


Institute  
and Faculty  
of Actuaries

## Review of IORP Directive

Just when you thought it was safe to go  
back in the water ...

Dave Roberts



06 November 2013

Context

- 2003 IORP Directive brought us the delights of SSFR, internal controls, TKU and more
- IORP Directive is being revised – largely to bring it into line with other (amended) financial regulation
- Model for IORP II Directive is Solvency II Directive for insurers
- Most focus and contention in relation to capital adequacy requirements, core of which was/is holistic balance sheet (HBS)
  - Quantitative Impact study – potentially disastrous for UK



Context

- 2003 IORP Directive brought us the delights of SSFR, internal controls, TKU and more
- IORP Directive is being revised – largely to bring it into line with other (amended) financial regulation
- Model for IORP II Directive is Solvency II Directive for insurers
- Most focus and contention in relation to capital adequacy requirements, core of which was/is holistic balance sheet (HBS)
  - Quantitative Impact study – potentially disastrous for UK
- May 2013: announcement that capital adequacy elements not to feature in IORP II
- Expect draft IORP II Directive – Governance and Disclosure - in December



Context

- 2003 IORP Directive brought us the delights of SSFR, internal controls, TKU and more
- IORP Directive is being revised – largely to bring it into line with other (amended) financial regulation
- Model for IORP II Directive is Solvency II Directive for insurers
- Most focus and contention in relation to capital adequacy requirements, core of which was/is holistic balance sheet (HBS)
  - Quantitative Impact study – potentially disastrous for UK
- May 2013: announcement that capital adequacy elements not to feature in IORP II
- Expect draft IORP II Directive – Governance and Disclosure - in December
  - .....but.....
- EIOPA has not abandoned the HBS and is hungry for more power



EIOPA - HBS

*"In the coming months, EIOPA will set out a **programme of work** to improve definitions and methodologies for assessing the holistic balance sheet. ... My aim is to present the next Commission with further tested technical proposals for a European risk-based prudential regime that appropriately reflects the specific reality of pension funds."*

Gabriel Bernardino, opening address at "EIOPA - QIS for pensions - closing event" 10 July 2013

*"In 2014, it is intended to further deepen the analysis in the Financial Stability Report with the development of new analytical tools to assess risk and the impact of such risks on insurers and occupational pension funds."*

EIOPA – work programme 2014, published 10 October 2013

*"I am glad that the QIS results confirmed that the concept of the holistic balance sheet suggested by EIOPA is sustainable ..."*

Interview with Gabriel Bernardino, published 14 Oct 2013

5

EIOPA – 2014+ work programme

**Five solvency-related work streams**

- Sponsor support
- Supervisory responses
- Discretionary decision-making processes
- Benefit reduction mechanisms
- Contract boundaries

**Aspirational timeline**

- First half 2014
- Second half
- 2015

Consultation papers deriving from further work  
EIOPA reports  
Impact assessment and delivery to European Commission

6

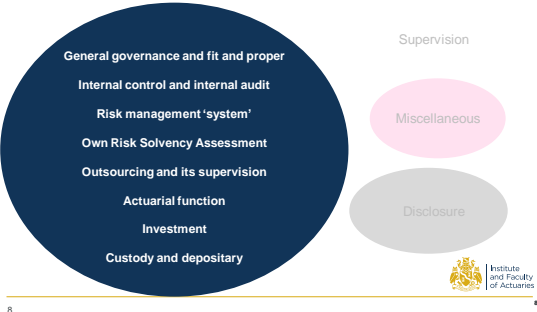
EIOPA – power grab

*"It is fundamental to strengthen our independent challenging role towards National Competent Authorities. We need to ensure EIOPA's access to individual information<sup>1</sup>....[and] extend the current powers<sup>2</sup> to conduct an inquiry into a particular type of financial institution, ..product, or...conduct"*

<sup>1</sup> In order to avoid the need for burdensome case by case discussions. This should allow EIOPA to obtain access to the information included in harmonised templates developed for Solvency II in a smooth and direct way  
<sup>2</sup> This power should not be confined to situations of potential threats to the stability of the financial system but be used more generally

