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Position paper

- **The review of the IORP Directive from an insurance perspective**

Key messages

- Insurance Sweden welcomes a revision of the IORP Directive with the aim of creating a modern risk-based regime for occupational pension provision.

- But the new rules should maintain consistency across financial sectors ("substance over form") and ensure that the safeguarding of pension schemes containing similar risks is subject to similar regulatory requirements ("same risks, same rules").

- In order to create a level playing field between IORPs and insurance undertakings providing occupational pensions Solvency II should be adapted to the future IORP regime.

- A transitional period for occupational pension provision should therefore be introduced into the Solvency II Directive to ensure that the new framework for occupational pension provision enters into force simultaneously for insurance undertakings and IORPs alike.

1. The case for a review of the IORP Directive

Prudential regulation of occupational pensions is an important tool to protect long-term savings aimed at ensuring a reasonable level of income during old age. Such savings can offer guarantees regarding the level and duration of the payments and contribute in a vital way to the standard of living after employment for large groups of citizens.

Given the demographic developments it has become increasingly clear that action needs to be taken in order to ensure a sufficient and sustainable pension framework for the future in the EU. Insurance Sweden therefore welcomes the debate on pension issues initiated through the Commission´s Green Paper on pensions.

Although all three pension "pillars" – the social security systems, occupational pensions and individual pensions – have an important role to play, this paper will give special attention to occupational pensions. The current legal framework, the IORP Directive, has not lead to the development of an internal market for occupational pensions that was anticipated. The interpretation of the directive differs widely between Member States, causing barriers to entry, distortions of competition and a lack of efficient management of pension assets and liabilities. The level of consumer protection thus differs among the Member States. Insurance Sweden therefore welcomes the review of the IORP Directive that has now been set in motion through the Commission´s call for advice to EIOPA.

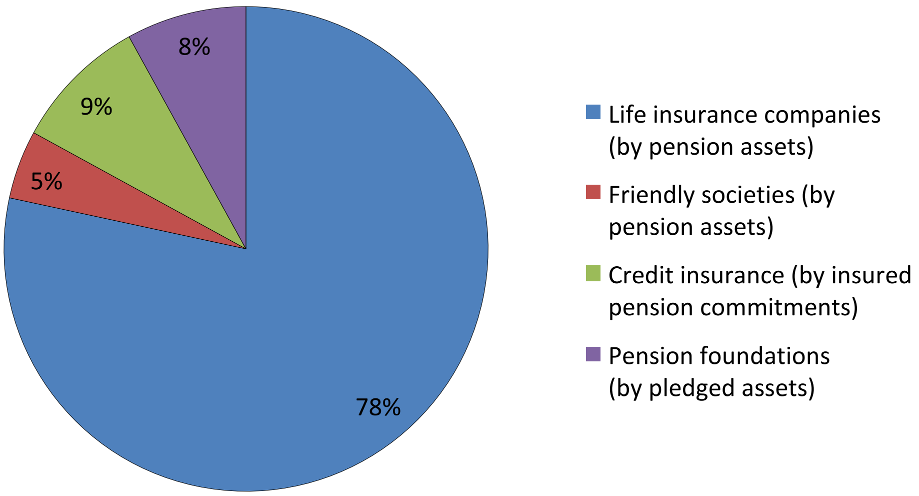
But occupational pensions are not only provided by pension funds ("IORPs") directly covered by the scope of the IORP Directive, but also by insurance undertakings. This is the case in Sweden where insurance solutions dominate the market for occupational pensions. The diversity of the markets throughout the EU represents a challenge when it comes to creating a level playing field from a regulatory perspective between the different providers of occupational pensions.

In this paper, Insurance Sweden will give a description of the Swedish market for occupational pensions followed by an outline of what we see as the best way forward to deal with the challenge of ensuring an efficient and sector neutral future EU framework for occupational pensions.

