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IORP II in a Nutshell: What is the Holistic Balance Sheet?

1. EIOPA nutshell notes for non-expert readers aim to facilitate understanding and to provide a sound basis for discussion on policy and regulatory issues relating to occupational pensions and insurance, such as the revision of the IORP Directive (IORP II) and Solvency II.
2. This nutshell note outlines the concept of a holistic balance sheet approach as proposed in EIOPA's advice to the European Commission on the Review of the IORP Directive.
3. The European Commission announced on 23 May 2013 that its forthcoming legislative proposal for a revised IORP Directive would not cover solvency rules for IORPs and that further work in this area was necessary.[1]
4. EIOPA is currently, on its own initiative, conducting further work to improve methodologies and specifications for assessing the holistic balance sheet.

Background of the holistic balance sheet

5. In April 2011 the European Commission asked EIOPA to provide advice on the review of the IORP Directive.[2] The aim of the Commission was to introduce a risk-based prudential regime for IORPs that achieves "a level of harmonisation where EU legislation does not need additional requirements at a national level."
6. The Commission's objectives are to encourage cross-border activity of IORPs, allow IORPs to benefit from risk-based supervision while ensuring regulatory consistency between and within sectors and to modernise the prudential regulation for IORPs that operate DC schemes.
7. According to the European Commission's Call for Advice the new IORP Directive should consist of three interacting pillars:

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[1] European Commission, Occupational Pension Funds (IORP): Next Steps, Memo, 23 May 2013, Brussels.
[2] European Commission, Call for Advice from the European Insurance and Occupational Pensions Authority (EIOPA) for the Review of Directive 2003/41/EC (IORP II), 30 March 2011, Brussels.

I. Quantitative requirements on the valuation of assets and liabilities and the solvency capital requirement;

II. Qualitative requirements relating to governance and the supervisory review process;

III. Transparency requirements regarding information disclosure to supervisors and members and beneficiaries.

8. On 15 February 2012 EIOPA published its response to the Call for Advice containing recommendations on all three pillars.[3] A key element of EIOPA's advice on the quantitative requirements in pillar I is the so-called holistic balance sheet. The aim of the holistic balance sheet is to create a common tool for a European prudential framework, while taking into account the diversity in national occupational pension systems.

Diversity of national occupational pension systems

9. IORPs in Europe provide a wide variety of occupational pension schemes, which are subject to a broad spectrum of risk-sharing mechanisms. These different kinds of IORPs are in turn subject to a wide variety of regulatory regimes applied at the national level.

10. IORPs allocate the demographic and financial risks of occupational pension commitments in different ways. The risks may be borne by the institution itself, the sponsoring undertaking, the members and beneficiaries or any combination thereof. As such, IORPs use different security mechanisms, such as solvency capital, sponsor support, pension protection schemes, and benefit adjustment mechanisms, such as conditional indexation, for-profit mechanisms and the possibility to reduce accrued benefit as a measure of the last resort.

11. The present IORP Directive sets out a number of minimum requirements that can be supplemented by member states in national prudential regulation. The directive prescribes that valuation methods and assumptions for establishing technical provisions should be chosen prudently. The discount rate must lie between the market yield on high-quality government bonds and the expected return on assets. As a result, member states use different discount rates, mortality tables and reserving methods for wage and price indexation.

12. The IORP Directive specifies as a funding requirement that IORPs should have sufficient assets to cover the value of technical provisions. Pension funds where the sponsor bears all the risk do not have to hold additional capital buffers. IORPs that cover all risks themselves are subject to a regulatory own funds requirement. However, this capital requirement only takes into account demographic risks and not financial market risk, such as equity and interest rate risk. Therefore, a number of countries have imposed additional risk-based capital requirements.

