



# AEIP Main Points on the Review of IORP II Directive

December 2022

European Association of Paritarian Institutions - AEIP

## Key points and main takeaways

- The review of the IORP II Directive must **stipulate provisions which remain within the framework of minimum harmonization**.
- The review should **not change the funding requirements or introduce capital requirements** for IORPs as the current prudential rules guarantee a high-level degree of security.
- The review should adopt a **principle-based approach** and lead to an **implementation of the proportionality principle** which takes into consideration the **diverse landscape of IORPs** within and across the EU countries.
- The review must underline that **IORPs are inherently different from other financial market entities**. IORPs are mainly ‘not-for-profit’ and employees often benefit from a mandatory affiliation to the pension scheme based on their employment relationship. IORPs by their nature are second-pillar entities – thus, they do not belong to the private competitive economy of third pillar financial undertakings.
- Second pillar pension schemes often have a paritarian structure, meaning that they are **set up and managed jointly by the national social partners**. Paritarian pension funds in particular are **set up by collective agreements** and therefore by design represent the interests of members and beneficiaries, irrespective of whether they are DB or DC.
- The review should **include a nuanced approach to address the indicated shift from DB to DC**. There are many forms of both DB and DC, with different types of guarantees or levels of directness of translating investment returns in pension outcomes. The fact that entitlements are administered as DB or DC from a legal point of views is not paramount.
- **NCA should stay independent in deciding on the supervisory policy for IORPs** which remain under the national social and labour law.
- To enhance communication towards members and beneficiaries there should be **more freedom for pension funds to layer the information to their members** and there is the need to foster and support the **improvement of digital tools**. National pension tracking systems should get a bigger role as facilitator of the pension benefit statement.
- AEIP and its members fully support diversity and inclusion in the management boards. In a paritarian pension funds **IORPs’ boards are appointed by different social partners and not by the IORP**. A further exchange is needed to assess how this measure can best work in practice.
- In the wake of the **UK LDI crisis, national supervisors should oversee whether EU IORPs with significant derivative portfolios are able to meet margin requirements**. However, mandates for this supervision already exist under IORPII and its national implementation. Moreover, very large rate hikes may lead to issues not because of the size of liquidity buffers, but by the limited capacity of financial markets to transform liquidity into cash.

## Recommendations on the general approach towards the IORP II Review

The review of the IORP II Directive must remain within the scope of a minimum harmonization framework and should not touch upon issues of national social, labour, tax or contract law, or the adequacy of pension provision in Member States. As social institutions, the IORPs fall under the provisions of national social and labour law (SLL) and are primarily subject to national supervision. Moreover, the review should adopt a principle-based approach and lead to an implementation of the proportionality principle which takes into consideration the diverse landscape of IORPs within and across EU countries. Notably, the review should not change the funding requirements or introduce capital requirements for IORPs as the current prudential rules guarantee a high-level degree of security. Also, the review should assess the need to improve cross-border procedures and assist cross-border activities, but importantly not through interfering with national SLL or tax law.

The IORP landscape among EU Member States is very heterogeneous in terms of scale, type of pension scheme, social and labour law basis, institutional design as well as contractual obligations. Given the diverse landscape of IORP across Europe, but also the fact that the vast majority of occupational pension funds are small and medium size, the proper implementation of the principle of proportionality throughout the Directive is of utmost importance. Notably, the adoption of a one-size-fits-all approach does not work for the IORP sector, as it generates unnecessary costs especially for small and medium sized IORPs. Such increased costs are detrimental for the members' benefits, as they destroy the affordability for many sponsors to organise an adequate pension scheme. In that regard, Art. 5 of IORP II should include better definitions on small and micro IORPs, in order to better reflect the proportionality principle.

In its upcoming review the European Commission must underline that IORPs are inherently different from other financial market entities in the sense that the vast majority are 'not-for-profit', they play an important social role in pension adequacy, they do not have any shareholders and most importantly do not sell products, since employees often benefit from a mandatory affiliation to the pension scheme on the basis of their employment relationship. In addition, it must be acknowledged that the clarification and further provisions on addressing the triangular relationship between the employee, the employer (sponsor) and the IORP should be a priority guiding the review of the Directive.