2. The Swedish market for occupational pensions

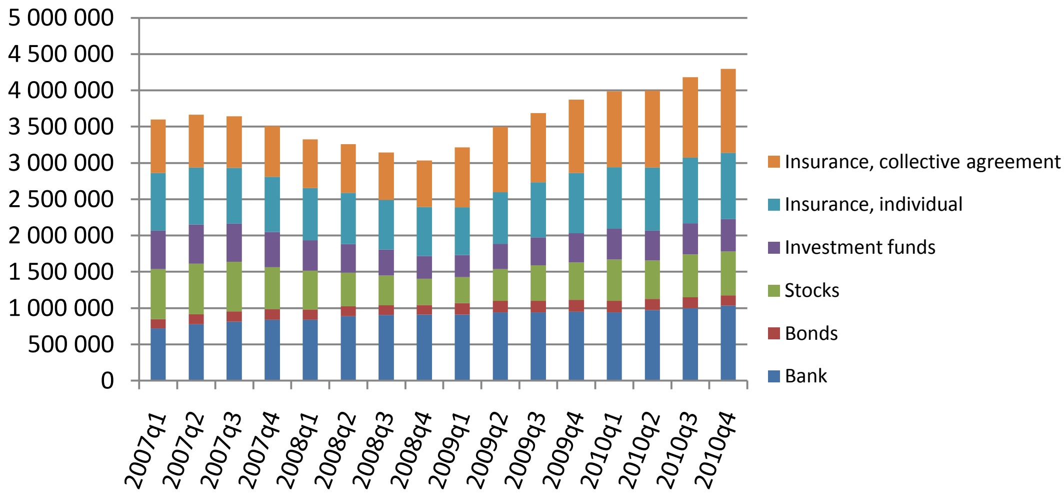
Over 90 per cent of the Swedish workforce is covered by occupational pension schemes decided by collective agreements. The main solution envisaged by these agreements is to safeguard occupational pensions through life insurance.

Providers of occupational pensions in Sweden 2009 (source: Insurance Sweden)



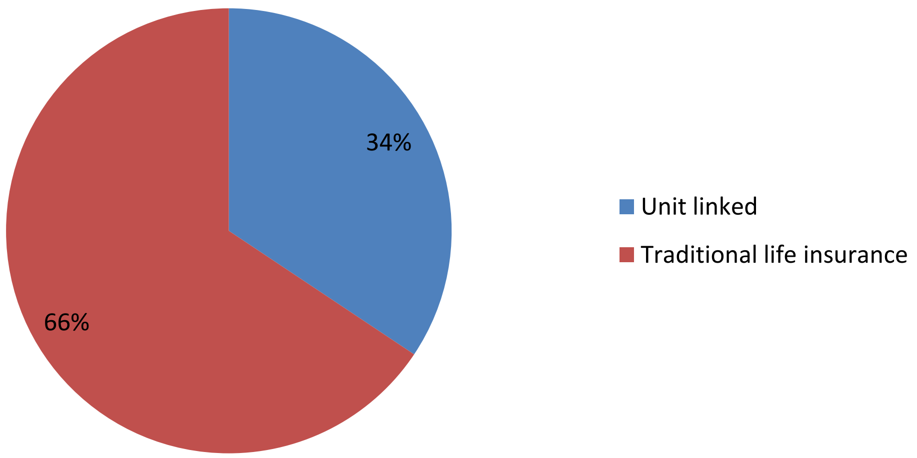
The combined premium income for life insurance covering occupational pensions amounted to approximately EUR 12 billion in 2010. The total value of assets relating to such insurance came to approximately EUR 130 billion in 2009. This segment of the insurance market therefore accounts for a substantial part of the total savings in Sweden.