7

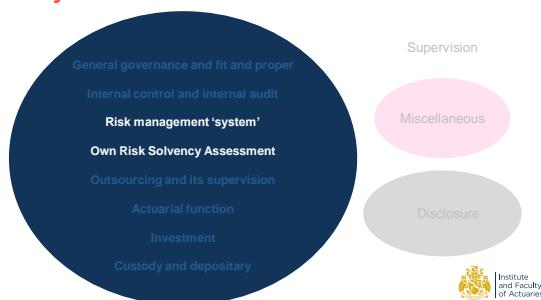
Key elements of IORP II - Governance



8

## EIOPA advice

## Key elements of IORP II - Governance



9

## Risk Management (1)

- Formal, documented risk management system to identify, measure, monitor, manage and report to trustees on material risks on a continuous basis
  - Specify how decisions are made
  - Specify how control is exercised when critical functions are outsourced
- System should cover
  - Reliance on sponsor support
  - Asset-liability management
  - Investment – particularly derivatives
  - Liquidity and concentration risk
  - Operational risk management
  - Any other material risks – credit, counterparty default, political, price/salary inflation

10



10

## EIOPA advice

## Risk Management (2)

- Formal risk-management function – independent of operational function
- Integrate with internal controls, ORSA and outsourcing
- Change in content of Statement of Investment Principles – to avoid overlap
- DC risks to be considered from **members'** perspective



11

11

## Guidelines

## Draft Guidelines - risk management (policy)

- Trustees establish a risk management policy that at least
  - Defines the risk categories and methods to measure the risks
  - Outlines how the trustees manage each category and area of risks
  - Describes the connection with the ORSA (forward-looking assessment of scheme's own risks)
  - Specifies risk tolerance limits within each relevant risk category
  - Sets out frequency and content of regular stress tests, and describe situations that would warrant special stress tests

12



12

## Guidelines

## Guidelines - risk management (policy)

- Trustees establish a risk management policy that at least
  - Defines the risk categories and methods to measure the risks
  - Outlines how the trustees manage each category, area of risks and any aggregation of risks
  - Describes the connection with the ORSA (forward-looking assessment of scheme's own risks)
  - Specifies risk tolerance limits within each relevant risk category
  - Sets out frequency and content of regular stress tests, and describe situations that would warrant special stress tests

"The chapter on risk management is generally considered (by stakeholders) to be too prescriptive and detailed"

"EIOPA believes the section is sufficiently principles based"



13

## Guidelines

## Draft Guidelines - risk management (operational risk)

- Trustees to include (at least) in risk management policy
  - Identification of such risks and how to mitigate them
  - Activities and internal processes in place, including IT system supporting them
  - Risk tolerance limits in key operational risk areas
- Trustees to set up a system for collecting and monitoring operational risk events
- Develop and analyse an appropriate set of operational risk stress scenarios based on, at least
  - Failure of key process, personnel or system and
  - Occurrence of external events



14

## Guidelines

## Guidelines - risk management (operational risk)

- Trustees to include (at least) in risk management policy
  - Identification of such risks and how to mitigate them
  - Activities and internal processes in place, including IT system supporting them
  - Risk tolerance limits in key operational risk areas
- Trustees to set up a system process for collecting and monitoring operational risk events
- Develop and analyse an appropriate set of operational risk stress scenarios based on, at least
  - Failure of key process, personnel or system and
  - Occurrence of external events

"...respondents object to the requirement to set risk tolerance limits, claiming such limits are difficult to set... and therefore unsuitable"

Respondents thought system implied IT-based system

"EIOPA acknowledges that assessing operational risk is not an easy task....."

"stress" deleted



15

## Guidelines

## Draft Guidelines - risk management (asset-liability management)

- Trustees to include (at least) in risk management policy
  - Description of the procedure for identifying and assessing the different natures of mismatches, at least with regards terms and currency
  - Description of mitigation techniques used and the expected effect on A-L management
  - Description of deliberate mismatches permitted and content and frequency of stress-tests to be conducted and monitored
  - Description of the underlying methodology and frequency of stress tests to be carried out



