EAPSPI – AEIRSP – EVVÖD

EAPSPI – **European Association of Public Sector Pension Institutions**

AEIRSP – **Association européenne des institutions de retraite du secteur public**

EVVÖD – **Europäischer Verband der Versorgungseinrichtungen des Öffentlichen Dienstes**

POSITION PAPER

ON THE ISSUE OF THE APPLICATION OF SOLVENCY II RULES FOR INSTITUTIONS FOR OCCUPATIONAL RETIREMENT PROVISION

EAPSPI, the European association of public sector pension institutions, is of the opinion that the extension of Solvency II rules to supplementary schemes of the second pillar is neither necessary nor appropriate:

- Increasing solvency margins will make equity investments less attractive for IORPs. The returns on equities, historically superior to other asset classes, will not be available to finance retirement income for members.
- A rigid, one-size-fits-all framework will make it difficult for pension contributions to be invested in companies and long-term growth and job creation in the economy as a whole. This might also have a negative impact on investments in SMEs.
- Application of proposed rules could trigger a move from equities and cause major volatility on the markets.
- IORPs have inbuilt sufficient and effective self-corrective mechanisms that do not require any additional solvency rules.

Executive summary

An Institution for Occupational Retirement Provision (IORP) is an organisation which exclusively operates pension schemes[1]. Occupational pension schemes are labour agreements in which the risk is often shared between sponsors and/or employees through pre-specified risk sharing mechanisms. These schemes are negotiated between employers and employees, to supplement state social security pensions.

Solvency II concerns a fundamental review of the capital adequacy regime for the European insurance industry. When an insurance company sells a guaranteed individual pension, the insurance company needs to minimize the shortfall risk in order to protect the interests of the individual beneficiary. Because an insurance company cannot change the contribution /premiums or the benefits of an individual retirement contract, the best way to ensure that a beneficiary gets out of the contract what was promised is by covering the liability with financial instruments that react in the same way as the risk the beneficiary is running (mostly long-term bonds). The only alternative is a very high solvency ratio to make 'sure' that the Solvency Capital Requirement will not fall below the Minimum Capital Requirement.

Charlie McCreevy, European Commissioner for Internal Market and Services recently[2] declared that "although IORPs are not addressed in the Solvency II proposal, we need to consider whether these IORPs ought to be subject to a similar regime to that of insurance companies in instances where they assume similar risk, or where they guarantee a certain investment performance or a given level of retirement benefits, such as under Defined Benefit schemes." He has asked CEIOPS' Occupational Pensions Committee to start a fact-finding exercise on Member States' current solvency regimes, as a starting point for considerations in the review of the IORP Directive which will begin in 2008.

On the one hand it is clear that the huge differences in supplementary pension schemes throughout Europe make it very difficult to create one single framework for supplementary pension schemes as far as solvency is concerned. On the other hand it is also clear that in the long run funded supplementary pension schemes (operating under the existing IORP Directive) will have to face some kind of framework, at least so that their financial conditions can be made comparable in terms of transparency.

[1] IORPs in the narrow sense are IORPs as defined in the IORP Directive (funded schemes – Art 6 a of the Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provisions). In a broader definition non funded schemes may also be seen as IORPs.
[2] AEIP Conference: The Construction Sector in the European Union - Pilot Sector for Pan-European Projects, Dublin, 8 June 2007

In such a harmonization the great advantages of the inbuilt 'self corrective' mechanisms and the fact that these schemes are often agreements negotiated between employers and employees should of course be taken into account. We think that because in pension schemes risks are shared between sponsors and employees in these cases, and also that in these schemes contribution and benefit rates can be changed, there are fewer financial risks for individuals since the capital adequacy regime for this kind of scheme can allow a higher shortfall risk and a longer recovery period than is the case with an individual insurance policy. Furthermore IORPs are able to invest pension contributions on average for 20 to 25 years, because they are mostly built on the concept of compulsory participation. This long investment horizon allows them to hold equities through the peaks and troughs in the financial markets. In this way an IORP is able to make extra return on investment so that they can always outperform insurance companies who have usually to invest more on a short-term horizon. Otherwise these IORPs would unnecessarily face a very high solvency ratio before they can index pensions, which is not in the best interest of beneficiaries. If IORPs had to sell their equities and go into bonds, the effect of these measures furthermore would be strongly pro-cyclical and thereby counterproductive for beneficiaries as well as the economy as a whole. So if Solvency II were extended to IORPs two key questions are: who is going to pay for the high premiums needed to reach the very high solvency ratio, and who is going to pay for the macro-economic effects (decrease in equities) when IORPs have to sell their equities?

