



**GROUPE CONSULTATIF ACTUARIEL EUROPEEN**  
EUROPEAN ACTUARIAL CONSULTATIVE GROUP

**SECRETARIAT, NAPIER HOUSE, 4 WORCESTER STREET**

**OXFORD OX1 2AW, UK**

TELEPHONE: (+44) 1865 268 218 FAX: (+44) 1865 268 244

E-MAIL: [mlucas@gcactuaries.org](mailto:mlucas@gcactuaries.org)

WEB: [www.gcactuaries.org](http://www.gcactuaries.org)

# **Security in occupational pensions**

**Report of working party**

**SUMMARY**

**May 2010**

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The Groupe Consultatif wishes to thank the following members  
of the working party for their contributions

Chinu Patel, UK (Chair)  
Jane Beverley, UK  
Jeroen van den Bosch, Netherlands  
Deborah Cooper, UK  
Richard Herrmann, Germany  
Niels Kortleve, Netherlands  
Christoph Krischanitz, Austria  
Jitske van Londen, Netherlands  
Konrad Niklewicz, Switzerland  
Philip Shier, Ireland

Job Stigter (Netherlands) and Deborah Cooper, assisted by various  
working party members, compiled the supplementary paper: [\*Survey of  
pension security in some European countries\*](#)

Eduard Ponds (Netherlands) and Job Stigter attended the first meeting of  
the working party but were not members of the working party. Jacqui  
Woodward (UK) substituted for Jane Beverley on a number of occasions.

Any views expressed in this paper are the personal views of the working  
party members and should not be read as being representative of their  
employers or professional organisations.

# SECURITY IN OCCUPATIONAL PENSIONS

## European pensions landscape

- 1.1 Occupational pension funds fulfil an important socio-economic role. Hardly a day goes by without a major pension story in the European press which, at its heart, has concerns about the sustainability of long term pension provision to meet the dual challenges of maturing economies and ageing populations. In many European countries with highly developed pensions systems, pension funds also have an important influence on the stability of their financial systems. Appropriate prudential treatment for pensions is therefore recognised to be of prime importance, but what form should it take?
- 1.2 The principles of partnership, flexibility and subsidiarity appear to be fundamental for co-operation between member states. We make the assumption that these principles are here to stay since they are already embedded in social and labour law all across Europe. Whilst some form of equalisation at the EU level to bring greater homogeneity in pensions is always a theoretical possibility, we believe the practical problems of doing so would be considerable. The design of pension schemes, IORP structures and practices has evolved, and we believe will continue to evolve, around the objectives and constraints of nationally decided social and labour law. Any reforms to improve the security of occupational pension benefits will need to have the flexibility to respect this.
- 1.3 We therefore think that it would be more helpful to focus on the wider concept of pension security which we define as a combination of financial and behavioural tools, some qualitative and others quantitative, some within the pension scheme and others outside it, all of which operate jointly to maximise the likelihood of the delivery of pension plan benefits and to manage the expectations of stakeholders. We distinguish this from the narrower, and more easily measurable, concept of solvency which is associated more with funding criteria and any additional buffers to absorb risk. Where products are homogeneous, then a focus on solvency alone may be sufficient to bring about a greater degree of harmonisation to security levels, but where they are not then regulatory tools need to be wider and more flexible. We believe defined benefit pensions generally fall in the latter category.

## Security as a pension scheme benefit

- 1.4 We view pension security as a benefit of the scheme, comprised of numerous interconnected components which need to be considered together. We do so because pension security competes for capital with the other elements of plan benefits, and at individual scheme level (within reason) a balance is struck between these different elements through the plan design (consider for example a generous unfunded scheme and a less generous but well funded one, or a

pension scheme with a high accrual rate and no indexation compared with a one that has a lower accrual rate and higher indexation). In the main report we summarise the diverse ways in which five European countries currently balance these components to provide pension security.<sup>1</sup>