It also must be recognized that second pillar pension schemes often have a paritarian structure, meaning that they are set up and managed jointly by (the national) social partners. IORPs have an important social function in supporting the EU economies and citizens as they ensure adequate benefits for old age income and at the same time, they work as much-needed automatic stabilizers in times of economic strain, as also the recent Covid-19 pandemic reaffirmed. Thanks to their joint decision-making process and due to the fact that they are most often managed by the social partners, they promote transparency, inclusiveness and democratic legitimacy.

AEIP underlines that the inclusion of social partners leads to better pension adequacy. Involvement of the social partners leads to long-term commitment to capital-funded pensions. Moreover, where benefits are not guaranteed, social partners often play a role in defining a pension benefit ambition and annually calibrate pension contributions against this ambition. Undermining the role of social partners would lead to an individualization of pensions, which – due to well-documented behavioural biases such as short-termism – would erode pension adequacy.

At the same time, IORPs are important institutional investors and can contribute to fostering long-term investment and sustainable economic growth, also in light of the development of the Capital Markets Union (CMU) as well as the much-needed transition to a climate friendly and digital EU economy. They also have a substantial role in maintaining financial stability and often act counter-cyclically by maintaining their long-term strategic asset allocation in stressed market conditions, meaning they rebalance and buy assets whose prices have diminished abruptly.

### **Governance, risk management requirements and prudential supervision**

The review of the IORP II Directive should maintain its existing clear requirements regarding governance and risk management (including those on operational and ICT risk) as these have been proven very effective in practice. The implementation of governance requirements under IORP II, in particular key functions, led to significant costs. Hence, the existing rules should be maintained without additional burdens for IORPs as IORPs have already established robust risk management mechanisms as well as good governance practices. Furthermore, we consider that the existing rules of prudential supervision are also adequate in protecting the rights of members and beneficiaries and ensuring the sound functioning of IORPs. Nevertheless, proportionality in governance and transparency requirements should be further enhanced, as this will improve in practice the functioning of many IORPs.

### **Costs and proportionality**

The review of the IORP II Directive should take into consideration the significantly growing cost burden for the sector. The low yield environment makes IORPs sensitive to any additional fixed costs, on top of the already existing investment costs, administration costs, governance costs and communication costs. Especially small and medium-sized IORPs are highly negatively impacted by additional measures, thus increasing the risk for detrimental effects on the retirement income of members and beneficiaries. Moreover, administration costs and governance requirements function as a significant hurdle to setting up new IORPs, at a time where it is the European Commission's ambition to boost funded pensions in many Member States.

Many IORPs do not even have personnel of their own, so they use sponsor resources and outsource their operational and investment services. The review of the Directive should aim for the proper implementation of the proportionality principle, which takes into consideration the size, nature, scale and complexity of the activities of the IORP. Another key element is that the review should aim at minimum harmonisation (the guiding principle of the IORP II Directive) and acknowledge the heterogeneous nature of IORPs.

### **Supervisory role of NCAs and EIOPA**

AEIP strongly believes that National Competent Authorities (NCAs) are best placed to judge the risks, vulnerabilities, threats and weaknesses of the system given the local labour market, the social and labour legislation as well as the local social environment, and to take any action required. NCAs should stay independent in deciding on the supervisory policy for IORPs which remain under the national social and labour law. As hardly any IORP is 'selling' or 'commercialising' a product across Europe, we believe supervisory convergence is subordinate to efficiency, value for money and affordability. Under the IORP II Directive, EIOPA's role in developing the regulatory framework is not comparable to its role under the Solvency II framework. This reflects a conscious choice of the co-legislators. Occupational pensions are still very divergent across Member States, both in terms of their prevalence and design. They are closely linked

to first pillar pensions, as well as social and labour law more broadly. Importantly, the strong link between occupational pensions and national tax and labour law has resulted so far in relatively limited cross-border activities of IORPs. For these reasons, the rationale for a bigger regulatory or supervisory role for EIOPA on IORPs is absent.

