires IORPs to adhere to the Prudent Person Rule (PPR) and lists a limited number of investment rules that must be respected by all IORPs.

The objective of this peer review is to explore **supervisory practices** relating to the PPR for IORPs with the aim of promoting a common supervisory culture and supervisory convergence by identifying best practices and by issuing recommended actions where needed.

The peer review was conducted among 27 national competent authorities (NCAs) from 24 European Economic Area (EEA) countries on the basis of EIOPA's Methodology for conducting Peer Reviews (Methodology). Note that only NCAs with IORPs operating in their country during the reference period are in scope of this peer review. Countries that have chosen to use the option of Article 4 of the IORP Directive applying certain provisions of the IORPs Directive to insurance undertakings with occupational retirement provision business (Article 4 ring-fenced funds) participated in the peer review on a voluntary basis. Therefore, the NCAs of the Czech Republic, Estonia, Iceland, Lithuania and Romania were out of scope of this peer view because no IORPs operated in these countries during the reference period. In addition, of the countries with Article 4 ring-fenced funds, the NCA from Slovenia participated and the NCAs from France and Sweden chose not to participate.

The reference period of this peer review was 2014-2016 under the IORP Directive. As the implementation of the IORP II Directive<sup>2</sup> does not substantially alter the rules for the PPR, the analysis in this report remains valid following the introduction of the IORP II Directive.

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1 Directive (EU) 2003/41/EC.

2 Directive (EU) 2016/2341/EC.

**MAIN FINDINGS**

Views differ on how **IORPs’ compliance with the PPR** can be ensured best, by applying:

1. quantitative investment limits/limits on the type of assets IORPs can invest in;
2. the PPR solely; or,
3. a combination of the two above methods.

NCAs’ supervisory approaches towards ensuring IORPs’ compliance with the PPR are to a large extent determined by the manner in which national legislators have embedded the PPR in national legislation.

However, one of the main findings of this peer review is that countries that have adopted a risk-based or a prudent person plus supervisory approach use more sophisticated tools and perform their supervisory activities in a risk-based and forward-looking manner, whilst a compliance-based supervisory approach focuses on past compliance. The peer review also found that NCAs in a compliance-based legal system can enhance their supervision by including risk-based, forward looking tools in their supervisory approaches.

Figure 1 reflects the **supervisory approach** towards PPR by each NCA.<sup>3</sup>

Figure 1 – Types of supervisory approaches towards PPR



At European level, supervisory approaches with regard to the PPR vary depending on the type of schemes and the development of the pension industry. Countries where occupational pension schemes have only recently been introduced have usually introduced quantitative investment regulations (for example in Croatia, Malta, Poland, Slovakia and Slovenia), whereas countries with growing defined contribution (DC) schemes (for example, Austria, Belgium and Italy) have often implemented more qualitative elements in their supervisory approach towards investments.

Some countries, where defined benefit (DB) schemes are predominant, have adopted a supervisory approach of a risk-based and qualitative nature (for example the Neth-

<sup>3</sup> Greece has three NCAs supervising the same IORPs. Therefore, where the report mentions Greece reference is made to the three NCAs. Luxembourg has two separate legal regimes for IORPs and each IORP is authorised and supervised by either the CAA or the CSSF. Therefore, where the report mentions Luxembourg reference is made to the relevant NCA.

erlands and the United Kingdom), whilst other countries have introduced quantitative investment regulations (for example Denmark, Finland and Luxembourg (CAA)).<sup>4</sup>

In countries that have adopted a **risk-based or a prudent person plus supervisory approach**, NCAs usually conduct supervision in a risk-based and forward-looking manner. This is in line with the principles of prudential supervision and compliant with the requirements – listed in the IORP II Directive – that cover the assessment of emerging risks and the adequacy of mechanisms mitigating these risks.

Contrary to this, a **compliance-based supervisory approach** focuses on past compliance and does not require NCAs to apply a forward-looking approach to assess potential risks that may have an impact on the interests of the members and beneficiaries in the future.

A compliance-based approach may be adequate in countries where a pensions industry has just started to develop. Pension markets that are at this stage of development usually require a significant number of ex-ante approvals, as well as extensive and frequent compliance reporting. IORPs in these countries are still developing and assets under management are at a low level. These IORPs are in the process of acquiring relevant expertise and resources. As NCAs need to monitor this process closely, their close involvement is very common.

As a pension market develops further, NCAs' supervisory approaches should also develop, for example from a compliance-based to a more risk-based approach. This in turn implies the use of different supervisory tools for ongoing supervisory purposes, particularly for the PPR assessment.