16

## Guidelines

**Guidelines - risk management (asset-liability management)**

- Trustees to include (at least) in risk management policy
  - Description of the procedure for identifying and assessing the different natures of mismatches, at least with regards terms and currency
  - Description of mitigation techniques used and the expected effect on A-L management
  - Description of deliberate mismatches permitted and content and frequency of stress-tests to be conducted and monitored
  - Description of the underlying methodology and frequency of stress tests to be carried out

deleted



17

## Guidelines

**Guidelines - risk management (risk-mitigation)**

- Trustees to include (at least) in risk management policy
  - Identification of the level of risk transfer
  - Principles for selection of risk mitigation counterparties – and how assessed and monitored for credit worthiness and diversification
  - Procedures for assessing effective risk transfer
  - Liquidity management to deal with timing mismatch between claims and recoverables



18

## Guidelines

**Guidelines - risk management (investment risk)**

- Trustees to include (at least) in risk management policy
  - Level of security, quality, liquidity, profitability as and availability that the IORP is aiming for (with regard to whole portfolio) and how it plans to do so
  - Internal quantitative limits on assets/exposures, including off-balance sheet
  - Consideration of the financial market environment
  - Conditions under which the IORP can pledge/lend assets
  - The link between market risk and other risks in highly adverse scenarios
  - Procedure for valuing assets
  - Procedures for monitoring performance and reviewing policy
  - How assets are selected in the best interests of members



19

## Guidelines

**Guidelines - risk management (liquidity risk)**

- Trustees to include (at least) in risk management policy
  - Procedure for determining mismatch between cash inflows/outflows
  - Consideration of total liquidity needs in short/medium term (including an appropriate liquidity buffer)
  - Consideration of liquid assets including quantification of potential costs/losses arising from enforced realisation
  - Identification and costs of alternative financing tools
  - Consideration of the effect on the liquidity situation of expected "new business" [accrual]



20

Own Risk Solvency Assessment (ORSA)

- Need to draft ORSA policy
- Design ORSA reporting template
- Quantification of risks not captured in HBS-style capital adequacy test, which could include
  - Regulatory risk
  - Risk of increased buy out costs
  - Stresses to sponsor support
  - Merger/split of scheme (if proposal to do so)
- Integrate with risk management, internal controls etc



Guidelines - ORSA

- Trustees' ORSA policy should include, at least:
  - A description of the processes and procedures in place to conduct the ORSA
  - Consideration of the link between the risk profile, the approved risk tolerance limits and the overall solvency needs
  - Information on
    - How and how often stress tests, sensitivity analyses and reverse stress tests are performed
    - Data quality standards
    - Frequency of the ORSA itself and justification of its adequacy (taking account of risk profile and volatility of solvency needs)
    - Timing of assessment and triggers for out of cycle ORSA
- Internal report to be communicated to all relevant staff
- Supervisors report (within 2 weeks of conclusion)
  - Qualitative and quantitative results
  - Methods and assumptions used



Other snippets from EIOPA response

"The...regular stress-testing is another issue that respondents object to."  
"Stress tests and scenario analyses do in EIOPA's view...determine how exposed the undertaking is to certain risks"

"[supervisors] have to report to EIOPA within 2 months whether they comply [or] provide an explanation...about non-compliance. The answers on comply-or-explain...will be made publicly available by EIOPA"

EIOPA Final Report on Public Consultation on the Proposal for Guidelines on the System of Governance

"The size of the undertaking alone can never be a reason to accept simpler solutions for the implementation of requirements"

"Among the most opposed requirements...is the development of an own set of key risk indicators...and the requirement not to solely depend on the information provided by other financial institutions, asset managers and rating agencies"

"Key risk indicators are an important monitoring tool...[and]...proper monitoring and controlling of assets...requires that the undertaking does not blindly trust...information [from financial institutions etc...]"



Limitations of reliance

- This material has been prepared by Towers Watson Limited. Its purpose is to provide an overview of the latest developments regarding governance under the review of the Directive for Institutions of Occupational Retirement Provision (IORP) by the European Commission. It is based on our current understanding based on EIOPA's advice to the European Commission.
- The material was not prepared for any other use or for use by any other party and may well not address their needs, concerns, or objectives. This presentation is based on data/information available to Towers Watson Limited at the date of the presentation and takes no account of subsequent developments after that date.
- This material should not be disclosed to any third party other than in accordance with the terms of engagement agreed with you or with our specific consent. Unless otherwise specifically agreed in writing we assume no responsibility, duty of care or liability to any third party who may gain access to a copy of this document and any such reliance that they place on it is entirely at their own risk. This material is not intended by Towers Watson Limited to form a basis of any decision by a third party to do or omit to do anything.