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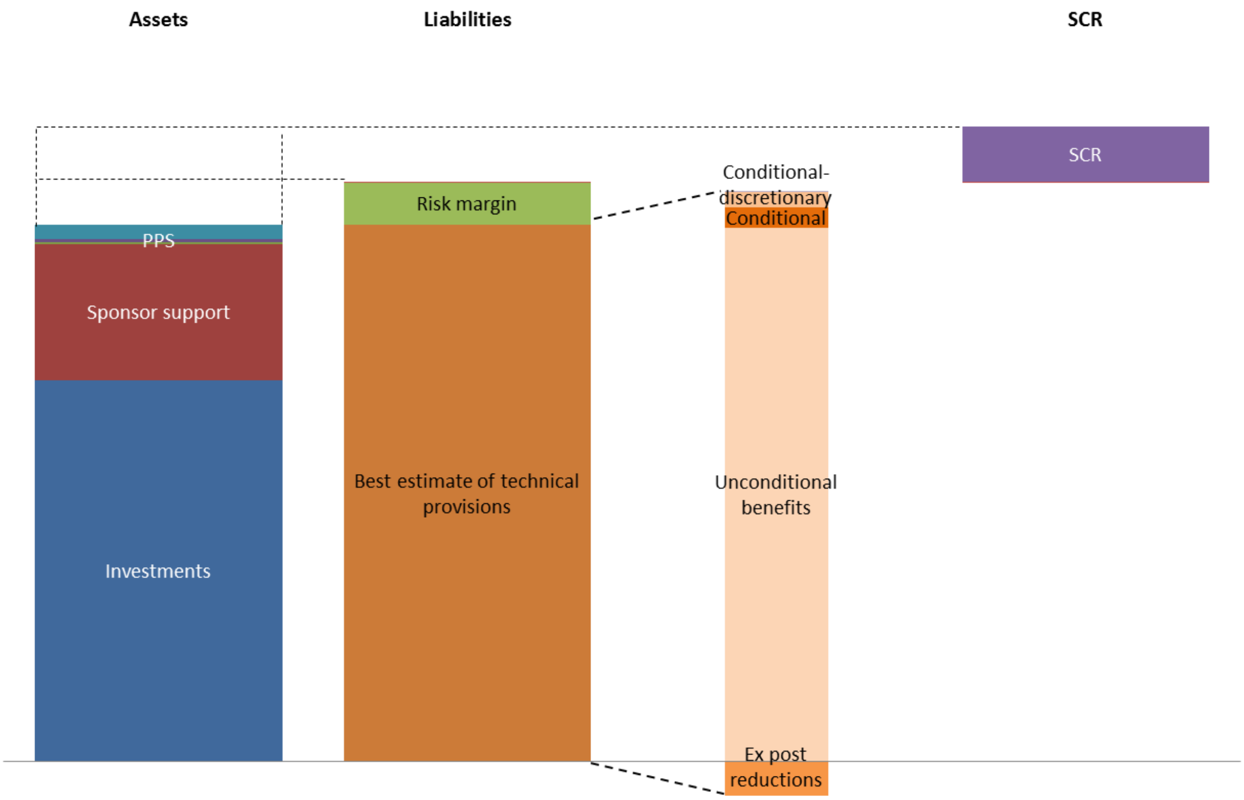
[3] EIOPA, EIOPA's Advice to the European Commission on the review of the IORP Directive 2003/41/EC, EIOPA-BoS-12/015, 15 February 2012, Frankfurt am Main.

Contents of the holistic balance sheet

13. EIOPA proposed the holistic balance sheet as a tool to support the development of a single, European regulatory regime that accommodates national pension schemes, as defined by national social and labour law and decided upon by employers and the social partners. The holistic balances sheet captures these national specificities by allowing IORPs to include explicitly all security and benefit adjustment mechanisms:

- On the asset-side, the value of sponsor support and pension protection schemes (PPS) may be recognised besides the value of investments;
- On the liability-side, various types of pension obligations – unconditional, conditional and discretionary benefits – may be included in the best estimate of technical provisions as well as possible benefit reductions.

