SPEECH

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How to ensure sustainability, strong governance and full transparency in occupational pensions?

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

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Ladies and Gentlemen,

I am pleased with the invitation to participate in this important Conference on "Occupational Pension Plan Management". Occupational pensions are one of the cornerstones of the European pension system and one of EIOPA's top priorities.

In my speech I would like to provide an update about the action and initiatives of EIOPA that are related to the pensions area and to share with you some thoughts about the opportunities that we have in front of us.

The EU pension reforms

Pension issues are definitely on the EU agenda especially after the European Commission published in 2012 its White Paper "An agenda for adequate, safe and sustainable pensions". In the different EU member states the economic, social and demographic reality calls for action on the design, structure and regulation of the pension systems. There is an overall understanding of the reforms needed but there is much to do on the way to implement them.

One of the general conclusions is that complementary retirement savings have to play a greater role in securing the future adequacy of pensions. But the 2nd and 3rd Pillar regimes have their own challenges. The crisis has highlighted the vulnerability of funded pension schemes to financial crises and economic downturns and the cost-effectiveness and transparency of some personal pension schemes have been put in question.

Therefore, it is of the utmost importance that the EU pension reforms include a review of the regulatory framework to ensure the sustainability, strong governance and full transparency of the supplementary pension schemes. In my view this is a crucial step to ensure the citizens' confidence in the private pension regimes.

EIOPA is keen to contribute to the development of these fundamental elements in the EU pensions agenda.

EIOPA Advice on the IORP Directive Review

EIOPA's advice to the EU Commission can in fact be seen in the light of the above three main objectives: sustainability, strong governance and full transparency.

Let me start by **sustainability**, certainly the most controversial one.

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) as well 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, that they should include the actuarial value of all enforceable obligations of the IORP and that there should be a risk-based solvency requirement.

In order to implement these principles we developed the concept of the “holistic balance sheet”. Nevertheless, 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. That was one of the purposes of the quantitative impact study (QIS).

The QIS exercise was conducted from mid-October until mid-December 2012. There were eight countries participating in the QIS on a voluntary basis. These countries represent over 95 per cent of defined benefit pension plans in the EU.

National authorities had considerable freedom in conducting the QIS exercise. In some countries the QIS was performed by IORPs, in others by the supervisory authority or by a combination of both. Overall, about a hundred pension funds took part in the exercise. This may be a small number, but the participating IORPs represented in general a substantial proportion of the national pensions sector in terms of assets. Here, in Germany, for example, the nearly forty participating IORPs represented a market share of around three quarters in terms of assets.

I would like to take this opportunity to thank all participating *Pensionsfonds* and *Pensionskassen* for contributing to the QIS exercise. I suspect there are some representatives of them among us. There has been a lot of discussion on the holistic balance sheet approach and there is no doubt in my mind that the calculations you did will bring this discussion to a higher level.

Before I go on any further, I would like to say that I cannot provide you with any quantitative outcomes of the QIS exercise today. Over the past months the national authorities and EIOPA have put a lot of effort in validating all the QIS results. At the moment, we are working on a set of preliminary results to be sent to the European Commission by the end of March. We expect to publish a final report on the QIS results by the end of June.

Although I will not present any numbers, I do want to make some observations.

The QIS is in my view a first step in making the balance sheets of IORPs across Europe more comparable and transparent.

At the moment, pension liabilities are calculated using a variety of discount rates in different countries, like the expected return on assets, fixed discount rate or government bond yields. In the QIS all IORPs were expected to value liabilities on a market-consistent basis. Market-consistency is an objective measure that provides a transparent view of the financial position of IORPs.

But, of course, market valuation is not without its challenges. That it is why, I think it is important that several adjustments to the risk-free interest rate were tested that take into account the long-term nature of occupational pension commitments. Participating IORPs had to test the so-called counter-cyclical premium and two versions of the matching adjustment. I think it will be worthwhile to further develop these long-term adjustments and tailor them to the specific features of IORPs.

IORPs also had to calculate the so-called Level B best estimate of technical provisions based on the expected return on assets. EIOPA's advice identified this Level B as a possible minimum threshold for covering liabilities with financial assets. Its role in the supervisory framework underlying the holistic balance sheet will have to be further specified together with other supervisory responses, like recovery periods.

Another important element of the QIS was the valuation of sponsor support and pension protection schemes on the asset side of the holistic balance sheet. This will have been particularly challenging, since it is an area that is largely unexplored.

