Please reply to:

Philip Broadley
Chairman, The Hundred Group Pensions Committee
c/o Old Mutual plc, Old Mutual Place
2 Lambeth Hill, London, EC4V 4GG

The Hundred Group
of Finance Directors

22 July 2011

Mr Gabriel Bernardino
Chairman
European Insurance and Occupational Pensions Authority
Westhafenplatz 1
60327 Frankfurt am Main
Germany

Dear Mr Bernadino,

Call for Advice from EIOPA for the review of the IORP Directive (IORP II)

I am writing on behalf of the Hundred Group of Finance Directors with regard to the European Commission's Call for Advice from EIOPA for the review of the IORP Directive. We have a number of serious concerns with the overall direction of the European Commission's policy in this area, and in particular with the proposals in relation to the risk-based supervision of IORPS and the proposed increase in funding requirements.

We welcome the indication that the Commission's proposal to review the IORP Directive will be accompanied by an impact assessment study; in our view, no change should be made to European pensions regulation without a full cost-benefit analysis having been carried out to identify the impacts on existing pension provision across Member States.

We note EIOPA's recent publication of its draft response in certain areas covered by the Call for Advice, which confirms that the draft response on the issues of particular interest to us will follow in October. We expect to respond to that consultation in due course, but wanted to present you with our high level views at an early stage in your drafting process.

I set out our principal arguments below. However, we would also appreciate the opportunity to engage in further dialogue with EIOPA as it prepares to respond to the Call for Advice.

Who we are

The Hundred Group represents the views of the finance directors of the UK's largest companies drawn largely, but not entirely, from the constituents of the FTSE100 Index. Our members are the finance directors of companies whose market capitalisation collectively represents over 80% of that of companies listed on the London Stock Exchange.

While this letter expresses the views of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual members or their respective employers.

Key principles

1. **Any review of the IORP directive must recognise the diversity of pension provision across Europe.**

   It is essential to realise that the ways in which retirement income is provided across Europe are very diverse. Within individual Member States, different weight is given to state or supplementary provision, defined benefit or defined contribution schemes, IORPs or non-IORPs, funded or unfunded schemes (whether book reserve or pay-as-you go). Full harmonisation of defined benefit IORPs is therefore neither desirable nor practical in a context in which there is no harmonisation of the overall picture of pensions provision.

   Any significant reform of the funding requirements in the IORP Directive would impact disproportionately on those countries with widespread systems of funded defined benefit provision without necessarily having any impact on the pensions systems of some of the Member States with the lowest levels of provision (because they do not provide defined benefit IORPs). The European Commission's overall focus on pensions should surely be on improving the pensions for those countries and individuals with the lowest level of retirement income rather than on over-regulating what are some of the best quality pension schemes in Europe.

2. **Pension schemes are not identical to insurance and should not be treated as if they were.**

   We believe that the attempt to apply an approach based on insurance regulation to pensions is fundamentally misguided and would impose a structure on pensions which is inappropriate in many Member States. Whilst, in some Member States, pensions may be provided in a form that allows analogies to be drawn with the provision of insurance, this is not universal across Europe.

   In some Member States, pensions are widely different products from insurance, in particular for the following reasons:

   - Pensions are usually provided as part of an employment agreement between employer and employee and not as part of a contract with an external commercial insurance provider.

   - Elements of the pensions promise may be negotiable (for example, pension increases may be conditional or discretionary).

   - Pensions are provided on a long-term time horizon, unlike many insurance products. This has important implications for the use of equity investment by pension schemes, since, over the long term, equity investment can help to provide inflation-linked cash flows matching pension scheme outgo. We therefore believe that it is appropriate for the valuation of equities to give consideration to the long-term discounted value of future cash flows as well as to current market values.

   - Pensions are often supported by external sources of support, such as the legal obligation of the employer to meet the pensions obligations and/or the existence of protection funds, such as the UK's Pension Protection Fund.

3. **Solvency II is not the right starting point for a review of the IORP directive.**

   We are concerned at the proposal that the approach taken for IORPS should be compatible with Solvency II. For the reasons given above, we do not believe that an approach that is appropriate for insurance companies will be appropriate for pension schemes.