- 1.5 By analogy with other financial services legislation, the components of pension security span the full spectrum of Pillars I (funding and solvency), II (supervisory process) and III (disclosure and market discipline). However, in pension schemes it is also necessary to include various aspects of plan design since individual governments may use some of these as tools for social policy, with cost and other consequences for sponsors which in turn may be reflected in other parts of the 'pension package'. The components of pension security<sup>2</sup> may be summarised as follows:

*Quality of benefits:* statutory minimum benefits; conditional benefits; protection of accrued benefits

*Scheme collateral:* technical provisions and prudence margins; deficit funding plans; asset protection measures; financing requirements for new accruals

*External security:* risk based capital; sponsor covenant; contingent assets; guarantee funds

*Governance:* regulatory powers; regulatory oversight; scheme governance; sponsor governance

*Disclosure:* to regulator; to members; to other influencers

- 1.6 In practice the overall level of pension security depends on the trade-off between its different components. These trade-offs vary between schemes depending on differing objectives and constraints imposed by social and labour law in the home state. In the same way that there is no compelling argument for equalising pension accrual rates or indexation levels or absolute amounts of pension benefits across member states, we question whether there should be a compelling reason for equalising a particular measure of pension security across IORPs throughout the EU; indeed we foresee many practical and other problems in doing so. Consequently, a 'top down' approach with a single solvency requirement across all European countries appears to us to be perverse against a background of non-uniform pension provision, raising many questions about the effectiveness of the end result. Instead, we think a more flexible 'bottom up' approach might be better placed to address the principles of partnership, flexibility

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<sup>1</sup> Summarised in Appendix to the main report, with a more detailed description in the supplementary paper accompanying this report 'Survey of pension security in some European countries'

<sup>2</sup> Discussed in detail in Section 3 of the main report

and subsidiarity<sup>3</sup> which appear to underpin the new European System of Financial Supervisors.

### **Decision making**

- 1.7 We have set out a framework in the main report within which discussion can take place on possible reform, against a background of the key obstacles, the key issues and the key impacts. We believe this framework provides sufficient flexibility to entertain a range of acceptable solutions which recognise the diverse requirements and preferences between different countries, as well as the balance in decision-making powers between Europe-wide and national legislation. The required level of consistency and convergence should be achievable through appropriate policy measures at the four levels of decision making at the EU level, as set out in the Lamfalussy framework, working in coordination with three levels of decision making at the national and IORP levels:

**Level 1** - framework legislation, voted on by the Council and Parliament  
**Level 2** - implementing measures for the Level 1, led by the Commission  
**Level 3** - supervisory committees facilitating convergence of regulatory outcomes  
**Level 4** - enforcement of all EU measures, led by the Commission

**Level A** – national law

**Level B** – national supervisory bodies

**Level C** – individual scheme sponsors, trustees or managers

- 1.8 The new European network of financial supervision is being built ‘*on shared and mutually reinforcing responsibilities, combining nationally based supervision of firms with centralisation of specific tasks at the European level so as to foster harmonised rules as well as coherent supervisory practice and enforcement*’. We believe the holistic approach to pension security which we have outlined provides a suitable framework within which the appropriate supervisory processes and tools for pension security can be developed further.

### **Best practice supervisory principles**

- 1.9 Policy measures, however implemented, are most effective if underpinned by best practice principles. We identify eight high level best practice principles<sup>4</sup> for the effective supervision of pension schemes. These require that supervisory arrangements should:

<sup>3</sup> EC Communication COM (2009) 252 setting out the new supervisory framework for the EU

<sup>4</sup> Described in greater detail in Appendix B to the main report.

- I. Achieve a *balance* between a high degree of security and affordable cost to the sponsor in the context of sustainable pension systems as decided by member states.
- II. Take account of the inherent *risks*, not just at particular points in time but also on a *forward-looking* basis.
- III. Use available market inputs to determine the appropriate measurement basis for assets and liabilities, within the context of the risks that are considered acceptable.
- IV. Provide full *transparency* to all stakeholders about how the financial position has been determined, including how the various risks are managed and their potential rewards and consequences.
- V. Be *proportionate* to the nature, complexity and scale of the inherent risks without imposing disproportionate compliance costs.
- VI. Have *flexibility* to adapt to changing conditions.
- VII. Be *counter-cyclical*, with incentives for pension schemes to improve security buffers during favourable economic and business conditions so that they may provide protection in less favourable conditions.
- VIII. Be *practical* to implement and administer.