Last year's public consultation on the technical specifications of the QIS already identified a number of issues, in particular with regard to unrated sponsors, multi-employer schemes, subsidiaries of companies and not-for-profit organizations. EIOPA has initiated further work on sponsor support and aims to publish a report with revised specifications by the end of June, together with the final report.

I would like to emphasize that the QIS was the first occasion for IORPs – but also for supervisors – to explore the practical application of the holistic balance sheet. For a number of reasons it is fair to assume that there will be considerable variation in the QIS results.

The inconsistencies encountered during this QIS need to be carefully mapped, so that they can be improved upon in future QISs. I think that the next exercise can be considerable less extensive with regard to the number of scenarios being tested and provide better guidance and more simplifications. A less elaborate QIS will not only allow for a greater focus on quality – instead of quantity - but also for a greater number of IORPs to participate.

Secondly, EIOPA's advice recommends a number of elements to reinforce the **governance** of IORPs.

EIOPA advises that there should be a common level of governance 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.

Sound risk management practices including the performance of an own risk and solvency assessment are crucial for strong governance of IORPs.

Thirdly, EIOPA's advice deals with **transparency** issues.

EIOPA advises that the information in pension schemes should be correct, understandable and not misleading. For defined contribution schemes EIOPA 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 information about the objectives and investment policies, performance, costs and charges, contribution arrangements and a risk/reward profile and/or the time horizon adopted for the investment policy.

I am convinced that this Key Information Document will be a huge step towards more transparency and confidence in the occupational pensions field.

This year EIOPA made another step towards a better information disclosure – we published the Report on Good Practices related to the provision of information for Defined Contribution (DC) schemes. In our report we called for a new approach to information disclosure in the context of the changes being made to pension systems throughout the EU.

It is a fact that with the move from DB to DC non-professional scheme members need to increasingly cope with risks previously managed by professionals. But current methods of information provision, focused on protecting the provider rather than helping the individual, lag behind this trend.

We advocate the use of behavioural economics for the information provision, focusing on the needs of an individual, to motivate, support and facilitate effective decision making by scheme members.

Behavioural economics tells us that people on average, are not as rational as we have expected them to be, or, to borrow the term – they are not *homo economicus*. People usually have limited time and motivation to be involved in long-term retirement planning; they do not like complexity, often use rules of thumb to process information quickly and are often satisfied if decisions lead to suboptimal results as long as they are reasonable. They prefer certainty, are unreasonably optimistic, put short-term interests first and have limited self-control to save for later. But, at the same time people are concerned about their future income in retirement: Will it be enough? If not, how much will the shortfall be? And what can they do to improve their pension situation?

So in our view, in order to be effective, information needs to be able to answer these basic questions while taking human characteristics into account. First of all, policymakers should think through the behavioural purposes of the information they are drafting: what should an individual be able to do with the information? What sort of financial decisions or choices should he make after reading the information?

EIOPA also suggests that information is presented in layers. The first layer should provide answers to key questions, such as: Do I need to adjust my current retirement strategy? Do I need to make any financial decisions? How much pension income can I expect from this scheme – will it be sufficient and can I bear the risk? What can I do to adjust my retirement planning and how? More complex information should be provided in subsequent layers for those who are interested. Legal information should be accessible as well, but in comprehensible and relevant language.

We hope that our Report will encourage those responsible for pension scheme communications to provide clear, member friendly and comprehensible information that guides and supports European citizens in effective retirement planning.

The way forward – challenges and opportunities

The review of the IORP Directive is definitely one of the most challenging projects in the EU agenda. To build a risk-based supervisory regime is extremely challenging, especially with the low interest rate environment that we live in. Nevertheless, I believe that this reform also brings huge opportunities to the EU pension landscape.

It can contribute to increase the feasibility and sustainability of DB schemes by recognising for supervisory purposes the various security and adjustment mechanisms present in the different systems. It can create appropriate incentives for the establishment of investment policies that reflect a sound diversification of assets and risks. It can reinforce the application of good practices of risk management throughout the EU pensions industry. Overall it can increase the public confidence 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. There are fundamental principles of sustainability, strong governance and full transparency that need to be pursued. These principles are unequivocal but they need to be implemented in close cooperation and dialogue with the different stakeholders, with sufficient time for testing and finding the most suitable solutions.

I am confident that we will update the EU regime in a way that will foster the development of further 2^{nd} pillar schemes for the benefit of employers and employees.

EIOPA is committed to achieve this goal. Together we will succeed in building up a pension system that would benefit us, our children and the next generations.