BNY MELLON

Institutions for Occupational Retirement Provision II

CHALLENGES AND OPPORTUNITIES

Introduction

A new version of the European Union Directive on Institutions for Occupational Retirement Provision (IORP) is set to have a profound impact on workplace pensions. IORP II updates, replaces and significantly expands IORP I, which was adopted in 2003. European Economic Area countries, which encompass the 28 EU member states, including the UK, as well as well as Iceland, Liechtenstein and Norway, must incorporate IORP II into national legislation by 13 January 2019. It will come into effect almost five years after it was first proposed by the European Commission.

IORP II addresses the activities and supervision of IORPs and introduces a number of new obligations. The directive seeks improved workplace pensions governance and accountability in order to better protect members and beneficiaries. Specifically, IORP II aims to enhance schemes' governance, risk management and member communications. In addition, it is hoped the directive will enhance stability and further the development of the occupational retirement savings sector. This should result in better savings provision for an aging population and reinforce IORPs' role as institutional investors in the EU.

The Directive Has Four Specific Objectives:

1.
Protect members and beneficiaries by ensuring good governance and adequate risk management policies and procedures

2.
Provide clear, relevant and regular information to members and beneficiaries and enhance transparency

3.
Remove remaining barriers for cross-border IORPs while leaving member states to continue to regulate IORPs on a national basis

4.
Ensure that supervisors have the necessary powers and tools to effectively supervise IORPs

In seeking to achieve these goals and others, IORP II creates both challenges and opportunities for occupational pension funds across the EU. At an operational level, schemes must be aware of the directive and consider its implications for their business model; a commitment of both time and money may be necessary. For companies with pension schemes in multiple countries in the EU, IORP II presents potential cross-border opportunities. It also creates new obligations in relation to environmental, social and corporate governance (ESG) investment.

The Origins and Implications of IORP II

IORP II responds to demands and concerns that have formed over many years. To gain greater insight into the directive's origins and assess its impact on the European pension landscape, we spoke to Hans Van Meerten, professor of EU Pension Law at Utrecht University in the Netherlands and a member of the EIOPA occupational pensions stakeholder group.

Hans Van Meerten has extensive knowledge of EU legislation regarding pensions and the cross-border activities of financial institutions; one of his main points of focus is IORP II. As a civil servant, he wrote Dutch legislation implementing IORP and was also involved in Brussels negotiations on the directive. Here he explains IORP II's main objectives, its potential shortcomings, and the opportunities it presents for pension schemes, both across the EU and in particular in the Netherlands.

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What was the genesis of IORP II and why was it required?

Hans Van Meerten: An internal market for pension funds has been on the agenda of European legislators since the 1980s. While pension funds had to comply with the rules of the Single Market, there was no common prudential framework. As a result, treatment varied widely and there was a perceived need for harmonisation. This was exacerbated by an ageing society and a falling birth rate in many European countries. Many countries sought to move from pay-as-you-go to capital-funded systems as a way of lightening the burden on government budgets. From the 1990s onwards, the development of the European Monetary Union and the euro also made the alignment of member states' pension mechanisms more important.

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These factors prompted IORP I in 2003, which introduced two key concepts. The first was a European passport for IORPs, which required member states to recognise IORPs from another country. The second was a move to increase the cross-border activity of IORPs: multinational companies active in multiple European countries wanted to achieve economies of scale and also facilitate workforce mobility. Unfortunately, these two concepts didn’t work as intended by IORP I. Pension schemes in each member state are complex and were governed both by IORP I and relevant pensions law. For companies, there continued to be a need to assess individual country legislation to understand the extent of their compatibility and overlap.

To address the shortcomings of IORP I, the European Commission proposed a revision of the directive in 2014. Its goals were to make cross-border activity a reality and improve consumer protection. Against a backdrop of rising funding pressures and market volatility—particularly following the financial crisis—there was a clear need in many countries for clarity and transparency regarding the stability of pension schemes, how they work, how they are governed and when benefits might be compromised. Improving consumer protection was particularly important as the financial crisis had undermined trust in the system.

