

## News Alert 2014/02

27 March 2014

### *A new European pensions directive is published*

#### *At a glance*

A proposal for a [new European pensions directive](#), which is intended to come into force at the start of 2017, has been [published](#) today. This will impose new governance and disclosure requirements on UK pension schemes as well as addressing obstacles to the development of cross-border schemes. As expected, the proposal is silent on the explicit introduction of new solvency rules, but it remains to be seen whether indirectly the directive will ultimately lead to more stringent *de facto* funding requirements for defined benefit schemes.

#### *Key Actions*

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##### **Trustees, pensions managers and sponsors**

Be aware of the likely significant increase in pension scheme governance and disclosure requirements when taking key strategic decisions. Also, stay abreast of this material development in European pensions law which is likely to have a widespread and significant impact in future.

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#### *The Detail*

The current European pensions directive on the activities and supervision of institutions for occupational retirement provision (IORP) is to be replaced by a new "IORP 2" directive. As at present, this will be the core piece of European level pensions law applying to UK occupational pension schemes and will include a number of requirements originally designed for insurance companies under the Solvency II directive.

The changes being introduced by the directive have four specific stated objectives:

- removing the remaining prudential barriers for cross-border schemes;
- ensuring good governance and risk management;
- providing clear and relevant information to scheme members; and
- ensuring that pensions supervisors have the necessary tools to effectively supervise IORPS.

The proposals relating to the first three of these objectives are summarised below along with our thoughts on what they may mean for UK schemes.

The directive does **not** set out new solvency rules, despite a clear intention earlier in the process to do so (see for example [News Alert 2011/07](#)) – the official line is that more work needs to be undertaken before the European Commission can take a decision.

### *Cross-border schemes*

A number of detailed requirements relating to the operation of cross-border schemes are modified. We understand that an earlier draft of the directive abolished the current requirement for those cross-border schemes that are defined benefit (DB) to be “*fully funded at all times*”, but this requirement remains in the published draft. New rules are also to be introduced for the cross-border transfer of schemes.

#### **Comment**

*The apparent last-minute change of tack on the fully-funded at all times requirement is a major blow to the development of cross-border DB schemes and could yet have adverse consequences for a number of UK DB schemes should the Scots vote yes on 18 September.*

### *Governance and risk management*

The Commission is concerned that measures need to be taken to deliver higher governance standards reflecting best practices at national level following the economic and financial crisis, in order to protect scheme members and beneficiaries (and to facilitate cross-border schemes). The Commission sees this as particularly relevant as more and more occupational pensions are delivered through DC schemes.

As a result the directive contains a whole new section laying down detailed governance requirements, many of which are the same or similar as those applicable to insurance companies under Solvency II. These are explored in the sections below.

#### **Trustees will be subject to new “fit and proper” requirements**

These extend beyond the existing requirements in UK pensions legislation:

- Current UK law includes a requirement for trustees to have appropriate “*knowledge and understanding*”. The UK has some basic “*proper*” requirements (eg a trustee cannot be an undischarged bankrupt or a person disqualified as a company director).
- The directive requires that the people who effectively run the scheme (which is to say the trustees in the UK context), or have other key functions must have “...*professional qualifications, knowledge and experience... adequate, to enable them to ensure sound and prudent management of the [scheme] and to properly carry out their key functions (requirement to be fit)*”; and “...*of good repute and integrity (requirement to be proper)*”.

#### Comment

*Depending on how this is interpreted by the UK Parliament and the Pensions Regulator, this could have a material impact on the UK's "lay trustee" regime and for member-nominated trustees in particular.*

#### Schemes will be required to have a "sound" remuneration policy

Such policies apply to those "who effectively run the [scheme] in a manner that is appropriate to their size and internal organisation, as well as to the nature, scope and complexity of their activities".

Schemes must "regularly disclose publicly relevant information regarding remuneration policy".

There will be a "delegated act" (this is a provision under the Lisbon Treaty for the Commission to make further laws) spelling out further detail covering how the remuneration policy aligns with the scheme's activities, risk management and long term interests and performance together with proportionate measures aimed at avoiding conflicts of interest. This may also extend the remuneration policy to third parties to whom key functions have been outsourced.