### **Market tests**

- 1.10 We ‘market-tested’<sup>5</sup> these principles against existing supervisory regimes in the context of a holistic pension security structure involving different balances between funded security and other forms of external security, to demonstrate that it is possible to respect national prerogatives and social choices and yet achieve the desired outcomes in terms of member security.
- 1.11 This analysis by itself provides much food for thought on many of the issues that need to be addressed, and how some regimes have addressed them in practice (see Appendix to this summary).

### **Possible ways forward**

- 1.12 The exact nature and design of any new EU-wide regulation for IORPs will depend on its objectives. However we expect pension security to be a central feature since it has been a common theme in the debate that has preceded this paper. A successful framework for the effective supervision of pension schemes can be constructed to meet desired objectives within the constraints of an uneven European pension landscape. Broad principles could be incorporated in European law with detailed implementation of those principles left to national law and to individual schemes. The different trade-offs between component elements of security at a national level lead to a requirement for flexibility which can be limited

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<sup>5</sup> Full results in section 5 of the main report and a scorecard in Appendix C to the main report.

by the need to comply with best practice principles, and if necessary by stronger guidance at Level 3.

1.13 We have set out in the main report<sup>6</sup> many of the issues likely to be raised and considered the merits of dealing with them within our proposed framework in three ways:

- A. A 'care and maintenance' approach within the existing IORP Directive, using the market testing analyses to inform where changes might be appropriate, either to address less than satisfactory features of the regulatory regime from the perspective of the risks to members, or to bring the regime up to best practice levels. If necessary the strengthened supervisory network for the Level 3 committees could be used to enable better and more uniform enforcement.
- B. 'Total harmonisation' within a new EU wide standard in the form of a 'top down' regime aimed at harmonisation of all rules for all IORPs across the EU. If member states considered it to be desirable then this could pave the way for a uniform Solvency II type standard for occupational pensions, possibly with a new form of balance sheet which incorporated elements of non-tangible pension capital.
- C. 'Evolutionary development' within a new EU wide standard which could take the form of a more flexible 'bottom up' regime, but with a greater focus on pension security. This could incorporate more detailed principles, this time from a risk perspective and consistent with the high level principles for banks and insurance companies. Disclosures could embrace valuation concepts from the Solvency II framework<sup>7</sup>. There should be flexibility for individual governments to decide the exact implementation tools between the three pillar supervisory process, underpinned by a structure for strengthened EU-wide governance, regulation and enforcement.

### **Further work**

Pensions and insurance are different in many respects, and the framework we have set out respects this. But there are also many similarities between pensions and some forms of insurance, especially participating insurance contracts and mutual insurance funds. The concepts of 'loss absorbency' and 'ancillary own funds' as defined in the Solvency II Directive may also be applicable to pensions. The supervisory approach employed in Solvency II for participating insurance and mutual funds may well help to narrow the gap between pensions and insurance. We have not taken this further for the time being, but insurance and pension experts from the Groupe would of course be very willing to work with authorities and stakeholders in taking these concepts forward if deemed appropriate.

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<sup>6</sup> Section 6

<sup>7</sup> Appendix E to the main report discusses the potential application of some elements of the Solvency II framework