The manner in which an IORP's compliance with the PPR is supervised depends mainly on the specific context of a national pension market, the predominant type of pension scheme (DB/DC), the size of the IORP and NCA's available resources. Following the mosaic-theory,<sup>5</sup> supervision of the PPR combines several elements, as listed below.

#### ➤ **Basis for the interpretation of the PPR**

- The fitness and propriety of the persons responsible for investments (the Netherlands, Slovenia)
- IORPs' internal investment limits as stated in the statement of investment policy principles (SIPP);
- IORPs' investment and risk management processes;
- IORPs' asset liability management for DB schemes, the liquidity of investments, the monitoring of costs (Italy) and correct valuation (Poland);
- In some countries IORPs are considered to comply with the PPR when quantitative investment limits or suitable asset requirements – as defined in national legislation – are respected (Germany, Spain).

<sup>4</sup> In some countries (e.g. Norway) a risk-based solvency regime comes on top of quantitative investment regulations. Overall and given a different capacity towards guarantees, there is increasing competition from the insurance regime (e.g. Denmark).

<sup>5</sup> CFA Institute: Standards of Practice Handbook, 10th ed., Charlottesville: 2010. Method recognised by the CFA Institute as a valid means of analysis, including both public and non-public data and through both material and non-material sources. See <https://corporatefinanceinstitute.com/resources/knowledge/finance/mosaic-theory/>.

### › **Legal and regulatory framework**

A majority of countries have, in addition to the implementation of the investment rules of Article 18 of the IORP Directive into national legislation, introduced:

- quantitative investment limits for individual assets and eligible asset classes (Austria, Bulgaria, Cyprus, Denmark, Finland, Germany, Hungary, Italy, Latvia, Luxembourg (CAA), Malta, Norway, Poland, Portugal, Slovakia, Slovenia, Spain);
- regulations and guidance related to for example due diligence processes (Austria, Italy), recovery plans (Belgium, the Netherlands), governance of IORPs (Belgium), the SIPP (Ireland) and risk management and reporting requirements (Austria, the Netherlands).

### › **Information gathered for PPR assessment**

- In addition to the information NCAs receive on IORPs' investments through regular reporting on their investment strategies and asset liability management, several NCAs use new information sources. Examples of these new types of information are:
  - the number of trades (Italy);
  - the top 5 individual positions or largest top 10 positions of funds (Germany) within a portfolio;
  - reports from external asset managers in case an IORP has outsourced its asset management (Belgium) and expected returns as reported by the IORP (Belgium).
- From external service providers, e.g. accredited statutory auditors (Belgium), custodians (e.g. Bulgaria, Hungary, Italy, Latvia, Luxembourg, Poland, Spain) and actuaries (Belgium, Finland, the Netherlands, Spain) are often actively involved in PPR-supervision;
- One NCA adopted the practice of storing PPR-related information on an intranet application (Luxembourg (CSSF)).

### › **Supervisory assessment method**

- Use of risk models (Belgium, Bulgaria, Denmark, Finland, Hungary, Latvia, Norway, Portugal), apart from solvency indicators for DB schemes, include information on asset allocations, liquidity risks and risk-adjusted performance measures. Often, risk models also include stress tests that are regularly conducted by IORPs (Denmark, Norway), as well as qualitative information on e.g. IORPs' governance models (Belgium, the Netherlands);
- In order to be able to monitor portfolio diversification, and based upon regular portfolio reporting, a number of NCAs analyse IORPs' SIPPs in order to verify whether the latter comply with their internal investment guidelines (e.g. Italy, Luxembourg (CSSF), the Netherlands, Spain) or with external quantitative investment regulations (e.g. Germany, Spain);
- 'Deep dive' thematic studies, e.g. on valuation (Poland), IORPs' data management in case of outsourcing (Belgium) or EMIR (the Netherlands), are conducted, both off- and on-site;
- Some NCAs carry out specific investment fit and proper examinations in a risk-based manner and on an ad-hoc basis, e.g. by focussing on changes in asset allocations (Luxembourg, the Netherlands, Slovenia);

- The frequency of on-site inspections related to the PPR varies significantly from NCA to NCA, from every 2 to 12 years, with an average of every 3 to 6 years.

#### › **Supervisory actions**

Supervisory actions were taken with regard to:

- concentration risks;
- IORPs' non-compliance with internal or regulatory investment limits (Denmark, the Netherlands, Portugal);
- missing benchmarks (Denmark);
- improper internal transactions (Slovakia);
- insufficient solvency (Norway);
- not meeting fitness or propriety and governance requirements (Portugal, the United Kingdom);
- insufficient risk management and internal control mechanisms (Portugal);
- the improper use of derivatives (Portugal) and valuation (breach of International Financial Reporting Standards (IFRS) rules, Slovenia).