#### Comment

*It is not clear how this requirement, designed originally to address executive pay in the insurance sector, is intended to read across to pensions regulation. If the requirement does come to extend to service providers some formalisation of relationships may be needed.*

#### Schemes will be required to have an effective "risk management function"

Schemes will be required to "...have in place an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report, on a continuous basis the risks, at an individual and at an aggregated level, to which they are or could be exposed, and their interdependencies".

The risk management system needs to cover at least underwriting and reserving, asset-liability management, investment (in particular derivatives and similar commitments), liquidity and concentration risk management, operational risk management and insurance and other risk-mitigation techniques.

#### Comment

*Depending on how this is interpreted by the UK Parliament, and the Pensions Regulator, this could mean a material step-up in the requirements for risk management.*

### **Schemes will be required to have an internal audit function and an actuarial function**

“Effective” internal audit and actuarial functions are required, with the directive spelling out what each should cover. In the former, the function must “*evaluate the adequacy and effectiveness of the internal control system and other elements of the system of governance...including outsourced activities*”.

#### **Comment**

*The internal audit function will be a new one for many UK schemes. While there will be some overlap with traditional internal financial audit procedures it does seem clear that this function is intended to be a check on how effectively the new governance system required is operating. We worry that this may be expensive, time consuming and bureaucratic.*

*In relation to the actuarial function, some re-evaluation and formalisation of relationships between actuaries and trustees may be required.*

### **Schemes will remain responsible for the services that they outsource**

The directive provides that, whilst member states may permit or require schemes to entrust their management, in whole or in part, to other entities operating on their behalf they must ensure that schemes which do outsource remain fully responsible for the outsourced functions / activities.

#### **Comment**

*There may be some formalisation of tender processes / agreements etc for outsourced functions required.*

### **Custodians for defined contribution (DC) schemes will become mandatory**

DC schemes will be required to have a single depository/custodian. Member states may impose a similar requirement on DB schemes. The directive goes on to lay down detailed rules governing the appointment of and the duties to be carried out by the depository.

#### **Comment**

*The implications for DC schemes with more than one investment option, which may use more than one custodian, do not seem to have been thought through here.*

### **Schemes must produce a “Risk evaluation for pensions”**

Schemes will be required “*appropriately to their size [etc]...as part of their risk-management system, to carry out their own risk assessment and to produce a risk evaluation for pensions in order to document that assessment.*”

This evaluation must be “performed regularly and without delay following any significant change in the [scheme’s] risk profile”.

The details are to be set out in a “delegated act”.

#### Comment

*Some commentators (including us) who have been following these matters have wondered if the Commission may try to find a “back door” to impose Solvency II style reserving for pensions. Despite the directive stating that the delegated act shall not impose additional funding requirements, this may be the back door, if the Commission chooses to specify holistic balance sheet type calculations for risk management. This would pave the way for tightened reserving requirements being imposed in future.*

### Disclosure of information

The disclosure requirements in the current directive are significantly expanded with a lot of detailed requirements set out.

#### Schemes will be required to provide a common “pension benefit statement” to members once every 12 months

The statement must be “comprehensible”, free standing, not needing to be read with any other document, provided free of charge and include prescribed information about the matters below:

- personal details of the member and identifying information about the scheme;
- information about guarantees;
- information about “balance”, contributions and costs;
- where the scheme provides for a target level of benefits, various pension projections;
- for DC schemes information about investment options;
- for all schemes information on past investment performance; and
- where to get more information.

The details are to be set out in a “delegated act”. Somehow, when delivered to the member, all the above has to fit on two sides of A4 using “characters of easily readable size”.

#### Comment

*In due course, schemes – and DC schemes in particular – will need to review their communications / disclosures against the new requirements.*

### Schemes will be required to provide other statements in particular situations

Such as the features and investment options (where applicable) to prospective members before enrolment; retirement income options at least two years before the member's pre-defined retirement age and the benefits which are due to beneficiaries during the pay-out phase.

### Next steps

The directive will now start its passage through the various European institutions. It is not yet clear when it will be finalised, but the ambition is for its new provisions to be in law before 31 December 2016. If this timetable is kept to we can expect a Pensions Act 2016 in the UK to implement the changes into UK law. Matters may proceed very quickly over the next couple of years.

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