2 How will the impact of IORP II vary by country?

For many Central and Eastern European countries, IORP II is a significant leap forward in terms of consumer protection. In terms of sizeable impact, the countries most affected by IORP II are the UK, which will implement the directive despite Brexit, and the Netherlands as these countries have the most developed second pillar (or occupational pension) sector.

For countries that have no relevant regulations in place, IORP II will serve as a way to introduce second pillar schemes. In other countries, such as Sweden, insurance companies are the dominant pensions providers and are therefore regulated under Solvency II.

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It is important to understand that IORP II is a directive and not a regulation. A directive must be legislated by each member state and therefore different approaches may be taken that undermine the original objectives of IORP II.

3 What are the most significant challenges for the pensions industry as a result of IORP II?

The introduction of independent functions such as risk management and audit will be significant in many countries, including the Netherlands. All of these functions currently exist but at some pension schemes, people may have different roles, which might result in conflicts of interest. Creating separate functions may require investment and additional personnel, which could increase costs and prove challenging, especially for smaller funds.

The introduction of pension benefits statements, and especially the need to communicate benefits in real rather than nominal terms, could also put further pressure on schemes' resources. More generally, pension funds will need to make it clear when they plan to reduce benefits, are underfunded, or intend to implement a recovery plan to become more financially sound. Currently such plans are only communicated to the supervisor. Presenting this information to members in an easily digestible way might be difficult and potentially costly. These, and other requirements, may consequently accelerate consolidation of the pension sector.

4 Will IORP II succeed in creating cross-border opportunities where IORP I failed?

It is important to understand that IORP II is a directive and not a regulation. A directive must be legislated by each member state and therefore different approaches may be taken that undermine the original objectives of IORP II. For example, in the Netherlands, Article 12 of IORP II seemingly makes it harder to move assets cross border than in the past. Intense national lobbying has resulted in the enabling legislation effectively going against one of the EU's intended aims—namely, to make cross-border activity easier, not harder. Similarly, while the requirement for schemes operating cross border to always be fully funded has been lessened to some extent, in reality the impact will be limited because of local requirements. In the Netherlands, two-thirds of members and beneficiaries must approve a cross-border transfer of their scheme's assets and liabilities (compared to the simple majority set out in the directive); this means [gaining] approval may be challenging.

5 What other options exist for pension schemes looking to cut costs?

There will still be many barriers that limit cross-border pension transfers. In addition, in many instances there is a reluctance to liquidate funds and merge into a general fund (known as an algemeen pensioenfonds or APF) because of loss of identity and the potential impact on funding ratios.

However, to a large extent there seems to be an alternative to transferring schemes that achieves many of the cross-border benefits originally envisaged by IORP II. Schemes can simply appoint a single depositary. A depositary can offer savings as a result of economies of scale, which could lead to cheaper schemes. The use of a single depositary could allow schemes to pool administrative and asset management services. Schemes are likely to create structures that optimise transparency and tax efficiency. National schemes will remain responsible for key functions to ensure they are accountable to their members. Full harmonisation may not be possible but it will be possible to gain significant benefits without merging schemes[1].

Currently, the appointment of a depositary is discretionary and it will remain so under IORP II. However, given the potential benefits available, the use of depositaries may increase.

6 Do you foresee the implications of the directive evolving over time with EU member state adaptations?

As IORP II is incorporated into member state legislation, it continues to develop. As member states legislate for directives such as IORP II, they are—to some extent—free to insert further adaptations.

Some recent national proposals could have far-reaching implications, especially those associated with ESG reporting. Originally, this was perceived to be largely optional, but it is being transposed into legislation as a mandatory measure. Currently, IORP II does not have prohibitions on certain types of investment for ESG reasons. But it is possible that going forward there could be significant changes in this area, such as a prohibition on tobacco investments. Such adaptations could have a direct impact on the pensions industry far beyond what was originally intended by IORP II.

1 *An explanation of how this process could work in practice is described in:*
H. Van Meerten, 'Iorp-bewaarder' biedt nieuwe mogelijkheid voor samenwerking fondsen', PensioenPro, May 2018.

What IORP II Seeks to Achieve

IORP II is a wide-ranging directive comprising 67 articles, compared to the 24 articles of IORP I. While the below is not an exhaustive analysis, we have identified some of the directive's key objectives as they relate to pension schemes.