As far as pay-as-you-go schemes or book reserve schemes are involved, they should also be transparent in the way the risks of the beneficiaries are managed and how they fit in to the claim of developing the financial markets. In these pay-as-you-schemes and book reserve schemes the fact that these schemes are labour agreements negotiated between employers and employees should not be overlooked in the way a framework is elaborated.

Because of the interference of supplementary pension schemes (funded and not funded) with social and labour law in the EU member states, the mitigating of the risks of beneficiaries can be different from the one member state to the other. In any kind of framework this should be taken into account as well.

The considerations in this paper demonstrate that any alternative cannot be 'rule-based', but should be 'principle-based'.

1. Introduction

The main subject of this paper is to examine whether the new Solvency II regime for the European insurance sector should be implemented for IORPs or not.

An IORP is an organisation which exclusively operates pension schemes. Pension schemes are labour agreements in which the risk is often shared between the sponsors and/or the employees through pre-specified risk sharing mechanisms. These schemes are often negotiated between employers and employees, to supplement state social security pensions.

The aim of the new Solvency II regime is to ensure a high standard of risk assessment and efficient capital allocation for the insurance industry. Furthermore it should also contribute to increased transparency and help in the development of a level playing field across Europe.

The existing funding requirements of the IORP Directive are deliberately not only focussed on securing the pension liabilities to the maximum, but also allowing pensioners to benefit from affordable, secure and cost-effective workplace pensions. At the same time they do not hinder the competitiveness of the European economy and, very important, they support the

values of the European social model. In that way they stand in a long tradition with all other occupational pension schemes in Europe (funded or pay-as-you-go) as far as governance structures (participation of employers and employees), coverage ratio, solidarity and low costs are concerned.

The structure of the paper:

- Section 2 gives a brief view as to what Solvency II for insurance companies is all about.

- Section 3 shows on the basis of the situation in the Netherlands what consequences a 99.5% degree of certainty (that there will be no shortfall on a horizon of only one year) will have for the required solvency ratio, and what reacting to these requirements by going into fixed income investments could mean for the beneficiaries and for the economy.

- Section 4 demonstrates that different sorts of old age provision need different solvency rules, because not all supplementary pension schemes are comparable to a guaranteed individual pension policy as sold by an insurance company.

- Section 5 outlines what kind of 'self-corrective' mechanisms many types of IORPs have inbuilt to ensure their long-term solvency position.

- Section 6 shows the advantages for European workers of the fact that supplementary pension schemes in Europe (be it funded or pay-as-you-go schemes) are in fact labour agreements negotiated between employers and employees.

- Section 7 points out that the deregulation and liberalization of the financial markets should not be the only perspective to look at the future of supplementary pension schemes. One should also see that a supplementary pension scheme is a social issue that is embedded in the social and labour structure of the various member states of the EU.

- Section 8 finally contains the conclusions.

2. What is Solvency II for the insurance industry all about?

Solvency II was originally positioned as a project to reform the prudential regulation of insurance and a way to come to a level playing field for the insurance industry. As such it adheres to two of the European Commission's most dearly held tenets, namely the protection of consumers, in this instance via the provision of a safety net for policyholders, and the promotion of market stability.

Solvency II[3] is basically about a fundamental review of the capital adequacy regime for the European insurance industry. The current framework (Solvency I) apparently is too simple and does not direct capital in the sector accurately to where the risks are. In the past years it has become quite clear that capital required under Solvency I is inadequately allocated and so regulation in several countries has been strengthened, resulting in a patchwork of rules in place across Europe. The lessons learned from the beginning of this century, when financial markets fell sharply, and the lessons from insurance company failures, have increased the

[3] For more information see: CEA and Towers Perrin Tillinghast (2006), "Solvency II Introductory Guide" - http://www.cea.assur.org/cea/v2.0/uk/solvency/solvdocs/SolvencyGuide.pdf

scrutiny of both the industry and of regulators on the importance of best risk management practice.