Total Swedish household savings by assets (source: Insurance Sweden)



The market for occupational pensions is dominated by four major occupational pension schemes covering, respectively, white and blue collar workers in the private sector, the state sector and the municipalities. All four schemes have moved from defined benefit (DB) to mainly defined contribution (DC) designs for new entrants, sometimes including options between DB and DC and combinations of both features. Older DB schemes are subject to transitional periods and are still being phased out. Additional, smaller schemes present in the market will generally mirror the conditions of the four major plans. The DC plans are member-directed, i.e. whilst the employer will pay the contributions the employees are given a range of insurance undertakings to choose from, including a default alternative where no choice is made. Moreover, the employees can choose among different products offered by these insurance undertakings such as unit-linked insurance or traditional life insurance or a combination thereof. Depending on the scheme, there may however be some limits to how much the employee is allowed to direct into each respective product.

Distribution of occupational pensions between unit-linked and traditional life insurance by premium income 2010 (source: Insurance Sweden)



Since life insurance is the predominant safeguard for Swedish occupational pension schemes, contributions and payments will be protected by laws governing insurance activities. This offers a guarantee that DB plans will be fully funded at all times. It also means that even DC plans can offer a guaranteed amount through traditional life insurance and that employees are granted a right to choose a solution tailored to individual needs as regards investment choice, should they opt for unit-linked insurance.

3. The interaction with Solvency II

Thus, insurance undertakings are the major suppliers of occupational pensions in the Swedish market. The reason for this is that insurance has proven to be an ideal vehicle to safeguard long-term commitments, given that the handling of longevity risks is one of the key features of life insurance. Indeed, the kinship between occupational pensions and insurance covering longevity risks was recognized when the current IORP Directive was adopted. Firstly, Article 17 in the Directive states that IORPs underwriting the liability to cover against biometric risk or guarantees a given investment performance or a given level of benefits shall be subject to a requirement of regulatory own funds calculated according to the Life Insurance Directive. Secondly, in order to ensure a level playing field, Article 4 gives Member States the option to apply the core prudential rules in the IORP Directive to the occupational retirement provision business of insurance undertakings.

The Life Insurance Directive will soon be replaced by Solvency II in the Member States. At the same time, the IORP Directive is being revised. But in the work undertaken since the Solvency II framework directive was adopted, it has become increasingly clear that Solvency II is not well-adapted to long-term commitments such as occupational pensions.

In the call for advice from the Commission to EIOPA, the Commission´s approach is that EIOPA should use Solvency II as a benchmark for the revision of the IORP Directive, but with special attention given to the specificities of occupational pensions. In this regard, the Commission also states that the advice should carefully take into account lessons learned from Solvency II relating to, in particular, the illiquidity risk premium in the discount rate, the need to better reflect long-term guarantees and to possible simplifications. Insurance Sweden welcomes this approach, although there may be a need for additional elements to be adjusted in Solvency II to ensure that the ability of long-term obligations to withstand short-term volatility is properly reflected.

Insurance Sweden also welcomes that, although the IORP Directive should still be a *sui generis* risk-based supervisory system for IORPs, the clear statement by the Commission that the EIOPA advice should endeavour to maintain consistency across financial sectors and that pension schemes containing similar risks should be subject to similar regulatory requirements.

These statements by the Commission point to two important objectives. Firstly, the coming risk-based framework should be well-adapted to the nature of occupational pension commitments. Secondly, a level playing field between different market players must be ensured. But given the concurrent work streams – Solvency II and the revision of the IORP Directive – how can these two objectives be best achieved?

4. Basic principles for the future regulation of occupational pensions

In line with what the Commission has expressed in the call for advice for EIOPA, Insurance Sweden sees the following basic principles as core to the future regulation of occupational pensions.

Firstly, the main objective should be "*substance over form*". We need to ensure an appropriate regime for the provision of occupational pensions, regardless of whether the provider is an IORP or an insurance company. But secondly, it is equally important that we follow a *"same risks - same rules"* approach. In our view, our main interest should be to ensure that where the activities of IORPs and insurance companies cover the same risks, the same rules should apply. Otherwise the risk of regulatory arbitrage is clear.

