

Chapter 14

EU Funding Requirements: Effective September 2005

The EU Pensions Directive (No. 2003/41), issued in June 2003, requires Member States to introduce domestic regulations by 23 September 2005. The UK's Pensions Act 2004, in its Part 3, gives effect to these provisions (*see* Chapter 11.1).

The three key aspects are:

- funding;
- investment;
- cross-border requirements.

The Directive itself has significantly wider scope, but in other major areas (such as information disclosure) the UK already has legislation in place.

The official notes to the UK's Pensions Act, issued four months later in March 2005, refer to the "IORP Directive", as the EU label for a funded pension plan is "Institution for Occupational Retirement Provision" ("IORP"). The Directive relates to the "activities and supervision" of these IORPs. Apart from the three above key aspects, the Directive contains requirements for:

- disclosure of information (broadly similar to existing UK requirements);
- registration and regulation (also existing UK requirements).

14.1 Funding

For a DB plan, the three key features of the funding requirements are:

- "prudent" actuarial basis;
- sufficient assets "at all times" (but *see* next bullet);
- permitted recovery time to deal with deficiency.

The appendix to this chapter gives a more detailed description, but it is sufficient here to mention the following uncertainties. These will not be completely removed when the UK regulations are issued as the uncertainties lie within the text of the Directive and, therefore, leave the way open for challenge to the subsidiary UK

regulations if a plan member considers that the regulations do not meet the Directive's requirements. The major uncertainties are:

- The "appropriate margin" to be adopted "if applicable" when fixing the actuarial basis. The margin is to allow for "adverse deviation" but no further guidance is given – Article 15.4(a).
- The investment of the assets held to cover the liabilities, "in a manner appropriate to the nature and duration of the expected future retirement benefits" – Article 18.1(b). For an ongoing plan, there may be no investments that are particularly appropriate to the distant pension liability for younger members, but the question may arise whether dated bonds, or the like, are required to match the liability to the older pensioners. As mortality is uncertain, there is no true match other than purchase of annuities.
- Permitted length of a recovery plan in the event of deficiency. The Directive refers to a "limited period of time" (Article 16.2), but the UK government in effect considers that each plan will set out its own timeframe (by agreement between trustees and company) which would be included in the annual information to members and notified to the pensions regulator.
- The numerous large DB schemes that do not insure risk benefits (death and ill-health) may have to hold a 4 per cent solvency margin (Article 17.2). The government's consultation paper, issued in October 2003, sought views on the interpretation, but regulations will not be issued until July 2005 (or thereabouts). The introduction of this 4 per cent solvency margin can be postponed by Member States (i.e., the UK government) until the year 2010 (except for cross-border plans), but it is not yet known if this postponement will be made.

The first two points are familiar to UK actuaries, but their inclusion in a regulatory framework will limit the flexibility with which discussion between PLCs and their trustees can take place on the funding basis.

The background to the funding provision is given in the Introduction to the Directive. Paragraph (5) refers to the state social security systems, and the increasing financial pressure upon them (through the increasing proportion of pensioners). It forecasts that occupational retirement plans will "increasingly be relied on" as a complement to the state systems, and paragraph (7) describes the new rules as intended to "guarantee a high degree of security for future pensioners". Although there are many features that recognise that pension plans are not the same as insurance companies, and that recognise the lower cost that is an intended part of the long-term investment policy of most plans, the thread running through the Directive is the analogy with insurance companies. This raises a material cost risk to employers, both from the direct rules and from the likely emphasis when ambiguities are interpreted.

14.2 Investments

The basic purpose of the investment framework (Article 18) is to support the flexibility of the “prudent person” rule, well understood in UK and Irish pensions law. Broadly, the Directive has succeeded in that aim, but it is so detailed that it creates a number of areas of uncertainty. From the PLC’s viewpoint, the chief uncertainty is:

- Can plan trustees, when setting investment policy, continue to take into account the interests of the employer?

At present, trustees have an obligation, under the UK’s Pensions Act 1995 as continued by the 2004 Act, to consult the employer when creating the Statement of Investment Principles, and a number of commentators consider that they must positively take into account the interests of the employer. However, the Directive states, in Article 18.1(a), that in the case of “a potential conflict of interest [the plan] shall ensure that the investment is made in the sole interest of members and beneficiaries”. There may in fact be no conflict if the employer’s commitment to the plan is based on respect for its investment risk appetite. This would be a positive reason for the trustees to take into account its reasonable views, assuming that the employer’s commitment was backed by sufficient financial strength for its ongoing existence to seem assured.

