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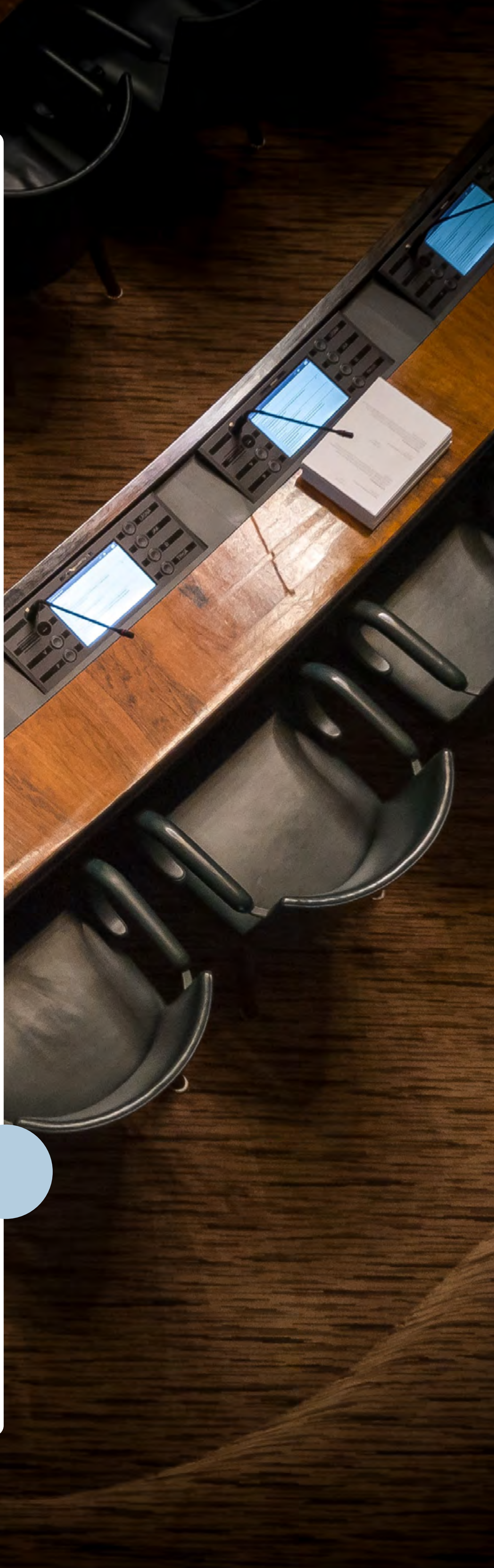
IORP II Directive: What does it mean for European pension funds?



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Marketing communication

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May 25, 2023 was the closing date for responses to the consultation conducted by EIOPA on the review of the IORP II Directive, which regulates the activities of European pension funds. The Directive came into being in 2016 after a lively debate in a Europe that still counted the UK among its members. Initially based on the Solvency II model, it has partially retained the second and third pillars, covering governance and reporting respectively. Transposed into national law in 2019, it is already subject to a review that may prove profound, depending on the final political arbitrations.

What can we expect? We'll start with an overview of occupational pension plans in Europe, then take a look at the main elements of the current Directive and the discussions underway.

1. Overview of occupational pension plans.

The IORP II Directive (Institutions of Occupational Retirement Provisions) defines Institutions for Occupational Retirement Provision (IORP) as

> **...an institution, irrespective of its legal form, which operates on a funded basis and is established separately from any sponsoring company or group for the purpose of providing occupational pension benefits.**

Pension systems are traditionally based on three pillars:

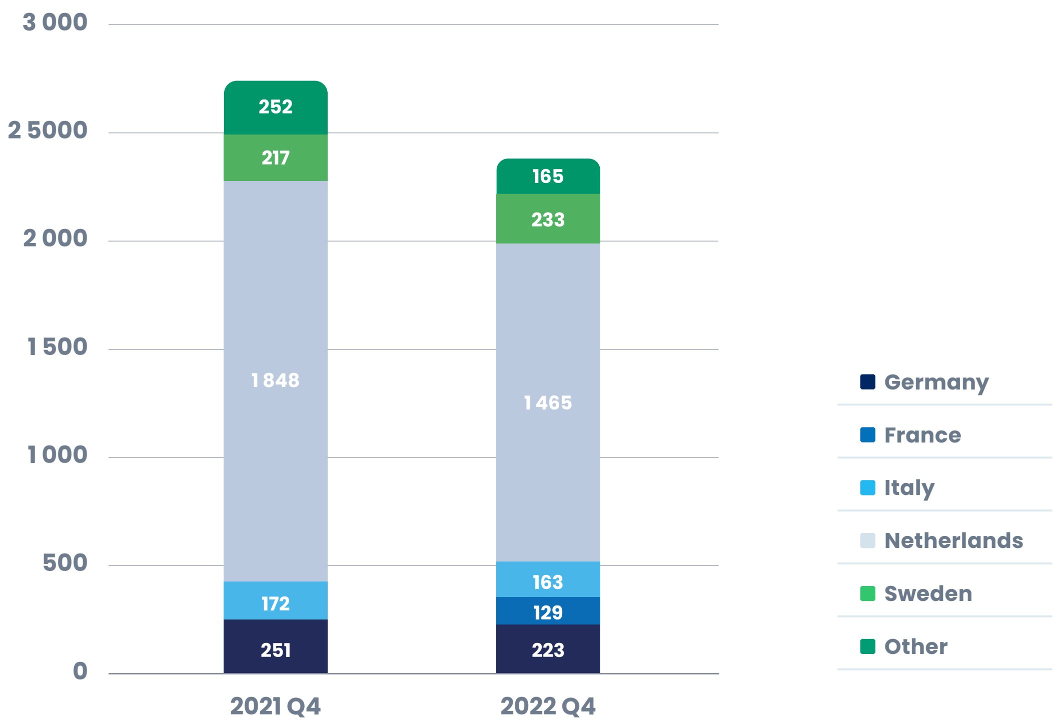
- The first is the state-sponsored statutory pension, which is generally financed on a pay-as-you-go basis and is often considered a living wage;
- The second is occupational retirement;
- The third is retirement financed by individual savings.

There is a considerable diversity of practices across Europe -- compulsory or non-compulsory plans; joint steering or not; single-employer, sectoral or multi-employer plans; defined benefit or defined contribution; obligation of result or of means at IORP level. IORPs can be set up directly by the employer, or by an external body such as an insurance company. There is also a wide diversity of prudential practices, with a regime close to Solvency II in the Netherlands and a regime close to Solvency I in France, for example. In terms of assets under management, the Netherlands has the largest IORPs in Europe.

The table below illustrates this diversity, based on statistics compiled from the EIOPA website.

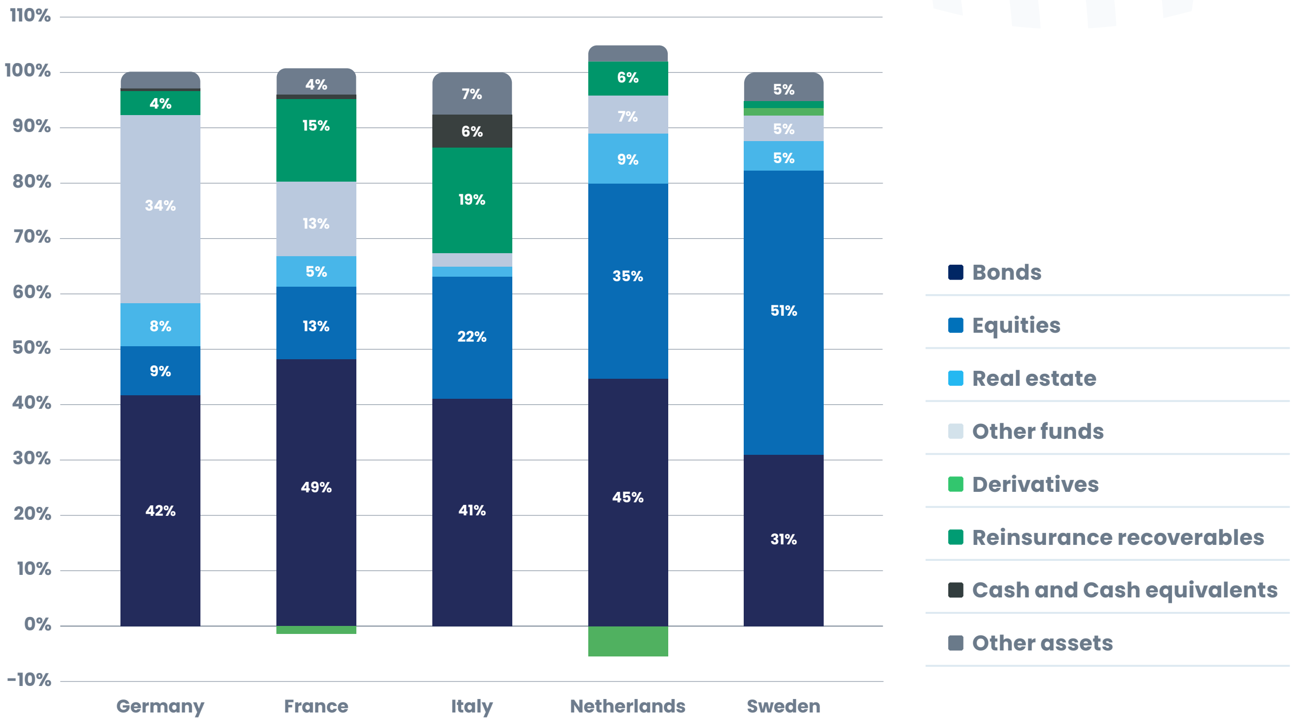
2021	Germany	Italy	Netherlands	Sweden
Number of IRPs	119	204	207	11
Of which multi-employer	23	81	77	10
Of which single-employer	96	123	130	1
Number of pension plans	356	256	14 720	35
Weight of the 3 largest IRPs in total assets	24%	21%	51%	94%
Weight of the 10 largest IRPs in total assets	46%	43%	68%	100%