Ensuring that insurance companies improve their risk management practices and hold appropriate levels of capital will give policyholders better protection against the risk of company failure. Furthermore the new rules are meant to further stimulate the creation of a free capital market for European insurance companies, which should lead to a better allocation of capital throughout the EU. In this way the new Solvency II regime should attain for the insurance industry what Basel II has done for the banks by connecting capital requirements to risks and the way these risks are managed.

The new Solvency II regime has *three pillars*: capital/solvency requirements, supervision and disclosure/information duties of the institutions to policy holders.

In *the first pillar* the new capital/solvency requirements will be more risk sensitive and aim to establish a revised set of EU-wide rules to calculate liabilities. The financial resources a company has to hold in order to be considered solvent will be defined. The main solvency requirements are:

- the best estimate of the market-consistent value of the liabilities (MVL)
- the marginal capital requirement (MCR): this defines the minimum level that requires action by the supervisor
- the solvency capital requirement (SCR): this are meant to make sure that unforeseen losses are bearable
- excess capital: in case parts of the risk control instruments are not implemented adequately.

The idea is that the intensity of supervision and the amount of intervention by the supervisor increases as the solvency ratio drops.

The second pillar on supervision is about rules to make sure there is a permanent dialogue between the supervisor and insurance companies. Supervision is meant to detect those insurance companies where for financial, organizational or other reasons risks are larger or smaller than in the insurance sector as a whole.

The third pillar is about disclosure/information duties of insurance companies to policy holders and the way in which open/transparent communication reduces the probability of market disruption and the way in which open/transparent communication will stimulate discipline on the part of insurance companies.

3. Consequences of implementing Solvency II for financial buffers of IORPs

The financial buffer requirements prescribed in Solvency II are very strict. The starting-point of Solvency II is a degree of certainty of 99.5% that there will be no shortfall on a horizon of one year.

The solvency ratio is defined as assets over liabilities times 100%, meaning that with a solvency ratio of 100%, the value of assets is equal to the value of liabilities. Below 100% there is a situation of shortfall, and above 100% the value of assets is more than the value of liabilities. The MCR (minimum capital requirement or required solvency ratio) is – for instance in the Netherlands – set over 100%.

The shortfall risk is the risk that the real solvency ratio will fall below the required solvency ratio within a period of time. So this shortfall risk determines what Solvency Capital

Requirement (SCR) will be needed to make sure the solvency ratio will (probably) not fall below the Minimum Capital Requirement (MCR) in case financial markets go down.

The case of the Netherlands – The supervisory context
When compared to the buffer requirements stipulated under the Netherlands' Financial Assessment Framework (FTK) the main differences with the requirements of Solvency II are:

- The required degree of certainty for pension funds in the Netherlands is at present 97.5%, whereas Solvency II raises that requirement to 99.5%.

- In the Dutch system a distinction is made between unconditional liabilities (in the Netherlands most pension schemes only guarantee nominal benefits) and conditional liabilities (indexation to wage or price inflation is conditional upon the financial position of the fund). Pension funds are only required to hold buffers for their unconditional liabilities.

So when in accordance with some representatives of supervisors in Germany and Denmark IORPs should also have a risk ratio of 99.5%, meaning a shortfall risk of only 0.5%, buffers would have to increase because pension funds have to be 'sure' that, whatever happens on the financial markets, there is only a probability once every 200 years that the actual solvency ratio will drop below the MCR. With a risk ratio of 97.5%, this would be only once every 40 years.

So the lower the shortfall risk (0.5% instead of 2.5%), the higher the required reserves will be. In combination with the requirement to value the whole pension scheme as an unconditional liability, the reserve requirements rise rapidly to a point where employers might not want to pay that kind of money to the pension scheme.

First of all a required degree of certainty of 99.5% would mean an asset liability ratio of an extra 10%[4]. Normally a pension fund in the Netherlands with indexation conditional upon the financial situation of the fund would have to hold an asset liability ratio of 130%: this would become 140%. If in accordance with Solvency II all indexation liabilities have to be seen as unconditional liabilities, then the asset liability ratio would have to go up with by 30% to about 170%. So Solvency II would require ABP, the largest pension provider in the Netherlands, to maintain an asset liability ratio of 170% to make sure that unforeseen losses are bearable (and there will be no shortfall below 100%). Meaning ABP would be facing an extra buffer of 40% before it would be able to index the pensions, and indexation is considered in the Netherlands to be the difference between a good pension and a bad pension. In the case of ABP, with liabilities of € 160 billion in 2006, with an asset liability ratio of 130% there would have to be € 208 billion in assets. If the asset liability ratio had to go up to 170%, ABP would need € 272 billion in assets instead of € 208 billion!! The question can be asked: who is going to pay the cost to make this possible?