## **RESULTS**

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As a result of this peer review, EIOPA identified a number of best practices, as well as areas where recommended actions are to be taken.

### **BEST PRACTICES**

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EIOPA identified **6 best practices** in relation to the supervisory assessment processes adopted by some NCAs and to the manner in which NCAs interpret the PPR.

The best practices were derived from 38 *sound practices* identified. EIOPA will consider further elaborating these practices at European level in the future in order to improve supervisory convergence in relation to the supervision of PPR.

#### › **Thematic review to identify potential vulnerabilities**

In large and heterogeneous IORP markets, NCAs can perform thematic reviews (both on-site and off-site) that cover a representative sample of all IORPs. Such thematic reviews enable NCAs to identify potential global and local vulnerabilities and track the development of the market. The approach could be labelled as 'proportional plus supervision.'

This best practice has been identified in the FSMA (Belgium).

This supervisory practice is risk-based, proportional, forward-looking and sustainable, optimising supervisory resources in large and complex IORP markets. It enables NCAs to gain insight into the development of the entire market with a reasonable use of internal resources and without putting too much of a burden on supervised entities.

### › **Quantitative indicator to assess quality asset management**

When supervising a non-negligible number of IORPs, NCAs can make use of quantitative indicators, for example in the form of a traffic light system, to assess the efficiency of the turnover of an IORP's assets. This is done with the aim of assessing the performance (and cost efficiency) of asset managers and, if needed to challenge the IORP's management.

This best practice has been identified in COVIP (Italy).

This supervisory practice is risk-based and proportional. Given the size and diversity of the IORP sector in Italy, this practice provides the NCA with an effective means of gaining additional insight into the quality and performance of an IORP's asset management style.

### › **Intranet application for recordkeeping and knowledge sharing**

When supervising a non-negligible number of IORPs, NCAs can establish an intranet application for recordkeeping purposes and facilitate sharing of PPR-related issues within the NCA.

This best practice has been identified in the CSSF (Luxembourg).

This supervisory practice enhances supervisory transparency and accountability. It also promotes cooperation and the exchange of information within an NCA. Given the size and diversity of the IORP sector in Luxembourg, this practice provides the NCA with an effective means of recording PPR-related views and opinions for an IORP, which are accessible to all departments within an NCA. This is an effective way to ensure an integrated approach for the supervision of IORPs and promotes the exchange of 'additional/ qualitative' information with regard to every IORP supervised by the NCA.

### › **Written and oral fit and proper assessment**

NCAs that supervise larger IORPs can ensure a robust fit and proper assessment of management board members (i.e. those responsible for an IORP's investment policy), consisting of a written and oral assessment of the applicants. In this way, NCAs are able to lay down in dedicated guidelines their expectations with regard to the standards for knowledge of investment.

This best practice has been identified in the DNB (the Netherlands).

This supervisory practice is risk-based, proportional and forward-looking. In larger and more complex IORP markets, this practice provides the NCA with an effective means to test the investment knowledge of management board members. This knowledge is screened during the selection stage of new board members, as well as during on-site inspections.

### › **Disclosure of the investment plan and risk appetite by the IORP**

In the absence of external investment limits, NCAs can require IORPs to set their own internal investment limits, taking into consideration their investment horizon and liquidity needs, and to set out in writing how they consider the Prudent Person Rule. A system to regularly receive information on internal limits enables NCAs to benchmark risk appetites, evaluate investment discipline and support PPR compliance checks through the comparison of internal limits to actual investment portfolios.

This best practice has been identified in the DNB (the Netherlands).

This supervisory practice is risk-based and proportional. In larger and more complex IORP markets where no investment limits are set by regulation, this practice provides the NCA with an effective means to assess the performance of the asset management function of IORPs.

#### ➤ **A comprehensive risk assessment system**

In the case of a large IORP market and complex investment portfolios, NCAs can perform a comprehensive, multi-dimensional assessment of an IORP's investment risks in the form of a traffic light system that may serve as a trigger for supervisory actions.

This best practice has been identified in the ASF (Portugal).

This best practice is high quality, risk-based, proportional, forward-looking, sustainable and suitable for enhancing supervisory transparency and accountability. In large and complex IORP markets (i.e. those with open and close-ended pension arrangements, with DB and DC schemes), the system is an effective tool for optimising supervisory resources.

