



## **KEYNOTE SPEECH**

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# **Reshaping the occupational pensions system in Europe**



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Ladies and Gentlemen,

It is with great pleasure that I have accepted the invitation of the National Association of Pension Funds to talk to this knowledgeable audience about how to reshape and improve the occupational pensions system in Europe. This subject has become very current especially this year after the European Commission published its White Paper "An agenda for **adequate**, **safe** and **sustainable** pensions" and when EIOPA submitted to the Commission its Advice on the review of the IORP Directive.

In my presentation today I will start by outlining the reasons for a change in the occupational pensions system, present you with EIOPA's proposals and its activities in this area and finally share with you some thoughts about the challenges and opportunities that we have in front of us.

### **Why do we need reforms?**

One of the main reasons why the reform of the pension systems became unavoidable is a consistently (some may say rapidly) aging population in the European Union. According to the research of the Organisation for Economic Cooperation and Development (OECD), elderly population in OECD countries has increased more than 1.5 times faster than the total population between 1995 and 2008. In around 30 years we will face another challenge when the "baby boom" generation approaches retirement age.

In its White Paper the Commission stated that "unless women and men, as they live longer, also stay longer in employment and save more for their retirement, the **adequacy** of pensions cannot be guaranteed as the required increase in expenditure would be **unsustainable**".

In some countries the problem has been already acknowledged. Here in the UK you have recognised these demographical, social and economic challenges that are ahead of the British citizens. This month's introduction of the pension auto-enrolment in the UK is a relevant response to the risks associated with providing **adequate**, **safe** and **sustainable** pensions. In the different EU member states the measures differ but we have a common goal and none of us should deny the economic, social and

demographic reality. We need all to be proactive, pragmatic and sensible in our solutions.

We all do realise that in the absence of changes, in some years we may face a sudden lowering in the value of pensions for members and beneficiaries, higher concentration of costs for employers and ultimately intergenerational conflicts. Furthermore, the switch from defined benefit pension schemes (DB) to defined contribution (DC) schemes is an undeniable fact. Not so long time ago in January 2009, NAPF rightly noticed that in the UK more than 50% of DB schemes could close to new members as a result of the economic crisis. As per the Purple Book from 2011, 58% of schemes are now closed to new members.

This crisis surely does not help to improve situation or moods in the pensions' world. Therefore, the need for pension systems' reforms and particularly for the review of the IORP Directive **from 2003** is undeniably justifiable.

The main objectives of the review of the IORP Directive are to create a Single Market for occupational retirement provision by facilitating cross-border activity (at the moment there are only 84 cross-border operating IORPs in the EU) and by developing risk-based supervision. But there are also other reasons why this revision could be beneficial for members, beneficiaries, employers and IORPs e.g. promoting long term investments or contributing to sustainability of public finances.

### **EIOPA's Advice**

Let me now mention key details of our advice which should be considered as a whole package and not only a recommendation for capital requirements.

For the vital issue of **governance** EIOPA advises that there should be a common level of principles and that Solvency II is a good starting point for further review of the IORP Directive. Obviously, the importance of proportionality must be emphasised in this area. Robust governance is crucial for the members and beneficiaries of the occupational pension schemes. It is essential that those who run IORPs are individuals of competence and integrity. Therefore, they should be fit and proper and also IORPs should be subject to robust internal and external controls in areas such as risk management, internal control and audit, appointments of a custodian and a depository.

For the cross-border activity both employers and employees will gain from making it easier to offer Pan-European pension schemes. Also, developing the internal market will be easier and quicker with convergence towards common standards and processes both in respect of IORPs themselves and also in how they are supervised. That is why it is important to mention that among 23 areas covered in the Call for Advice, EIOPA was also asked to advise on supervision, which demonstrates our duty to contribute to supervisory convergence.