By these growing demands, the risks for individual beneficiaries that there will be no indexation do not become lower. There is a real threat that employers will not want to pay contributions to ensure indexation for individual beneficiaries, so the risks will shift from employers to employees. So in the end the kind of supervisory demands and additional financial security requirements that follow from the Solvency II requirements will weaken the sustainability of workplace pensions because employers will either stop offering pension schemes or shift away to DC-scheme contracts simply because they do not want to pay that kind of money for the sustainability of workplace pensions.

[4] Dr. Olaf C.H.M. Sleijpen – Solvency II ook voor pensioenfondsen?, in the Dutch magazine: TPV (Tijdschrift voor Pensioen), April 2007

Solvency requirements of this type might force pension funds to act like an insurance company, and move exclusively into fixed income instruments (government bonds); this would have enormous consequences. ABP again, one of the largest pension funds, shows a total amount of assets over € 200 billion and an asset allocation of 50% in equities, 10% in real estate and 40% in fixed income. Going into fixed income would mean selling equities in such an amount that this would have a significant negative effect on markets and on economic development. One may also wonder who is going to pay for these costs. At the same time because of investing in fixed income instruments instead of in equities the return on investment would go down. Thus in so doing the fund loses the opportunity to index properly, unless of course social partners are prepared to raise pension fund contributions significantly, which obviously is no option.

With total assets of European pension funds at the moment of € 2,500 billion, extra Solvency II buffers up to 40% would lead to extra assets with pension funds to the amount of € 1,000 billion. When all European pension funds would go into fixed income, European pension funds would have to sell equities at about the same amount of € 1,000 billion with severe negative effects on markets and on economic development.

4. Different sorts of old age provision require different solvency rules

The idea behind the application of such a high solvency ratio for IORPs is that pension funds are just another sort of insurance undertaking. Both make people pay premiums and pay them an income at a certain age or (to their survivors) when they die. The basic idea is that to compete fairly both should have the same solvency requirements.

In this section we want to show why in the case of a guaranteed individual pension policy offered by an insurance company there should be a very low shortfall risk in order to make sure the beneficiaries receive out of their contract what they expected. On the other hand, in a supplementary pension scheme, because of all kinds of risk sharing possibilities between participants and sponsors, a higher shortfall risk and a longer recovery period will in the long run be better for beneficiaries and for economic development.

When an insurance company sells a guaranteed individual pension policy, the insurance company needs to minimize the shortfall risk in order to avoid a disastrous fall in confidence; the only way to do so is either by matching liabilities with long-term bonds so they know exactly what the investment result will be, or in adjusting their portfolio to their liabilities in such a way that both react in the same way to market developments such as a change in the discount rate. This in turn means a low return on invested capital, which is the price of security. There is simply no other possibility to cover the risk for the beneficiaries, because risks in such an environment cannot be shared with other participants and sponsors.

Funded pension schemes can be compulsory or voluntary, collective or individual and Defined Benefit (DB: pension results depend on salary) or Defined Contribution (DC: pension results depend on investment results).

On the one end of the scale we see voluntary individual pension schemes offering a DC-product, on the other end of the scale we see compulsory collective DB-products[5] (compulsory systems can only exist with the help of legislation or collective agreements: the market alone can not produce them).

[5] Compulsory pension systems such as in the Netherlands for employees working in different sectors or industries can be defended, because in that way they get the best of both worlds: they do not have to make difficult investment choices that they do not want to make and in most cases cannot make. Research shows people have a too short horizon for their own pension accrual, meaning they will almost always make non-optimal decisions.

When we have a pure DC-product/system, all shortfall risks are borne by the employees: meaning, be it a pension fund or an insurance company, there is no funding surplus needed (the deal is: when financial markets go down, the savings of employees also go down!).