## OVERVIEW OF RECOMMENDED ACTIONS

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EIOPA issues **27 recommended actions, addressing 19 NCAs located in 16 countries**. The proposed recommended actions concern:

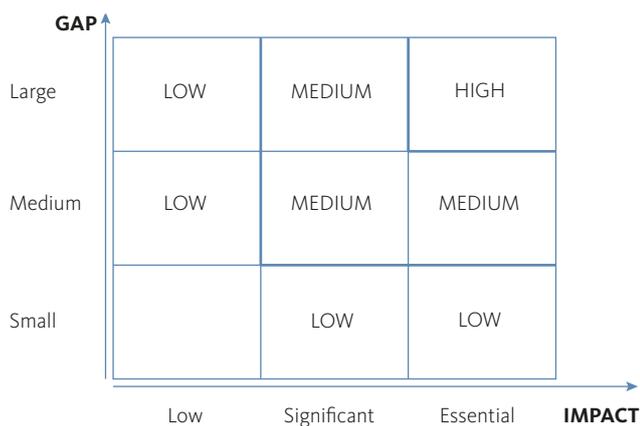
- the frequency and granularity of the data collected;
- the manner in which NCAs conduct their supervisory assessment;
- the regular application of the look-through approach;
- the appropriate consideration of interest rate risks for DB schemes;
- NCAs' supervisory practices with regard to IORPs' governance; and
- the frequency of on-site inspections.

The recommended actions are not equal in terms of importance, ranging from a shortcoming in a rather specific area to overall inadequate supervisory practices, tools or powers. Therefore, the sheer number of recommended actions addressed to a particular NCA should by no means necessarily be considered indicative of its overall supervisory effectiveness.

In terms of importance they differ in terms of gaps to close and their impact on the supervisory assessment:

- A large gap with obstacles for completeness of supervisory assessment and a large difference between what was expected to be covered by the supervisory systems and what is in place to a small gap with a minor potential for incompleteness of the supervisory assessment.
- An essential impact bringing substantial negative consequences posing serious threat to the supervisory assessment to a low impact with almost no potential for negative consequences on the supervisory assessment.

Although the recommended actions are based on the supervisory practices of individual NCAs, a comparison among countries shows that most of the identified supervisory shortcomings are similar for several NCAs. In order to clearly identify supervisory issues and gaps and to prioritise the areas of supervisory convergence, the recommended actions have been grouped by topic and then within each topic ordered by importance (high/medium/low).



High importance indicates a large gap with an essential impact. Medium importance indicates a large or medium gap with significant impact or a medium gap with essential impact. Low importance is a large or medium gap with low impact or a small gap with significant or essential impact. Following a risk-based approach no recommended actions were issued in relation to findings closing a small gap and having a low impact.

Area of recommended action	Authorities concerned	Importance
<b>Supervisory structure and supervisory resources</b>		
The NCA should significantly increase its qualified and expert staff to ensure adequate off-site and on-site supervision of IORPs, in particular an IORP's compliance with the PPR	Registrar of Occupational Retirement Benefit Funds (Cyprus)	High
The three NCAs should assess the efficiency of the current supervisory structure, currently composed of three separate NCAs all dealing with the supervision of IORPs.	Ministry of Labour, Capital Market Commission, National Actuarial Authority (Greece)	High
<b>Information gathering for the assessment and processing of the Prudent Person Rule</b>		
The NCA should develop, as soon as possible, an IT tool that will allow it to receive reporting by IORPs in an automated and secured manner and format.	Registrar of Occupational Retirement Benefit Funds (Cyprus)	Medium
The NCA should introduce more formal reporting obligations for Pensionsfonds (PF).	Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)	Medium
The NCA should receive granular data of the investment portfolios of IORPs currently received by the National Actuarial Authority.	Capital Market Commission (Greece)	Medium
The NCA should regularly receive sufficiently granular information on the portfolio as a whole and to use it for the supervisory assessment of the PPR, enabling the CSSF to identify key exposures of the portfolio as a whole.	Commission de Surveillance du Secteur Financier (Luxembourg)	Medium