## Appendix: Summary of observations from market tests

- A.1 To improve pension security it is not necessary to focus on funding and solvency alone. Pension security should be viewed more holistically. CEIOPS also came to the same conclusion in 2008<sup>8</sup>. This diversity is of course quite consistent with the principles of partnership, flexibility and subsidiarity, but it also highlights the scope for a different balance between uniformity of principles and the detailed implementing measures.
- A.2 We also find that different member states apply different levels of focus to the different elements that make up the full spectrum of security (for example to direct funding or external support from other sources), and usually other elements of security may then compensate; therefore it is necessary to understand the checks and balances being applied to deliver the overall level of security in any one regime. In regimes that rely significantly on the sponsor covenant for security, there may or may not be other security measures to protect members against the sponsor's credit risk (for example contingent funding vehicles or compensation schemes). Such protection does not exist in all countries – where it does not then the immediate security would be poor if the pension scheme failed to meet the funding standard. Specific protection against a solvent sponsor walking away from its obligations exists in only one country.
- A.3 In general, we find that the practices in the countries we have examined do comply with the best practice principles but in different ways to accommodate social preferences and the nature and structure of national regulatory processes. Where there are obvious shortcomings, it would appear that progress is being made to address them. There are however exceptions.
- A.4 There is generally a higher standard of transparency to the supervisor than to other stakeholders (like sponsors and members); most supervisors also have the power to demand extra information. A large gap can exist between expectations and delivery, partly due to insufficient understanding by members of risks taken on their behalf and their potential consequences. We think the greatest room for improvement is in providing more transparency to stakeholders other than supervisors in how the various components of pension security have been reconciled overall, what this means in terms of the ongoing risks being run on behalf of members, and communication of the potential impact of these risks on

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<sup>8</sup> CEIOPS-OPSSC-01/08 Final: Survey on fully funded, technical provisions and security mechanisms in the European occupational pension sector (31 March 2008): Member States currently use different **valuation methods** and different **security mechanisms** to protect pension benefits. The differences have historical and cultural roots, and at times reflect national Social and Labour Law. This variance in valuation measures and security instruments does not necessarily imply substantially different security levels between Member States: in practice, the variances are linked and often cancel each other out. As the interaction between security mechanisms and technical provisions takes differing forms, analysis of any one element in isolation does not accurately reflect the security provided to members. Put differently, partial analyses of security levels based on individual valuation elements or adjustment instruments are misleading and conclusions can only be drawn from a comprehensive analysis of all different elements. By implication, as different methods can be used to secure pension benefits, national pension supervision frameworks do not have to be identical.

members expectations in a language that they can understand. Whilst some countries are making some progress in this area, we perceive a major need in all countries for better communication and pension education.

- A.5 Most pension systems were not designed to cope with counter-cyclicalities and seem to put an extra burden on the economy when it is least affordable. The pragmatic solution to this during the present financial crisis has appeared to be a relaxation in recovery periods, but from the members' viewpoint this entails an increased risk. This may not matter in countries that have compensation schemes which can withstand the shock of multiple insolvencies, but elsewhere members might be justifiably concerned. This is an area which has already been flagged by others for further examination.
- A.6 In some countries the regulatory approach is specifically related to the level of risk, but not in all. The funding requirement in some countries is based on snapshots of the funding position each year or every three years; other countries use forward looking approaches with stress tests, ALM (like) analysis or proactive monitoring requirements of the principal risks.
- A.7 In pensions the concept of 'market-consistency' (as defined for insurance in Solvency II) does not generally prevail, although even here we note that there is an unresolved debate about the appropriateness of an allowance for the illiquidity characteristic of long-term liabilities. For IORPs assets are mostly based on market value, but the calculation of technical provisions varies from fixed discount rates to methods which come close to 'market-consistent' (notwithstanding the illiquidity point) to others which, whilst market based, incorporate some risk in the discount rate through advance credit for some of the expected outperformance from the scheme's asset portfolio.
- A.8 The concept of 'proportionality' varies between countries between countries. In some countries the focus is on reducing the administrative burden for small schemes through exemption or simplified (but prudent) rules. In other countries the focus is on the risks to the system and the proportion of regulatory resource applied to the 'high impact' schemes relative to others. For individual members these are very different perspectives.
- A.9 Some regimes are more flexible than others in the way in which they cope with changing conditions, ranging from rigidly prescribed boundaries for funding levels and recovery plans, to greater flexibility in the extent to which under-funding can be permitted or the length over which deficits can be repaired. The risk connotations for members and sponsors are different but they need to be considered against other checks and balances for a more meaningful picture