### **Investment rules and the prudent person rule**

Paritarian pension funds in particular are set up by collective agreements so by construction they do not present any conflicts of interest and comply with the prudent person rule regarding investment policies. Their affiliated beneficiaries are not customers in this relationship, but they are affiliated automatically when concluding their employment contracts. Often they do not – and cannot – intervene in any investment decision, so there are no options for direct investment choice. The investment decisions are taken by the board of the pension scheme or by the asset management department, always in accordance with the prudent person rule which incorporates ESG aspects. Bearing in mind the specific way that the sector operates as well as the particularities of occupational pension funds, we stress once again that the principle of proportionality must be ensured in practice for IORPs.

The European Commission has announced it will consider expanding the role of sustainability in the prudent person rule. This would entail the so-called double materiality perspective and the mandatory inclusion of the sustainability preferences of members and beneficiaries. Many IORPs have increasingly ambitious responsible investment policies. Therefore, a principle-based consideration of double materiality under prudent person rule would match the investment practices of many pension funds.

Another element the Call for Advice considers, is the incorporation of the preferences of members and beneficiaries on sustainability matters in the investment policy. As a principle, it is right to consider the preferences of the people on whose behalf the contributions are invested. However, AEIP believes that the IORP Directive should not prescribe through which method these preferences are ascertained and taken on board. While there are an increasing number of – particularly larger – IORPs that survey members, it remains challenging to translate these preferences to a single investment policy. The board will need to have sufficient flexibility to accommodate all views. Moreover, surveying is cost intensive and the governance structures of paritarian IORPs include representatives of members and beneficiaries in the Board and sometimes additional representative bodies.

Most important, AEIP cautions against copy-pasting related rules from retail products (MiFID, IDD) without taking into account the paritarian and collective nature of IORPs. By usually having a single investment policy and not requiring distribution channels, paritarian IORPs keep costs well below retail products, leading to much higher pension outcomes. However, this means that there is no precontractual phase and employees that are enrolled automatically – due to their employment relationship with their employers - engage differently with information than retail clients as they have no ability to act on information. It is not possible to give them individual choice. Moreover, we strongly believe that the way that e.g. MiFID conceptualises the outcomes of the consideration of ESG preferences is inadequate in the context of a pension scheme. In the retail sector the provider has to assess whether a product should include underlying article 8 or article 9 SFDR products, Taxonomy-alignment or the consideration of adverse impacts. Preferences do not align with these legalistic concepts and it is difficult to understand how to apply this approach to a portfolio with many different asset classes (equity, bonds, real estate, infrastructure, private, public) and asset management structures (funds and direct mandates).

### Addressing the shift from DB to DC

The European Commission indicates that EIOPA should look into the shift from DB to DC and explore whether changes to IORP II are needed to address this shift. AEIP acknowledges that there is indeed a trend in Europe towards DC, but at the same time it cautions against a binary and simplified understanding of this trend. The definition of DB and DC used most often is one that is based on the question of how the entitlements are administered (as benefits or capital). This should not be confused with the question of whether members' pensions are 'protected' or not. It is very well possible to have a DC system with sponsor support (e.g. Belgium) or a DB system in which the benefits can be cut (e.g. the Netherlands). This latter question is more important when thinking about communication rules and risk-management rules. AEIP would be very concerned if a misinterpretation of the definition of DB and DC would lead to inadequate rules for IORPs.

### Substantially increased costs are detrimental for the functioning of IORPs

As most IORPs are not-for-profit and do not compete with each other, they provide stable retirement benefits with great cost efficiency, also due to the fact that there are virtually no marketing or advertisement costs. However, the increasing reporting requirements<sup>1</sup> result in significant additional administrative and financial burden. IORPs are already subject to numerous novel EU reporting requirements; including the statistical requirements by ECB and EIOPA as well as the SFDR requirements. The ever-increasing reporting burden is detrimental for the IORPs' efficiency as they make pension schemes less affordable for sponsors, who are eventually forced to opt for commercial products – which have less tailor-made solutions and lead to lower benefits for the members.