14.3 Cross-border activities

A major development within the Directive is to require Member States to permit pension plans to accept participation by employers located within other Member States. In practice, UK plans are unlikely to take advantage of this until two points are addressed:

- removal of additional funding requirements;
- resolution of the taxation issues.

Regarding the first bullet, it would appear from Article 16.3 that a cross-border plan must be fully funded at all times, without being able to take advantage of a “limited period of time” recovery plan that would be permitted to domestic funds under Article 16.2. The UK consultation paper stated “The Directive does not make provision for recovery periods in the case of cross-border activity, but no scheme can guarantee full funding at all times. The government is considering whether a more onerous supervisory oversight might provide the necessary reassurance, rather than requiring schemes to maintain significant reserves with the associated cost implications . . .”.

Regarding the second bullet, a key missing feature from the Directive is an indication of the tax position regarding cross-border contributions. The European Court

of Justice has been developing a line of cases that prevents national tax laws from discriminating against insurance companies established in other Member States to which retirement premiums are paid. It seems likely that, in a suitable case, it may give a similar ruling in respect of pension plans (which would assist multi-national PLCs). Perhaps for this reason the UK consultation paper stated that the government is separately addressing the issue of how tax approval and relief should operate for cross-border activity as part of its proposals for general simplification of pensions tax (for which the target date is April 2006 – see Chapter 12).

The Paper considered that an individual working for a branch of a UK employer abroad can pay into the UK Plan without triggering the cross-border provisions. However, the government was uncertain of the position where the individual is working for a subsidiary company rather than a branch office of the UK company.

Appendix to Chapter 14

The five main areas covered by the Directive are mentioned at the beginning of this chapter. They are described more fully below, following the same sequence since the first three are of greater material interest to most PLCs than the remaining two.

The Directive can be downloaded from the website of the EU Commission, www.europa.eu.int/eur-lex/en then search legislation, directive, 2003, 41. As with all Directives, it is an instruction to Member States to introduce national laws to give effect to its provisions. Some Directives are “frameworks” and leave significant scope to the individual Member States. The IORP Directive is not in that category. Although the Introduction, at paragraph (9), refers to Member States retaining “full responsibility for the organisation of their pension systems” the Directive in fact lays down detailed requirements in the particular areas that it covers.

As most of the provisions come into force on 23 September 2005, the UK will aim to issue regulations before that date, probably in July 2005. The chief problem for employers is that where the UK regulations clarify an uncertainty in the Directive, there will always be the risk that an individual who is adversely affected will challenge the UK government in the European Court of Justice for having incorrectly “transposed” the Directive into UK law. While an adverse ruling would normally only have retrospective effect on public sector schemes, PLCs would still be caught by any correcting regulations so far as they affect future aspects. Ambiguities in the Directive therefore represent a risk to employers.

1. Funding

The funding provisions are in Articles 15–17, with an important additional provision tucked away in the investment rules of Article 18.

Article 15 requires plans to establish their liabilities and then to establish “technical provisions” in respect of them. From the context, “technical provisions” seem to be the current discounted capital value, in actuarial terms, of the future stream of liabilities, and this is confirmed by paragraph 3.18 of the consultation paper issued by the UK government in October 2003, and by Section 222(2) Pensions Act 2004.

The calculation is to be made by an actuary or a similar specialist according to four principles set out in Article 15.4:

- (a) The minimum amount is to be “calculated by a sufficiently prudent actuarial valuation, taking account of all commitments for benefits and for contributions”. The economic and actuarial assumptions are also to be chosen “prudently taking account, if applicable, of an appropriate margin for adverse deviation”.

- (b) The maximum rates of interest used [bearing in mind that a high rate produces a low current capital value] are to be chosen “prudently” and determined by taking into account:
 - the yield on the corresponding assets held by the [plan] and the future investment returns; and/or
 - the market yields of high-quality or government bonds.
- (c) The biometric tables (defined in Article 6 by reference to death, disability and longevity) are to be prudently based having regard to the main characteristics of the plan members.
- (d) The method and basis of calculation “shall in general remain constant from one financial year to another”. Changes “may be justified by a change of legal, demographic or economic circumstances underlying the assumptions”. It may be that the professional guidance note will permit a change on the basis of different professional or fiduciary judgment, but it is not clear that (d) would authorise the regulations to take that step.