Strengthen governance and risk management

The directive requires schemes to have a proportionate, effective system of governance and adequate risk management in order to protect members and beneficiaries. One way it does this is by introducing the concept of 'key functions' for scheme governance—these are risk management, internal audit and actuarial (for defined benefit schemes).

IORPs must have a risk management function that is appropriate given their size and complexity. It should be well integrated into the IORP and its decision-making processes. The function's role is to identify, measure, monitor and manage risks, and report regularly to the IORP's administrative, management or supervisory body.

One new risk management requirement of IORP II is the own risk assessment (ORA), which identifies long-and short-term term risks and provides insights into the effectiveness of risk management measures. Schemes must conduct an ORA at least every three years, or sooner if there is a significant change in the risk profile of the IORP or its pension schemes.

Raise the profile of ESG

As part of efforts to improve the sustainability of pension schemes, IORP II emphasises ESG-related risks. Specifically, it requires IORPs to either invest for the long-term interest of members and beneficiaries in accordance with the "prudent person" rule, taking into account the long-term impact of ESG factors, or explicitly account for reasons why ESG factors have not been incorporated into investment strategy. There are indications that ESG could even become more important as member states legislate for IORP II. Some countries plan to extend existing legislation to reflect the need for pension schemes to consider the impact of ESG on performance returns.

> One way in which IORP II makes consolidation easier is by amending the existing obligation for schemes operating cross-border to always be fully funded.

Facilitate an expanded role for depositaries

IORP II notes that member states can (but are not obliged to) require DC schemes to appoint a depositary, for the safekeeping of assets and oversight duties. If a custodian is not appointed, a scheme must make alternative arrangements “to prevent and resolve any conflict of interest in the course of tasks otherwise performed by a depositary and an asset manager”. Importantly, IORP II prevents member states from restricting IORPs’ ability to appoint depositaries in another country: this could pave the way for the appointment of a single depositary for multiple schemes.

Enable cross-border pensions consolidation

IORP II aims to create a “genuine internal market for occupational retirement provision” by facilitating cross-border activity by IORPs and complete or partial cross-border transfer of pension schemes. In theory, it allows multinational pension funds to consolidate workers’ pension fund savings in a single jurisdiction. Assuming consolidation is possible, increased scale could cut running costs, facilitate access to new investment classes, and enhance governance and risk management.

One way in which IORP II makes consolidation easier is by amending the existing obligation for schemes operating cross-border to always be fully funded, which is contentious and seen as an obstacle to cross-border activity. Schemes that operate cross border can now run a deficit for a limited period as long as they implement a recovery plan and receive local regulatory approval.

There are clear rules on cross-border transfers of pension scheme assets and liabilities, designed to protect members. Schemes cannot pass on the costs to members and beneficiaries remaining in the transferring scheme, or those in the receiving scheme.

One potential stumbling block to consolidation is that a majority of the transferring scheme’s members and beneficiaries must approve transfers (moreover, ‘a majority’ has been interpreted differently by each member state). Transfers also need prior consent of the transferring scheme’s regulator, and authorisation by the receiving scheme’s regulator.

Helping Pension Schemes Make the Most of IORP II

To make compliance with IORP II as simple as possible and ensure pension funds are well positioned to take advantage of the opportunities it offers, BNY Mellon offers a suite of solutions that can help clients achieve IORP II-related goals.

Gain risk management insights

IORP II requires pension schemes to improve transparency and gain greater insights into their risks and exposures. We can help pension funds understand what drives their performance. We also make it simple for pension funds to assess the risk profile of their investment strategies, without having to invest significant time and resources in data gathering and model building.

Meet new ESG requirements

IORP II places new emphasis on the ESG impact of investment decisions. Our compliance monitoring service ensures clients that exclude certain stocks from their portfolios, such as tobacco or armaments investments, are notified if their fund manager breaches an investment mandate.

ESG encourages pension schemes to proactively engage with the companies they invest in so they can mitigate risks and generate alpha. We offer class action and proxy voting services, as well as support on dialogue and divestment, to enable schemes to play a greater role in corporate governance.