Solvency II is primarily an issue in DB systems, but even in a collective DC system where there is any kind of (minimum) guarantee, Solvency II might be an issue to some extent. This depends to what extent that part or the whole pension scheme can be seen as an unconditional liability. To the extent part or the whole pension scheme can be seen as a liability conditional on the financial situation of the fund, there will be less necessity of maintaining a solvency ratio.

When we have a compulsory DB-system a high degree of solvency requirements is inevitable, but on the other hand these requirements do not have to be as high as with insurance companies, because the shortfall risks and not being able to index the accrued rights of the members are shared between employers and employees. However, an insurance company which sells a guaranteed individual pension policy needs to be liquid at the right time. IORPs instead are long-term investors who are looking for stability, in particular stability of the contribution rate and stability in terms of indexation.

A shortfall situation is most often caused by negative developments on financial markets. Such developments occur frequently, but normally they do not last long.
A well diversified worldwide portfolio may suffer one or two bad years, occasionally three years, but markets tend to recover within a few years. To react to a short-term phenomenon would be very costly for sure, because it would mean selling equity when it is cheap and buying bonds when they are expensive. Furthermore it would mean increasing the contribution rate (and therefore wage costs) when unemployment is high and consumption is low. The effects of these kinds of measures would be strongly pro-cyclical and thereby counterproductive for beneficiaries as well as the economy as a whole. For IORPs this means that they can do with a higher shortfall risk and a longer recovery period to function optimally.[6]

Basically one could say: the lower the possibility of risk sharing between participants and sponsors in a funded scheme and the higher the guarantees in the pension contract, the more necessary it is to have strict solvency rules. No matter who promises a certain level of pension (be it the employer, the insurance company or the IORP), solvency rules are applicable. In the next section we will see what kind of risk sharing mechanisms make it possible for IORPs, unlike insurance companies or individual employers, to ensure their long term solvency position.

5. Inbuilt mechanisms of IORPs to ensure their solvency position

To elaborate the possibilities of risk sharing mechanisms between participants and sponsors, in this section we will show what kind of 'self-corrective' mechanisms many types of IORPs have inbuilt to ensure their long term solvency position. These mechanisms are sufficiently widespread and sufficiently significant that any review of the solvency aspects of IORPs should take them into account:[7]

- **Flexible parameters**: within a pension fund agreement, the contribution and the main benefit parameters can be modified, so employers and employees together can modify, adjust or re-negotiate them even while entitlements are being built up.

[6] For the last part of this section thanks to Dr. Peter Kraneveld, an international pensions expert
[7] We acknowledge the input from EFRP Working group on Funding & Solvency

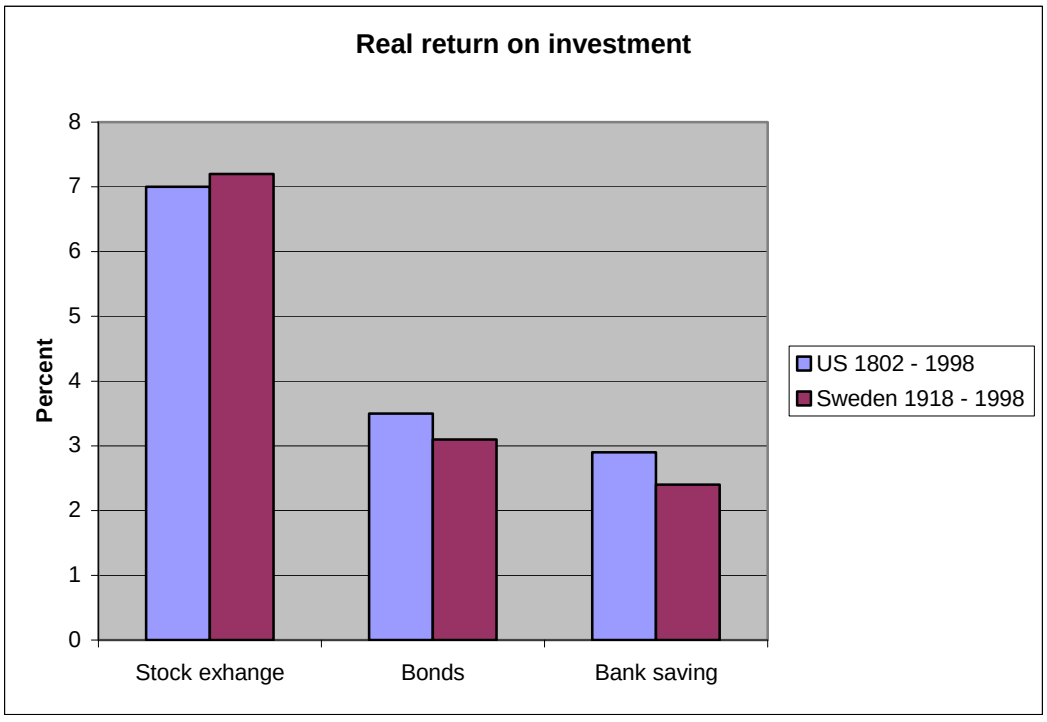
For instance the benefit parameters can be scaled down from final pay to average income (as has happened frequently in the Netherlands over the last years). In this way an IORP is able to mitigate any negative impact on its financial position. Such an adjustment of benefit parameters cannot be done in an insurance arrangement.