About the Commission´s aim to use the Solvency II approach as a starting point for the revision of the IORP Directive, Insurance Sweden agrees with the intention to introduce truly risk-based rules also in the area of occupational pensions. However, we are all aware of the potential problems this framework could pose to products with long-term guarantees. Moreover, Solvency II does not take into account other specific aspects of occupational pension provision, such as additional safeguards and other conditions flowing from the relationship between employers and employees and between the employer and the occupational pension provider. Such aspects have been highlighted by the Commission in the call for advice on the IORP Directive. A crucial factor to consider in this context is of course the existence of collective agreements. As has been described above, over 90 percent of the Swedish workforce is covered by collectively agreed pension schemes. These elements change the risk setting for all stakeholders in the product and – adhering to the principle of "*substance over form*" – such specificities should be reflected in the framework, regardless of the provider of occupational pensions.

Again, it seems that the Commission is broadly in line with these principles in the call for advice, but in our view it is unclear how the principles are to be put into practice. Given the timeline for Solvency II and the fact that the revision of the IORP Directive is lagging behind, how do we achieve a level playing field between insurance undertakings and IORPs in this area?

5. Why do we need a level playing field?

To some extent, this question has already been answered above. Pensions are about longevity risks. Insurance providers specialize in handling longevity risk. The clear ambition for the future is to provide sustainable pensions, where occupational pensions already play a significant part in many jurisdictions, such as Sweden, and may increase in importance given the foreseen demographic strains on society.

As also described above, the role of insurers in the area of occupational pensions was recognized already when the current IORP Directive was adopted. IORPs taking on the same risks as insurance undertakings are subject to the rules on own funds in the Life Insurance Directive. And, in order to guarantee a level playing field, Member States were given the option to apply the core prudential rules of the IORP Directive to the occupational pension provision business of life insurers. Given that the Swedish market for occupational pensions is dominated by insurance solutions, Sweden has made use of this option.

The current IORP framework has thus provided for an interim solution to ensure, to the largest extent possible, that the objectives of *"substance over form"* and *"same rules, same risks"* can be fulfilled as regards the treatment of occupational pensions. But in the incoming Solvency II, problems affecting long-term commitments such as occupational pensions have been identified. This fact, together with the clear wish from the Commission to take into account lessons learned from Solvency II in the IORP revision, creates a risk that the two frameworks will go their separate ways. The IORP Directive will take account of the specificities of occupational pensions, whereas Solvency II will not, at least not to a sufficient extent. This means that insurance undertakings providing occupational pensions will no longer be on equal footing with IORPs, despite the fact that insurers handle the same risks as IORPs and have a long and excellent track record in doing so.

6. How do we achieve a level playing field in practice?

Our starting point is that all insurance undertakings should ideally be regulated under Solvency II and all IORPs under the IORP Directive. But in order to guarantee a level playing field between insurance undertakings and IORPs the two directives need to be aligned as concerns occupational pension provision. We do not believe that adjustments to Solvency II at levels 2 and 3 can achieve the same objectives as regards occupational pensions. Amendments to Solvency II should therefore be made through the IORP Directive in this regard. But both sets of new rules should enter into force simultaneously in order to avoid a situation where insurance undertakings providing occupational pensions would be subject to the new Solvency II regime whereas IORPs would continue to follow the current IORP Directive.

Our conclusion is therefore that a transitional period for the occupational pension activities of insurance undertakings needs to be introduced into Solvency II in anticipation of the revision of the IORP Directive. Technically, such a transitional provision could be effectuated through the Omnibus II proposal. A transitional provision of this kind would not affect the playing field between insurance undertakings in general, as no other insurance activities apart from that of occupational pensions will be affected. Instead, this solution would ensure that the *current and future* level playing field between insurance undertakings and IORPs is retained.

It is the firm belief of Insurance Sweden that this solution would not only live up to the objectives of *"substance over form"* and *"same risks – same rules"*. It would also give us valuable time to draw on the lessons learned in Solvency II as regards long-term guarantees and hopefully leave enough room to correct the mistakes that were made there. Moreover, it would ensure that all providers of occupational pensions are subject to an appropriate, sector neutral regulatory framework and thus able to be part of the solution to the EU pension challenge.