An important provision in Article 15.5 permits each Member State to make “additional and more detailed” requirements (affecting plans whose main administration is carried on within it) for the protection of members.

With a view to further EU harmonisation of the actuarial rules, the EU Commission is required by Article 15.6 to issue every two years a report on the development in cross-border activities.

Article 16.1 requires every plan (which in practice will normally mean a DB plan) to have “at all times sufficient and appropriate assets to cover the technical provisions” – but see below regarding the Article 16.2 relaxation. The UK consultation paper, at paragraph 5.14, in effect stated that Article 16.1 does not mean sufficient assets to cover the cost of annuity purchase. The paper stated “The Government takes the view that Article 16(1) does not prevent a scheme choosing to calculate its technical provisions as a proportion of a conservative measure, such as the cost of securing all accrued benefits immediately by means of annuity purchase . . . provided that the calculation still meets the requirements of Article 15(4). If the amount of the assets of the scheme is at least equal to the amount of the technical provisions so calculated, no recovery plan will be required”. This implies that a less conservative measure will be acceptable in the UK. Draft regulations issued in March 2005 confirm this.

Unfortunately, the Paper went on to state that “The issue of what is meant by “at all times” is problematic”. However, the government considered it sufficient if the trustees commission an interim valuation where they have reason to believe that the assets may not cover the liabilities, so that they can put in place a recovery plan. Certainly Article 16.2 envisages (except for cross-border plans) a recovery plan that operates over a period of time, and the Pensions Act 2004 provides for this in Section 226.

Article 16.2 uses the words “limited period of time”, but the government does not intend to prescribe a specific timeframe. In effect each plan will create its own timeframe when putting in place a Statement of Funding Principles and its allied Schedule of Contributions. The government approach depends on an interpretation of Article 16.2 which, while not absolutely certain, is well supported by two aspects. First, paragraph (b) of the Article requires the recovery plan to take account of the specific situation of the pension scheme, and second it gives as an example schemes “changing from non-funding or partial funding to full funding” and this clearly could be expected to take place over a considerable period of time.

Where a recovery plan is in place, paragraph (a) of Article 16.2 requires it to be made available to members and/or subject to approval by the regulatory authority. The consultative document chose the first option and stated that the government “does not intend to require that the Regulator should generally approve recovery plans, although it does envisage that schemes would routinely submit a copy of the Plan to the Regulator”.

Article 16.3 requires cross-border plans to be “at all times . . . fully funded”.

Article 17 requires a plan to hold additional assets, to serve as a buffer, where the plan, and not the sponsoring employer, underwrites risk benefits. The consultation paper regarded the general interpretation of this as uncertain and, at paragraph 2.31, stated the government’s preliminary view that the Article will rarely be relevant. In the government’s view “In general, the financial backing for pensions . . . derives from a combination of the assets built up in the scheme *and* the sponsoring employer’s ongoing commitment to pay the necessary contributions”. It remains to be seen whether this is a concluded view that funding commitment amounts to underwriting the liability. Either way, the government sought views on whether to postpone the Article for five years, as this is one of the two provisions where Member States have the power of postponement until the year 2010.

2. Investments

Articles 12 and 18 relate to investment. The former is very short, and requires a statement of investment principles, while the latter is very long, and is detailed below.

The statement of investment principles has been a requirement of UK pensions law since 1997. The only addition to arise under the Directive is a requirement that the statement be reviewed by the plan at least every three years. This will come as no hardship in the light of the regular re-assessment expected under the UK draft code of practice. In the light of the Directive, the government intends to legislate for the three-yearly requirement, by regulations authorised under an amendment contained in Section 244 Pensions Act 2004. This will not prevent more frequent reviews being required under the code of practice to be issued under the Act, for example where the sale of a major part of the company’s business is accompanied

by a bulk transfer to the purchaser's plan, leaving the vendor's plan relatively more "mature" (i.e., with a greater proportion of pensioners).