<b>Area of recommended action</b>	<b>Authorities concerned</b>	<b>Importance</b>
The three NCAs should work further on creating a single entry point for all regular reporting by IORPs and consequently establish an efficient information exchange between them.	Ministry of Labour, Capital Market Commission, National Actuarial Authority (Greece)	Low
The NCA should introduce automatic data processing for quantitative investment data.	Financial Supervisory Authority (Finland)	Low
The NCA should regularly gather information on the duration of both assets and liabilities, as the mismatch of assets and liabilities is reported by the NCA as the most important trigger for the recovery/de-risking plan.	Pensions Authority (Ireland)	Low
The NCA should regularly collect sufficiently granular information on portfolios as a whole and to use it for the supervisory assessment of the PPR, enabling the FMA to identify key exposures of the portfolio as a whole.	Financial Market Authority (Liechtenstein)	Low
<b>Application of the look-through methodology</b>		
The NCA should regularly collect look-through information for CIVs.	Capital Market Commission (Greece)	Medium
The NCA should establish a regular look-through approach for CIVs, obtaining at least the same level of, if not more, granular data from IORPs or other external sources, regardless of whether the investments are made through Hungarian or foreign CIVs and to use this information for the supervisory assessment of the PPR.	Magyar Nemzeti Bank (Hungary)	Low
The NCA should develop the practice to regularly look-through (off-site and on-site) to ensure that key exposures and allocations of CIVs are analysed and assessed on a regular basis.	Finanzmarktaufsicht (Austria)	Low
The NCA should extend its look-through approach to CIVs further, by collecting more granular information on a regular basis.	Financial Services and Market Authority (Belgium)	Low
The NCA should develop the practice to regularly look-through (off-site and on-site) to get an insight into the exposures and allocations of CIVs and to use this for the supervisory assessment of the PPR.	Finanstilsynet (Norway)	Low
The NCA should develop the practice to regularly look-through (off-site and on-site) to get an insight into the exposures and allocations of CIVs and to use this for the supervisory assessment of the PPR.	Komisja Nadzoru Finansowego (Poland)	Low
The NCA should develop the practice to regularly look-through (off-site and on-site) to get an insight into the exposures and allocations of CIVs and to use this for the supervisory assessment of the PPR.	Nationa Bank of Slovakia (Slovakia)	Low
The NCA should develop the practice to regularly look-through (off-site and on-site) to get an insight into the exposures and allocations of CIVs and to use this for the supervisory assessment of the PPR.	Insurance Supervision Agency (Slovenia)	Low
<b>Supervisory assessment of Prudent Person Rule related issues</b>		
The NCA should integrate the two developed scoring models with a quantitative risk assessment framework into its PPR assessment framework	Hrvatska agencija za nadzor financijskih usluga (Croatia)	High

Area of recommended action	Authorities concerned	Importance
The NCA should consider reinsurance agreements in view of PPR assessments (e.g. notification of contracts including terms and conditions).	Commissariat aux Assurances (Luxembourg)	Medium
The NCA should provide evidence of the negative impact of the legal requirements that allow IORPs to reduce the contribution rate, in order to start a discussion with the legislator on the potential changes to the legislation regarding the assumptions used by IORPs.	De Nederlandsche Bank (the Netherlands)	Medium
The NCA should ensure supervision of assets beyond technical provisions (surplus) and consider whether the investments of the surplus are in the best interest of members.	Financial Supervisory Authority (Finland)	Low
<b>Supervisory tools</b>		
The NCA should provide more focus in its supervisory assessment of interest rate risk to ensure a prudent computation of liabilities and a more prudent assessment of asset liability matching.	Financial Supervisory Authority (Finland)	Medium
<b>Governance</b>		
The NCA should strengthen the supervision of the governance system of IORPs by assessing it on a regular basis instead of on an ad-hoc basis and in order to ensure a systematic check of governance issues.	Finanstilsynet (Norway)	Medium
For small IORPs, the NCA should strive to set requirements on the fitness of members of the administration committee.	Registrar of Occupational Retirement Benefit Funds (Cyprus)	High
<b>On-site inspections</b>		
The NCA should start setting up on-site inspections of IORPs, including for PPR-related activities and in particular for larger IORPs.	Registrar of Occupational Retirement Benefit Funds (Cyprus)	High
The NCA should increase its inspection cycle (currently 7 – 12 years) to conduct more on-site inspections, depending on the risk categorisation tool.	Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)	High

According to the Methodology, NCAs that have strong objections to findings related to their supervisory practices or to recommended actions towards their authority have the right to submit a written statement. For this peer review the Bundesanstalt für Finanzdienstleistungsaufsicht (Germany) submitted a statement regarding the frequency of on-site inspections and is included in the annex of the full report.

**The 3 actions to be undertaken by EIOPA** aim to ensure that the work on improving supervisory practices with regard to the supervisory assessment of the PPR will continue at a European level). These actions concern the inclusion of more qualitative elements in supervision, a more detailed investigation into the intensity of PPR-related supervision and further identification of best practices, based on the sound practices identified through this review.

## FOLLOW UP AND NEXT STEPS

As follow-up to this peer review, NCA compliance with the recommended action will be assessed, as foreseen in the Methodology.

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