   We are relieved to note that the Call for Advice recognises that IORPS where the sponsoring undertaking has an ongoing commitment to support the pension fund should not be subject to a Solvency Capital Requirement or a Minimum Capital Requirement. However, we also think that the remainder of the Solvency II framework should not be applied to pension schemes.

   It is clearly essential that pension schemes should have appropriate standards for funding, governance, supervision and disclosure, but these should be designed taking account of the specific nature of the pensions context in individual Member States and not adopted with minimum changes from the very different insurance context.

4. **Over-regulation is likely to be counterproductive and lead to the closure of defined benefit pension schemes.**

   We are very concerned that the imposition of higher, more expensive funding standards to pension schemes would be likely to accelerate further the trend to the closure of defined benefit schemes and the replacement with defined contribution schemes, which provide less certainty of benefit for members. It is hard to see how increasing the funding requirements for defined benefit schemes will benefit members if the result is the replacement of their pensions with benefit designs which transfer risks from employers to individuals.

5. **There is no need for pension funds to hold higher technical provisions than at present.**

   Under the proposals set out in the Call for Advice, technical provisions would have to be based on a market-related risk-free rate with the incorporation of an additional risk margin.

   First, there is a question of what is meant by ‘risk-free’: the selection of a risk-free rate has recently become much harder, as the assumption that sovereign debt represents the lowest risk may no longer be true in many countries. It may be that companies are actually investing in a more prudent way by using corporate bonds. The key issue is that the discount rates be selected to suit the requirements of the fund and are agreed with actuaries and auditors, who are best placed to assess the specific risk profile of the scheme.

   Second, we do not understand the insistence on the use of a market-based valuation. Pension schemes adopt equity investment strategies that match expected cash inflow with benefit outgo. From the perspective of the pension scheme, the appropriate valuation method should reflect the discounted value of future cash flows as well as the current market value of any particular stock.

   In a system where pension schemes are supported externally by sponsor commitments and/or protection funds, there is no need for the amount of funds held by the pension scheme to be increased. The key requirement should be for the pension scheme to have appropriate and adequate financial support rather than for it to hold a high level of assets within the pensions fund. Any funds committed to the pension scheme are not available within the business of the sponsoring employer, whose existence is essential for the continued operation of the pension fund. Assets may be better applied in developing the business that will support the pension scheme rather than in providing surplus assets for the pension scheme.

6. **There is no need for an explicit financial value to be set on sponsor covenant and/or protection funds.**

   In the Call for Advice, the European Commission envisages a mechanism whereby additional external supports provided to pension schemes should be valued and taken into account when assessing the overall funding position of the scheme. We believe that it is sufficient for such mechanisms to be recognised in broad terms, as occurs for example currently in the UK where schemes with a higher sponsor covenant are permitted to have lower technical provisions within the scheme.

   However, the explicit quantification of the financial value of the sponsor covenant or protection fund would add considerably to the cost of carrying out a pension scheme valuation. It should be remembered that, in some Member States, there are very many defined benefit schemes (over 7,000 in the UK, for example), many of which are relatively small. The cost of carrying out calculations to put an arbitrary value on the sponsor covenant should be weighed against any additional protection that this might provide over and above a broader, more qualitative covenant assessment.

7. **The risk of regulatory arbitrage between financial sectors is over-stated.**

   Whenever the issue of imposing a Solvency II structure on pension schemes is mentioned, the reason for this approach is frequently given that this is required to avoid regulatory arbitrage between the pensions and insurance financial sectors.

   However, in many Member States, there is no evidence of such an arbitrage risk; the pensions and insurance sectors provide different benefits in different contexts to different individuals. It would seem overly burdensome to introduce a framework that could fundamentally damage pension schemes simply in order to address a hypothetical risk that has not been observed in practice.

8. **Any move to risk-free funding would impact on scheme's investment strategies and therefore on equity markets across Europe.**

   If pension schemes were required to fund on the very cautious basis proposed in the Call for Advice, this would be likely to drive pension schemes into investing in matching risk-free assets, leading to massive disinvestment by pension schemes from equities. This would be highly damaging for European financial markets and commerce as well as for pension schemes.

I hope that these comments will be helpful to you in developing your response to the Call for Advice. In the event that EIOPA issues any consultations during the preparation of its advice to the European Commission, we would welcome an opportunity to respond to those consultations.

Yours sincerely,

Philip Broadley
Chairman
The Hundred Group – Pensions Committee