### Communication to members

The review of the provisions on communication should start from the premise that information does not equal communication. Information needs to be relevant, personal and actionable in order to be relevant. Communication to members and beneficiaries should be done in a simple and comprehensible manner, while layering should enable members who want to know more to access more detailed information. AEIP believes that the IORPs should be able to decide on their own *how* to share information as they best know what information needs to be shared and communicated to their members and beneficiaries. Additionally, opinions vary between our members on the impact of the Pension Benefit Statement (PBS) to information provision. Some AEIP members believe that the PBS provides a clear format and, having gone through, implementation, want to avoid new implementation costs. Other members believe it inhibits a more ambitious, targeted and digital approach to communication.

Consequently, AEIP supports that there should be more freedom for pension funds to layer the information to target the information to their members while there is the need to improve the use of digital tools in a way to support pension communication. Additionally, IORPs that lack the ability to develop new layered digital communication tools could continue to use the PBS, but those that want to improve

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<sup>1</sup> Costs linked to ESG data have a strong 'one-off character', which are unrelated to the size of the buyer. This means that the costs of ESG data and SFDR reporting weighs much stronger on smaller pension funds.

communication should be able to do so. National supervisors should be tasked to ensure that the communication objectives should be met.

Pension tracking services (PTS) are proving to be highly effective tools to communicate information and are more effective than the PBS as they can combine pension information of different sources. The PTS combines information from different first and/or second pillar providers and typically is better known by the general public than the PBS. The Commission should consider providing flexibility to member states with PTSs to incorporate the PBS as part of the communication rules. It should be possible for Member States to transfer parts of the pension benefit communication to national pension tracking systems to enable integration with other retirement benefits (First pillar benefits, benefits coming from other pension institutions, benefits stemming from previous careers with other employers, etc...).

Full harmonisation of pension communication is undesirable because of the many diverging national components of pension systems that must be taken into account to make information relevant and personal. Pension communication is a complex issue because of the existence of multiple factors which have an impact, such as the benefit at retirement age, the current provisions, the impact of inflation, the impact of a future salary increase, the impact of the financial markets as well as the combination of communication on second pillar pensions with this of the first and third pillar. Pension communication should reflect the particular setup and character of IORPs, in accordance to the proportionality principle and always taking into consideration the limited cost capacity of IORPs.

The current experience with SFDR disclosures is that they lead to an overload of ‘push’ information to the individual. Despite the fact that IORPs are communicating about a pension benefit and not an investment product, pension scheme information will be diluted due to the sustainability disclosures: several pages of information on investments in particular, apart from the necessary information regarding the scheme, will be overwhelming for the reader.

### **Diversity and inclusion in the management bodies**

AEIP and its members fully support diversity and inclusion in the management boards and are committed to creating diverse workplaces and inclusive societies. As part of the review of the IORP II Directive the Commission has asked EIOPA to explore prudential requirements to include diversity and inclusion issues in relation to management bodies. AEIP would like to underline that in the paritarian pension funds context (joint management by employers and trade unions) IORPs’ Boards are appointed by different social partners<sup>2</sup> and not by the IORP itself. Therefore, the paritarian composition of management boards reflects different perspectives and ensures that diverge interests are represented. It should also be emphasized that diversity and inclusion have a broad meaning thus is suggested that EIOPA takes a broad approach when addressing this matter for IORPs in order to take into consideration their characteristics. AEIP stresses again that it welcomes diversity and inclusion in management bodies but urges the European Commission to allow for sufficient flexibility that would fit all national context and the diversity of the operating environments of IORPs at national level.

### **Liquidity management is important, but will not tackle collateral transformation challenges**

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<sup>2</sup> Appointing procedure is a very extensive practice to ensure that each party is equally and fully represented, this is based on fit and proper requirements also taking into consideration diversity and inclusion requirements.

The recent events in the UK have put the spotlight on so-called LDI investment strategies by pension funds. Within the EU, interest hedging plays an important role in managing investment risks in some European countries, notably the Netherlands. In particular, derivatives are used to extend the duration of the matching portfolio as there are not sufficient government bonds to do so. By being able to match the duration of the liabilities, members are better protected against movements of the interest rates, leading to more stable pensions. Interest hedging has to be seen in the context of the management of the overall balance sheet. In the UK the losses on LDI positions were fully compensated by the reduction of the value of the liability, leading to an on average better solvency position.