Our Advice on supervision includes:

- a set of principles on ring fencing of assets and liabilities to be applied by supervisors where schemes are operating cross-border;
- protection of members and beneficiaries and sound and prudent management of IORPs should be expressly stated as the main objectives of supervision and should be included in the revised IORP Directive;
- potential pro-cyclical impact of their decisions should be considered by supervisors; this of course is an area where the coordination of decisions at an European level may be particularly effective;
- a common set of principles for supervision: that supervisors should take a prospective and risk-based approach, and that there should be proportionality in implementation of these principles;
- supervisors should be transparent in their conduct and carry out their duties in an accountable manner. The governance structures and processes of supervisors should also be transparent;
- increased harmonisation of information to supervisors would be appropriate under a revised IORP Directive. Supervisory convergence is in EIOPA's view a process that is not separated from EIOPA's principal objective of protecting occupational pension scheme members and beneficiaries;
- supervisors should have the power to carry out stress tests on IORPs.

### **Protecting interests of members and beneficiaries**

Let me now switch to the crucial aspect of providing the **information** to members and beneficiaries of defined contribution pension schemes. I consider this a fundamental part of the advice. There are already today nearly 60 million Europeans who rely on DC pension provision. Shift from DB to DC is, as I mentioned before, unquestionable.

Members of defined contribution schemes bear on their shoulders many risks (market, longevity, inflation) and are asked or have the right to make choices at individual level. Therefore, they need to be well informed before they make their pension-related decisions.

EIOPA states in its Advice that the information in defined contribution schemes should be: **correct, understandable** and **not misleading**.

Let me clarify these three features in more detail:

- “**Correct**” implies that the information provided should be regularly updated, in particular after substantial changes have been made to the scheme;
- “**Understandable**” means that all information documents are written in a way and have a lay-out that has proven to be clear and understandable and hence useful for people;
- “**Not misleading**” implies that members should not receive information which gives them an unjust impression of the functioning of the pension scheme.

EIOPA also believes that it will be useful to introduce a requirement of a pre-enrolment information document – the Key Information Document (KID).

In particular, such a **KID** could contain the following elements:

1. an identification of the IORP;
2. a brief description of the objectives and investment policies;
3. information on performance;
4. costs/charges;
5. a risk/reward profile and/or the time horizon adopted for the investment policy;
6. contribution arrangements and in particular contribution commitments of an employer and an employee as a percentage of the salary;
7. practical information, allowing Member States to add country-specific information;
8. cross-references to other relevant documents that are also available to members.

I am convinced that this Key Information Document will be a huge step towards more transparency and confidence in the occupational pensions’ field. However, it is not EIOPA’s intention to diminish standards in those Member States where substantial requirements (to provide information to members) already exist.

## Capital requirements and HBS

Finally, let me turn to another important and so far the most debated aspect of the Advice: capital requirements and the holistic balance sheet.

EIOPA's starting point is the protection of members and beneficiaries. We believe that all occupational schemes throughout Europe should have sufficient resources to meet their pension promise under a reasonable but realistic and transparent framework.

We have abundant lessons from the consequences of ignoring the economic-based value of assets, liabilities and the inherent risks. Therefore, EIOPA supports the following principles for the valuation and capital requirements of IORPs:

- **Transparency** i.e. the derivation of how a valuation was reached should be clear;
- **Comparability** – it should therefore be possible to compare the valuation of one IORP's liabilities with another, and likewise the value of the assets which support that liability;
- **Comprehensiveness** – all potential security mechanisms (regulatory own funds, sponsor support, pension protection funds) similarly as various adjustment mechanisms (conditional indexation, reduction of accrued rights) should be included in an explicit way.

Consequently, EIOPA recommends that:

- Valuations should be **market consistent**;
- The valuation should include the **actuarial value of all enforceable obligations** of the IORP;
- The "**holistic balance sheet**" should be the means in principle of including all security mechanisms;
- The adoption of the holistic balance sheet in practice is subject to further investigation and in particular, the development of a methodology for the quantification of the security mechanisms, and whether that methodology is cost effective;
- The "holistic balance sheet" approach reflects different means by which pensions throughout Europe provide security for their members. In some Member States for example the sponsoring employer plays a key role and this

should be recognised; in others pension protection schemes play an important part.