- **Governance structure**: IORPs have a governance structure which frequently involves the participation of social partners (employers and employees). They will carefully assess the solvency position at all times in the best interest of all stakeholders (employers, employees and pensioners) and are therefore willing to use the instruments they have (contribution rate, benefit rate, investment policy), to secure purchasing power both in the build-up period and in the pay-out period.

- **Long-term investment horizon:** IORPs are able to invest pension contributions on average for 20 to 25 years because they are based on the concept of compulsory participation, meaning members do not have the possibility of withdrawing, except in case of transfers. This long investment horizon allows IORPs to hold equities through the peaks and troughs in the financial markets, and to invest in other kinds of illiquid assets. In this way an IORP is not only able to make extra return on investment, but it also contributes to a further diversification of the investment portfolio, which contributes to good risk management. Although, as we all know, results in the past are no guarantees for the future, it is interesting to see the real return on investment in equities as compared to bonds or bank saving rates in Sweden the last century or in the United States the last two centuries (figure 1). Furthermore we see that the longer the investment period, the more the highest and the lowest return on investment move towards each other (figure 2).

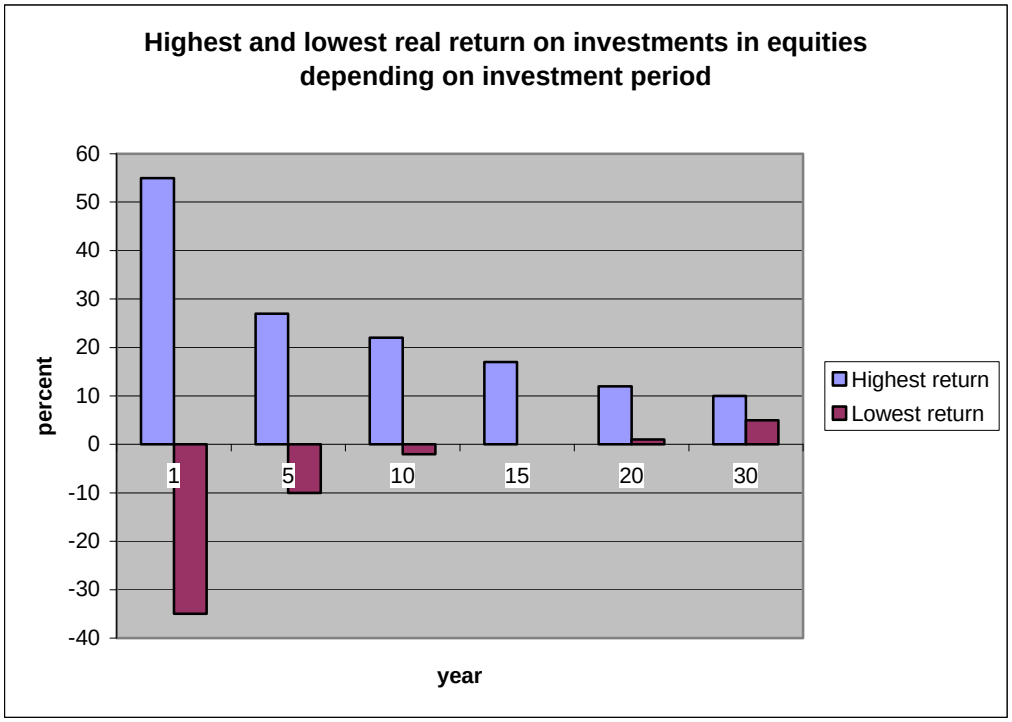
Therefore the financial buffers and other proposed measures envisaged for life-insurance companies under Solvency II do not appear to be necessary for IORPs.