It is important to note a number of important differences between the situation in the EU and the UK:

- In the UK, LDI strategies were executed by investing in investment funds, so-called LDI pools. In the Netherlands, pension funds tend to appoint a fiduciary manager who buys derivatives for the pension fund and at the same time oversees treasury functions. By centralizing both functions, the pension fund is operationally much better prepared to meet intraday margin calls. This structure also avoids including entities that are leveraged with more than 100% interest rate exposure.
- The level of interest rate hedging in the Netherlands is lower. Most pension funds, including the large industry-wide pension funds, somewhere between 30% and 70% of interest rate risk.
- While the derivative exposures of the Dutch pension sector are large, it does not nearly play the same role in the EU bond market as the UK pension funds do in the UK gilt market. This preponderance set off the negative feedback loop, when pension investors were selling off gilts to meet margin requirements further push bond prices down, leading to more margin calls.

Nevertheless, the situation in the UK has demonstrated the implications of the post-crisis margin rules, for which the pension sector has long warned. These implications were the reason the EU decided to grant pension scheme arrangements (PSAs) a temporary exemption from central clearing under EMIR. This exemption, which is set to expire in June 2023, was meant to provide time to find a solution for the question of how PSAs can access cash to meet the cash variation margin requirements that CCPs impose. This solution has not been found.

EIOPA has stated that in the wake of the UK LDI crisis, it will explore whether liquidity management or risk management requirements in IORP II need to be reviewed. AEIP believes that national supervisors should indeed oversee whether EU IORPs with significant derivative portfolios are able to meet margin requirements. However, mandates for this supervision already exist under IORP II and its national implementation.

Moreover, very large rate hikes may lead to issues not because of the size of liquidity buffers, but by the limited capacity of financial markets to transform liquidity into cash. The Dutch Central Bank reported that Dutch pension funds sold EUR 88bn of assets, mainly to meet margin requirements for a the rate rises in the first six months of 2022. As this occurred gradually, this did not lead to any problems. However, a very high interest rate hike within a single day would lead to intraday margin calls of tens of billions of euros. Pension funds cannot hold these buffers in cash, as no bank is willing to provide this services and it would introduce significant counterparty risk. Therefore, high-quality liquid assets must be converted into cash through the markets. The repo market plays a very important role here, as pension funds can temporarily exchange bonds, which they own plenty of, for cash. However, AEIP is concerned that the repo market will not function sufficiently during a crisis situation. In this case, having very high liquidity buffers will not prevent stress, while they do come with an opportunity cost of not being able to invest more in assets with

a decent return. EIOPA should consider this full picture when thinking about liquidity management rules under IORP.

### Concluding remark

We call the Commission and EIOPA to exchange with AEIP and paritarian pension funds in order to best assess how potential future measures can best work in practice.

We ask the European Commission and EIOPA to take into consideration the above points, in order to ensure the optimal functioning of the IORP sector and the protection of the interests of members and beneficiaries.

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### AEIP Disclaimer



AEIP represents the European Paritarian Institutions of Social Protection in Brussels since 1997. The Association gathers 29 leading large and medium-sized social protection providers, which are managed on the basis of joint governance and equal representation by both employees and employers' organizations (the social partners) in 12 EU Member States.

AEIP represents its members' values and interests at the level of both European and international institutions. In particular, AEIP - through its working groups - deals with EU coordinated pension schemes and pension funds, healthcare, unemployment, provident and paid-holiday schemes.

Owing to the quality of its members and to the delegation of powers conferred to its Board, AEIP aims at becoming the leading body for the promotion of balanced paritarian social protection systems in Europe. AEIP promotes and develops programs and orientations aiming at the sustainability of paritarian social protection systems at local level taking into account the national specificities aiming at ensuring social cohesion in Europe.

Based thereon, AEIP prepares recommendations, proposes local programs and influences European decisions to safeguard and promote the interests of its members. AEIP thinks ahead and anticipate modern paritarian social protection systems that take into account changing economic and societal pattern. It furthermore seeks to find a new balance between and across generations.

For more information: [www.aeip.net](http://www.aeip.net)