Figure 1:
Breakdown of total IRP assets



Source: EIOPA, Candriam

Figure 2:
IRP asset allocation in 2022



Source: EIOPA, Candriam

In France, IRPs are generally very recent entities established following the transposition of the IORP II Directive and the vote of the Loi Pacte in 2019. The number of players and the volume managed by ORPS (Organismes de Retraite Professionnelle Supplémentaire, French IORPs) has exploded between 2019 and 2022, rising from 5 to 22 organizations and the sum of cumulative assets from ten billion to over 200 billion euros.

2. The IRP Directive: what does it say, what changes can we expect?

The 2016 IRP Directive sets ambitious targets:

- Promote the European single market by facilitating the establishment of transnational IORPs;
- Protect Europeans against poverty in old age and promote protection which complements to public pension plans;
- Promote best practices in risk management and governance by setting up key functions (risk management, internal audit and actuarial) and introducing an Own Risk Assessment (ORA);
- Explain how environmental, social and governance aspects are taken into account in asset management;
- Improve information for current and future affiliates and beneficiaries, the supervisory body and the public – including accounts and annual reports, investment policy, ORA.

The Directive is based on the principle of minimum harmonization, in view of the diversity of practices described above and the interaction of occupational pension activities with social, tax and labor law, which fall within the national remit of the Member States.

Another important point: the Solvency II Directive mentions in paragraph 77 that "the further implementation, at Union level, of solvency models, such as the 'holistic balance sheet', is not realistic from a practical point of view, nor is it efficient in terms of costs and benefits, taking into account in particular the diversity of IORPs within and between Member States." The holistic balance sheet was the IORP version of Solvency II, rejected en masse by the various European countries, with the notable exception, at the time, of France.

Although lighter than Solvency II, the governance and reporting aspects have had a significant effect on the IRP landscape, with their number having fallen sharply since 2019, an effect that was observed with Solvency II on small and medium-sized insurance companies and mutuals.

What can we expect from the review of this Directive?

Firstly, we note that EIOPA has not abandoned its idea of a holistic balance sheet. This idea is returning as a "common evaluation framework", albeit not linked to capital requirements. This framework has few followers in Europe, and we can imagine that it will not be retained, even though EIOPA regularly uses it as part of its stress-testing of European pension funds. EIOPA also proposes raising the Directive's exemption threshold for IORPs based on a risk criterion. The notion of "low-risk" IORPs could lead to a significant distortion in the market, as it would imply that IORPs that do not benefit from this measure are "high-risk". In the background, the effective maintenance of the principle of minimum harmonization, which is incompatible with a common risk-based approach at European level, is at stake. And therefore the risk of supervision that is ill-suited to the plurality of institutions and practices.

Other major challenges relate to various governance and reporting measures, for example:

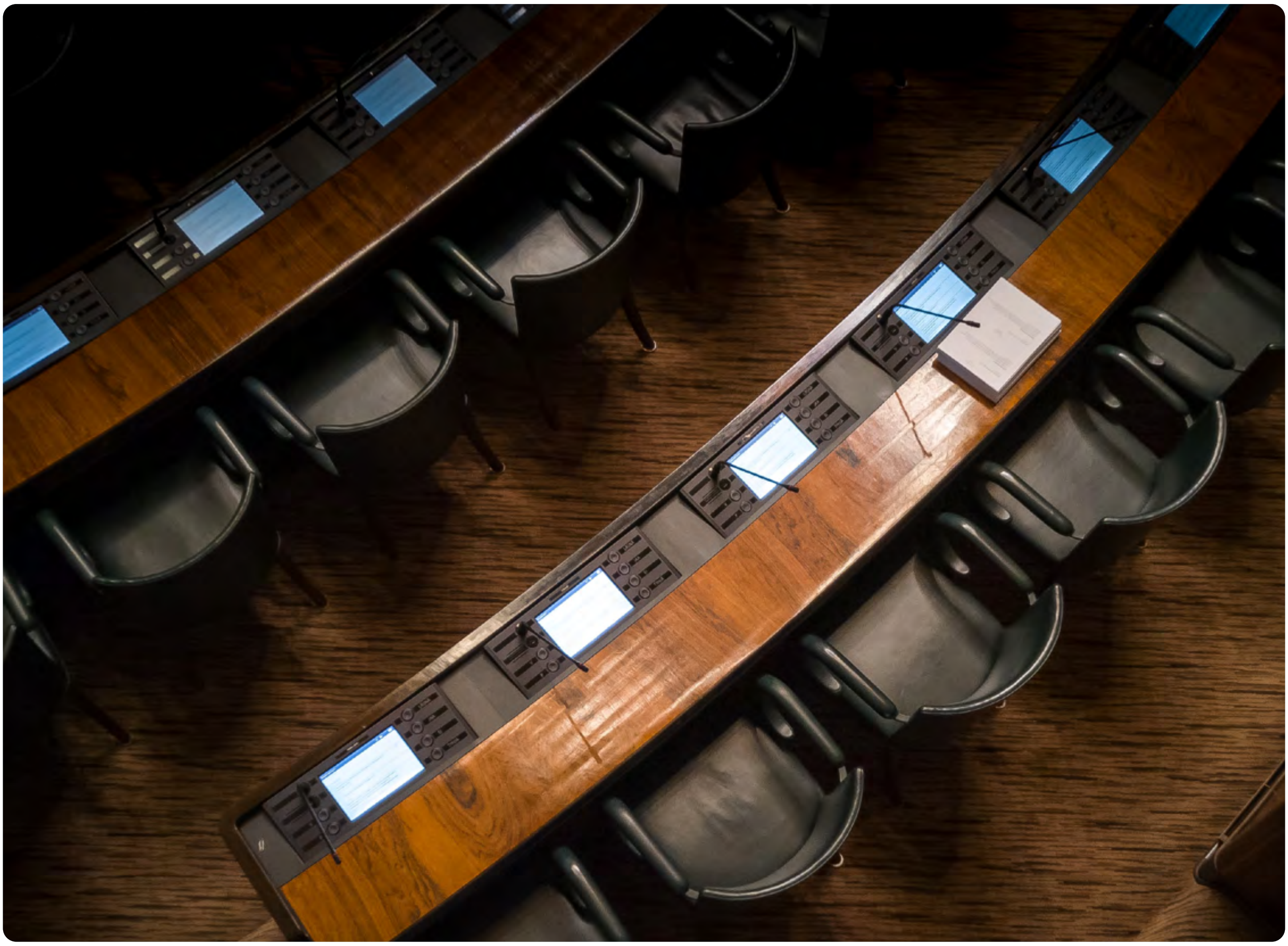
- Significant increase in the amount of information to be provided as part of the pension entitlement statement and additional information ;
- The introduction of new procedures documenting liquidity risk management, measures to manage the risk of conflicts of interest, and cost transparency, already covered by the current directive at both national and European level and in other directives;
- Clarification of ORA content.

While we welcome the greater precision of certain passages, our interest in these measures is linked to the estimated cost/benefit ratio associated with them. IRPs are also subject to other directives, such as SFDR and DORA, which increase their structural costs. They will need to strengthen their human and IT resources, which may call into question the viability of some programmes.

Last but not least, two major themes would enable major societal advances -- taking ESG aspects into account in greater depth, and promoting diversity and inclusion in employee representative bodies. ESG aspects would be reinforced by five pillars:

- Require investment decisions to take sustainability into account, and incorporate double materiality into the definition of a prudent person.
- Indicate how the remuneration policy takes into account the integration of sustainability risks in risk management.
- Require IORPs reporting negative impacts (PAIs) on sustainability factors in SFDR to adapt their procedures, systems and internal controls accordingly.
- Include in the ORA a quantification of exposure to climate change
- Add to the directive a definition of sustainability factors and sustainability risks aligned with that of Solvency II or SFDR.

These factors still imply higher structural costs, and increase the pressure on institutions that have not sufficiently embraced ESG. But above all, they hold out the promise of a profound integration of ESG aspects into the overall governance of IORPs, well beyond communication aspects.



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*As of 30/06/2023, Candriam changed the Assets Under Management (AUM) calculation methodology, and AUM now includes certain assets, such as non-discretionary AUM, external fund selection, overlay services, including ESG screening services, [advisory consulting] services, white labeling services, and model portfolio delivery services that do not qualify as Regulatory Assets Under Management, as defined in the SEC's Form ADV. AUM is reported in USD. AUM not denominated in USD is converted at the spot rate as of 30/06/2023.

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