Figure 1



Source: Riksbank of Sweden

Figure 2



Source: Riksbank of Sweden

The above mentioned adjustment mechanisms as well as some of the features of the governance structure may also have a social and labour dimension, thereby being assessed by Member States as a question of subsidiarity and thus way falling outside the scope of any EU financial services measure.

Furthermore, the extension of Solvency II to cover investments by IORPs will possibly have a negative effect on inward investment in SMEs. To quote the European Commission: "Small and Medium Enterprises make up 99% of all enterprises in Europe, account for the majority of new jobs created, and make an important contribution to achieving the European Union's goal of more growth and more and better jobs"[8]. Clearly it is important to ensure that SMEs can benefit from long-term finance to ensure their growth. Adding quantitative restrictions to pension funds' investment universe will not improve this situation.

The European Federation for Retirement Provision (EFRP) points out in its position paper on Solvency II that the extension of Solvency II to IORPs is unwarranted and untimely. Specifically the fundamental differences of IORPs as compared to insurance companies were presented. Furthermore the Solvency II project for the insurance industry is already so far developed that it is inappropriate at this stage to consider mechanically[9] extending a framework tailored to insurance companies to IORPs, without having first considered whether the funding requirements in the new IORP directive are appropriate. Last but not least, there has been no systematic consultation of IORPs in relation to any solvency issues so far at all.

[8] DG Enterprise website : http://ec.europa.eu/enterprise/index_en.htm
[9] Mechanically extending aspects of the new Solvency II regime to IORPs is indeed possible via the linkage established by article 17 of the IORP Directive with the Life Insurance Directive (2002/83/EC).

6. Advantages of occupational pension schemes for employees

In this section we wish to show that the inbuilt mechanisms of IORPs to ensure their solvency position are fundamentally based upon the fact that supplementary pension schemes in Europe are often labour agreements negotiated between employers and employees. Such a concept has all kinds of advantages for European workers, be it funded or pay-as-you-go schemes:

- **Lower costs:** collective pension schemes generate economies of scale which drive down costs.

- **Solidarity** through contributions: schemes can be set up to ensure that there is no link between the risk, age, and sex profile of the individual and his/her contributions, and that pension rights are built up during the whole career even in times of sickness, maternity leave etc. Some of these points may be seen as social and labour law priorities of individual Member States that fall outside the scope of any EU financial services measure.

- **Better coverage**: pension schemes are very efficient in reaching those categories of the working population that are unlikely to save adequately for retirement.

- **Not for profit**: all benefits return to the participants in the pension fund (employers, employees and pensioners).

Especially for funded schemes, in addition to those mentioned above, the following advantages are also present:

- **Less financial risk for individuals:** the individual's pension is not necessarily influenced by cyclical investment returns, unforeseen effects in the financial markets or the interest rate at the time of retirement.

- **Better investment decisions**: a professional team takes over the main investment decisions in the interest of the whole pool of employees.

All these advantages should not be put aside as a result of implementing the Solvency II framework on IORPs. Basically it should be considered whether the risks to beneficiaries are sufficiently taken care of, be it in a funded scheme or in a pay-as-you-go scheme.

7. The impact of European integration

Deregulation and liberalization of the financial markets should not be the only perspective to look at the future of supplementary pension schemes. It is important to understand that a supplementary pension scheme is a social issue that is imbedded in the social and labour structure of the different Member States of the EU.

It is therefore important to look at the huge differences in supplementary pension schemes throughout Europe, which perhaps make the creation of one single framework for supplementary pension schemes very difficult. On the other hand, where pension schemes are comparable it is evident that, from a European perspective, there should be some sort of 'level playing field'.