We are of the view that a “holistic balance sheet” is the right way forward in ensuring a future risk based supervisory and regulatory framework for IORPs. This supervisory tool allows recording and measuring on a market consistent basis the obligations and resources (including both assets and security mechanisms) of an IORP.

The “holistic balance sheet” should be seen as a prudential supervisory assessment tool rather than a “usual” balance sheet based on generally agreed accounting standards. It includes all economic exposures and also considers conditional, discretionary or contingent elements like various security and adjustment mechanisms.

### **Next steps - the QIS**

It is important to note that aspects of our Advice, particularly in relation to the “holistic balance sheet”, have been made conditional on the results of the Quantitative Impact Study (QIS) exercise, which is scheduled for mid-October to mid-December 2012. Before launching the QIS we conducted a public consultation on technical specifications. The aim of the technical specifications is to provide guidance to IORPs participating in the QIS to perform the necessary calculations.

We are grateful for the numerous responses received during the consultation which allowed us to improve the specifications, namely by introducing more simplifications and reducing complexity. We have developed helper tabs that will assist IORPs in valuing the sponsor support and pension protection schemes and calculating the capital requirement for a number of risks. All of this will facilitate the participation in the exercise of small and medium size IORPs.

We have launched the QIS exercise yesterday and we expect to finalise the report on its findings in spring 2013.

There are nine countries participating in the QIS on a voluntary basis: Belgium, France, Germany, Ireland, the Netherlands, Norway, Portugal, Sweden and (last but not least) the United Kingdom. These countries represent the huge majority of defined benefit pension plans in the EU.

The technical specifications are the same for all countries, but there is a level of freedom in conducting the actual QIS exercise. In some countries the QIS is performed by IORPs, in others by supervisory authorities.

The QIS exercise will only assess the financial impact on IORPs of valuing assets and liabilities in the holistic balance sheet and introducing a solvency capital requirement (SCR) under various policy options of the EIOPA's advice. However, the results will feed into the European Commission's impact assessment of all costs and benefits accompanying its legislative proposal.

It is important to mention that the QIS should not be viewed as a complete assessment of the practicality of the holistic balance sheet, and that further modeling will be needed. In particular in the area of the quantification of the sponsor support EIOPA continues to work on an improved methodology. Furthermore, work continues to be done on the ways to adjust the discount rate to take into account the long-term nature of pension liabilities. Therefore, EIOPA is working under the assumption that further assessments will be undertaken.

### **The way forward – challenges and opportunities**

The review of the occupational pensions Directive is definitely one of the most challenging projects in the EU agenda. But we should also be aware of the opportunities that such a reform can bring to the EU pensions landscape.

#### **Challenges:**

- To develop a set of balanced supervisory responses to the holistic balance sheet
- To develop a prudent risk-based supervisory approach while incentivizing sustainable long-term investment by IORPs
- To apply sound and robust governance requirements in a proportionate way

#### **Opportunities:**

- Contribute to increase the feasibility and sustainability of defined benefit pension promises by recognizing for supervisory purposes the various security and adjustment mechanisms present in the different systems



- Create appropriate incentives for the establishment of investment policies that reflect a sound diversification of assets and risks
- Reinforce the application of good practices of risk management throughout the EU pensions industry
- Increase the overall public confidence in defined contribution plans by improving the quality and timeliness of the information provided to members and beneficiaries about the risks that they run

## **Conclusion**

The revision of the IORP Directive is an important reform for all EU citizens. I believe that creating conditions to increase the **sustainability** of the occupational pension systems is a fundamental element in the overall pensions' policy measures in the EU. We cannot continue using valuations and risk assessments that deny economic reality. We need to create better management of risks that would reflect true risks that different stakeholders are running. Naturally, this needs to be done via consultations and dialogues with all impacted parties. We need sufficient time for testing and finding the most suitable solutions; at the same time we need to thoroughly look at transition periods for schemes which are already in place. This is going to be challenging but I am confident that we will succeed. So let's start building the future now, let's create "game-changing pension reforms" in the European Union that would benefit us, our children and the next generations. Let's do that together.

Thank you for your attention.