14. Example of holistic balance sheet



15. All assets and liabilities on the holistic balance sheet have to be valued on a market-consistent basis, i.e. making use of and being consistent with information provided by financial markets. Market-consistency is an objective measure to achieve a comparable and realistic view of an IORP's financial situation. The concept of market-consistency is not without challenges though, as – for example – not all obligations can be replicated on financial markets. To establish a market value for such non-hedgeable obligations, the holistic balance sheet includes a risk margin on top of the best estimate of technical provisions. It represents the cost-

of-capital of underwriting these obligations in case of a hypothetical transfer to an insurer.

16. The holistic balance sheet provides for a transparent view of the extent to which pension obligations can be supported by financial assets and security mechanisms as well as the extent to which benefit adjustments may occur in the future. It does not only compare assets and liabilities under 'normal' circumstances, but also in stressed situations by means of the solvency capital requirement (SCR). The SCR measures whether IORPs have sufficient financial capital, security mechanisms and/or benefit adjustment mechanisms to absorb demographic and financial shocks given a certain level of confidence.

Quantitative impact study (QIS)

17. The European Commission requested EIOPA to carry out a quantitative impact study (QIS) to collect information on the financial impact of the holistic balance sheet on IORPs. This QIS exercise was conducted between mid-October and mid-December 2012 in seven European countries where the provision by IORPs of defined benefit and hybrid pension schemes is most dominant. The QIS contained eighteen scenarios testing different ways of establishing the holistic balance sheet and calculating the solvency capital requirement.
18. The overall impact of the holistic balance sheet approach varies widely between participating countries. The impacts range from surpluses for IORPs in some member states to large shortfalls for IORPs in other member states. This demonstrates that the minimum harmonisation approach of the current IORP Directive has resulted in large differences in the protection of members and beneficiaries across Europe.
19. The outcomes also reveal that pension funds are vulnerable in different places. IORPs in some member states are very dependent on future payments by the sponsor. It is not uncommon for future sponsor support to cover as much as 25% of liabilities. IORPs in other member states expect the need for substantial future benefit reductions up to as much as 75% of liabilities.
20. EIOPA concluded in its final report that the QIS demonstrated the need to continue working towards a market-consistent and risk-based regulatory regime for Europe that takes into account the specificities of occupational pension provision.[4]

Further work on holistic balance sheet

21. The QIS did not constitute a full assessment of a comprehensive supervisory framework. A supervisory framework does not only comprise of the prudential balance sheet, but also of a set of responses by supervisors. However, the technical specifications for the QIS did not model the timing of sponsor support and benefit adjustment mechanisms and the nature of recovery plans.

[4] EIOPA, Report on QIS on IORPs, EIOPA-BoS-13/124, 4 July 2013, Frankfurt am Main.

22. The QIS also demonstrated that definitions and methodologies for establishing the holistic balance sheet need further work. Stakeholders already raised a number of issues during the public consultation on the draft technical specifications, which could not be satisfactorily resolved before the start of the QIS exercise. The QIS confirmed many of these issues, but also identified some new areas for further scrutiny.

23. Last year, EIOPA commenced on a programme of own initiative work to improve definitions and methodologies for implementing the holistic balance sheet. The programme consists of five specific workstreams:

    I. Valuation of sponsor support;

    II. Supervisory responses;

    III. Valuation of discretionary decision-making processes;

    IV. Definition and valuation of benefit reduction mechanisms;

    V. Boundaries for cash flows to be included in technical provisions.

    Together with the final report on the QIS on IORPs, EIOPA already published a discussion paper on the valuation of sponsor support in July 2013.[5]

24. EIOPA intends to release the results of these five areas of further work for a public consultation at the end of September 2014. The ultimate aim is to present the next European Commission with further tested technical proposals for a market-consistent and risk-based prudential regime for Europe.

[5] EIOPA, Discussion Paper on Sponsor Support Technical Specifications, EIOPA-13/322, 4 July 2013, Frankfurt am Main.