One of the great developments of European integration is the deregulation and liberalization of the financial markets. Since the 1990s successively the capital markets, the banking

sector, the insurance sector and investment funds have been deregulated and the markets have become wider and more liquid. IORPs are, in the perspective of the ageing of the population, a natural extension of this process of financial liberalization. For this reason the factors of deregulation and increasing competition in Europe, already are, or will soon also become, a major issue for IORPs, just as it already is for banks and insurance companies.

Given the fact that we already have a framework in the form of the IORP Directive 2003/41/EC, one possible way forward would be for the pension fund industry to adopt this directive, in order to avoid mechanical extension of Solvency II.[10] Insofar as solvency is necessary for IORPs, such a framework should ensure a viable occupational pension system in Europe and should respect institutional differences in various countries.

In this respect it is important to notice that the Commission has already encouraged CEIOPS' Occupational Pensions Committee to start a fact-finding exercise on Member States' current solvency regimes, as a starting point for considerations in the review of the IORP Directive which will begin in 2008.

As we have already seen, when implementing Solvency II for IORPs, short term security would be preferred over long-term efficiency and affordability. This would mean that funded schemes will be weakened in the long run because employers will stop offering pension schemes or will shift the risks and costs into DC-contracts.

In occupational pension schemes on a pay-as-you-go basis or companies using book reserve schemes we need to understand how the risks of the beneficiaries are managed and how they fit in to the aim of developing financial markets.

In the long run it seems inevitable that, no matter what kind of harmonization there will be, in the end all European funded occupational pension schemes will have to face some kind of framework as far as minimum solvency ratios are concerned or, at the very least, so that their financial conditions can be made comparable in terms of transparency. In such a harmonization the great advantages of the inbuilt 'self corrective' mechanisms and the fact that these schemes are agreements negotiated between employers and employees should of course be taken fully into account.

As far as pay-as-you-go schemes or book reserve schemes are involved, they should also be transparent in the way the risks of the beneficiaries are managed and how they fit into the claim of developing the financial markets. In these pay-as-you-go-schemes and book reserve schemes also the great advantages of the fact that these schemes are labour agreements negotiated between employers and employees should not be excluded in the elaboration of a framework.

8. Conclusion

Because of the interaction of supplementary pension schemes (funded or not funded) with social and labour law in the EU Member States, mitigating risks of beneficiaries can be different from one Member State to another. In any kind of framework this should be taken into account.

Whatever alternative is chosen, it should not hinder initiatives of several countries to put in place funded occupational pension schemes by confronting them with huge solvency

[10] The Commission has already announced its intention examine by 2008, when reviewing the IORP Directive 5 years after its entry into force, whether and how suitable solvency requirements can or should be developed for pension funds (Explanatory memorandum of the draft of the Solvency II directive COM(2007)361 final - § 4).

requirements that would make funding prohibitively expensive. Both killing existing funded occupational pension schemes and hindering the starting of new ones, is clearly neither in the best interests of individual beneficiaries nor in the best interests of the capital markets.

In any alternative it should be possible to respect the large differences in occupational pension schemes and related social and labour law throughout Europe: in the end there are more ways to mitigate the risk of beneficiaries that they will not get what was promised them (be it in funded schemes or in unfunded schemes).

The considerations in this paper demonstrate that any alternative can not be 'rule-based', but should be 'principle-based'.

Munich, 27 November 2007

About EAPSPI

The European association of public sector pension institutions (EAPSPI) is a group of 21 public sector pension schemes throughout Europe. The members and observers are institutions from the following countries: Austria, Belgium, Denmark, Finland, France, Ireland, Italy, Germany, the Netherlands, Portugal, Spain, Sweden, Switzerland and United Kingdom. These institutions cover the special basic schemes for civil servants or the supplementary schemes for public employees. They are responsible for nearly 26 million active members in the public sector and pensioners.

The main purpose of EAPSPI is to enable their members to improve the reciprocal knowledge of their institutions and that of the social organisation of their respective countries. Furthermore, the association intends to take part in the construction of a social Europe and, in this context, to study the consequences of the opening up of Europe, particularly regarding free movement. In this context, EAPSPI analyses ways and means of improving services offered to their clients (pensioners, active members or employers). To achieve this purpose, the association mainly intends to promote exchanges of expertise and information, involving also the area of products and services linked to retirement and to position itself as a pension expert, in order to develop relations with European institutions and other international organisations.