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Solutions such as consolidated multinational reporting and asset pooling facilitate a variety of approaches for consolidation of multiple plans across EU member states.

Many pension funds welcome the emphasis on ESG in the directive. “A correct incorporation of ESG risks can enhance the risk-return profile of the investment portfolio, by mitigating the potential effects of climate related damage, regulation and/or carbon tax,” says Fred Wouters, Senior Investment Specialist at Dutch pension fund UWV. “However, the challenge when implementing an ESG-focused investment strategy is to quantitatively measure ESG risks.”

BNY Mellon has developed a solution that helps to address this challenge. It enables clients to assess and report the performance of their investment portfolio or funds against a variety of ESG benchmarks. By tracking ESG scores over time, pension funds can demonstrate that they are meeting ESG requirements. This service will be available from Q1 2019.

Improve efficiency by using a single depositary

IORP II allows multiple schemes to use a single depositary, which can be based in any member state. This opens up opportunities to pooling services, such as administration and governance and lower costs as a result of economies of scale.

As one of the leading providers of depositary services for institutional investors around the globe, including across the EU, we are well positioned to support. Depending on the country and composition of a pension plan, we can also service UCITS and AIFMD fund structures.

Make cross-border pensions reporting straightforward

IORP II presents potential opportunities to combine pension schemes locally and cross border. BNY Mellon solutions such as consolidated multinational reporting and asset pooling facilitate a variety of approaches for consolidation of multiple plans across EU member states, from simple aggregation of specific functions, to the creation of a single legal structure.

CONSOLIDATED MULTINATIONAL REPORTING

For clients combining pension schemes across EU member states, it is critical to effectively monitor exposure for risk management and oversight. This can be challenging as there are numerous levels of oversight reporting and statistical reporting obligations for individual pension funds based on domicile jurisdiction. We offer multinational reporting services both for assets held in custody with BNY Mellon and other custodians. Reports are easily configurable, covering pension investments held by different plans in different countries or aggregated information across the region. Better reporting makes analysis easier, improves oversight and empowers clients to make well-informed decisions.

POOLING VEHICLES

One of the potential benefits of IORP II is the ability to generate economies of scale, improve operating efficiency, and eliminate inconsistencies across multiple countries. Pooling vehicles can deliver these benefits and also enhance transparency and facilitate pension fund-to-pension fund benchmarking. A variety of strategies are possible, ranging from appointing the same investment manager for different plans to consolidation of schemes (with participating plans ring-fenced if required). BNY Mellon works closely with clients to ensure they select the appropriate pooling vehicles to achieve their objectives.

Conclusion: Embracing the new world of pensions

IORP II is intended to create a pension environment that is more effective, efficient and stable. By increasing transparency and accountability, it should strengthen people's trust in pensions. Members and beneficiaries will benefit explicitly as a result of new protections contained in IORP II. Hopefully these advances will encourage increased saving for retirement and soften the impact of aging populations and low birth rates in many EU member states.

The scale and complexity of IORP II will require occupational pension funds across the EU to commit time and resources to study the directive and devise an appropriate response. While this may entail new costs, the potential opportunities could also be significant.

On paper, pension funds will have a greatly enhanced ability to work together across borders, which would potentially lower costs and improve efficiency. Some observers are pessimistic that the rewards promised by IORP II will materialise; cross-border pension provision could continue to be thwarted by national hurdles. Nevertheless, many of the anticipated optimisation benefits of the directive may be realisable through greater use of depositaries.

Some pension schemes will find it hard to adapt to IORP II. However, all IORPs should recognise that they do not have to tackle tasks associated with the directive alone. BNY Mellon's commitment to our position as a responsible service provider makes us well placed to assist. We offer a suite of products to help pension schemes overcome the challenges and harness the opportunities presented by IORP II. With our support, IORPs can achieve their strategic goals in the new world of pensions created by IORP II.

Authors

Pieter Strik
Product Manager, Global Product Management
pieter.strik@bnymellon.com
+31767602306

Marvin Vervaart
EMEA Asset Owner Segment Head
marvin.vervaart@bnymellon.com
+31202035638

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