Article 18.1 opens with a general requirement for investment in accordance with the "prudent person" rule and then goes on, in paragraphs (a) to (f) to specify particular provisions. Paragraph (6) of the introduction to the Directive, states that "By setting the 'prudent person' rule as the underlying principle for capital investment and making it possible for institutions to operate across borders, the redirection of savings into the sector of occupational retirement provision is encouraged, thus contributing to economic and social progress". The UK government's consultation paper simply stated that the majority of 18.1 mirrors existing UK requirements, but that there may be a need for legislation in respect of non trust-based plans. See below regarding paragraph (f). The respective paragraphs can be summarised as follows:

- (a) Assets are to be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, investment is to be in the sole interest of members and beneficiaries. As already stated in the chapter above, from a PLC's viewpoint, the chief uncertainty is whether this includes the interests of the employer. If an employer is regarded as financially stable, and good for an increase in contributions, members' interests might be best served by a cautious investment policy. On the other hand, if there are discretionary benefits, it might be of great importance to retain the goodwill of the employer and agree a potentially less costly investment basis. In broad terms, that goodwill has always been of paramount importance, and it is helpful that the UK consultation paper did not suggest that restrictive wording will appear in the UK regulations.
- (b) After a general reference to "security, quality, liquidity and profitability", the paragraph goes on to require investment in a manner "appropriate to the nature and duration of the expected future retirement benefits". This could be translated into a very restrictive regulation or code of practice, particularly for DB funds that have become closed to new members.
- (c) Assets which are not traded in regulated financial markets "must in any event be kept to prudent levels". This suggests that, for example, property holdings must not be too large a proportion of the portfolio.
- (d) This is a detailed paragraph that opens by permitting derivative instruments where hedging investment risks or facilitating portfolio management. There is a requirement, presumably to be included in regulations, to "avoid excessive risk exposure to a single counterparty and to other derivative operations".
- (e) There is a general requirement for diversification, similar to the long-standing UK principle, with a permission, at the end of Article 18.1, for local regulations to exclude government bonds from the diversification requirement. Regulations should prohibit excessive concentration in a single or linked stock.

- (f) A restriction on investment of more than 5 per cent of plan funds in the sponsoring employer (or 10 per cent in grouped employers) will be required, and the consultation paper indicated the need to amend the UK's present technical provisions. As Article 22.4 permits this provision to be delayed until the year 2010, the UK government requested views on whether this is desirable or necessary. In practice, the 1997 UK restrictions on self-investment are very similar to the main EU requirement.

Article 18.2 will require a prohibition on borrowing for investment purposes, although it will permit it for liquidity purposes on a temporary basis. The UK intends to adopt the latter provision.

Articles 18.3–18.6 are either not relevant to the UK, or do not feature (according to the consultation paper, paragraph 6.12) in government plans for legislation.

Article 18.7 would permit certain investment restrictions in the case of cross-border activity. The consultation paper, at paragraph 7.12 suggests that the UK is unlikely to adopt such restrictions.

Article 19 prohibits Member State from limiting the appointment of fund managers established and authorised in other Member States. Similarly, duly authorised custodians are to be permitted to operate in other Member States.

3. Cross-border requirements

There are a number of relevant requirements in the Directive, but the starting point is whether a pension plan is engaged in cross-border activities as described in Article 20. The Article should be read together with the definitions in Article 6, but broadly cross-border activity involves an employer in one Member State contributing to a pension plan in another Member State. The Directive is concerned with the regulation of these activities and not with taxation.

Where extra regulation is optional, the UK government does not intend to adopt additional requirements (according to paragraph 7.12 of the consultation paper). Until the taxation provisions are settled, either by negotiation between Member States, or by ruling of the European Court of Justice, Article 20 will remain theoretical. Further, the requirements that the Directive would impose on a plan that accepted contributions from employers in other Member States, are such that few UK plans would be likely to engage, as a matter of policy, in cross-border activities. There are employment law requirements, mentioned briefly below, that multinational companies might regard as not a problem, as they would be familiar, but the key requirement of Article 16.3, mentioned in the chapter above, would impose a significant funding inflexibility. In full, the Article reads as follows:

“16.3 in the event of cross-border activity as referred to in Article 20, the technical provisions shall at all times be fully funded in respect of the total range of pension schemes operated. If these conditions are not met, the competent authorities of the home Member

State shall intervene in accordance with Article 14. To comply with this requirement the home Member State may require ring-fencing of the assets and liabilities.”

Article 6 defines the home Member State as the one where the plan has its registered office and its main administration. The host Member State is the one whose social and labour law, relevant to pensions, is applicable to the particular participating employer and members. Article 20.5 requires that a plan proposing to accept a participating employer from another Member State must first await from its own government information regarding the social and labour laws applicable to that employer in its own State.

The sequence would be that under Article 20.2 the pension plan intending to accept contributions from abroad, would notify its own government which would inform the competent authorities within the State where the employer is established. The latter would respond with information regarding its social and labour law which would then be passed on to the pension plan. There are provisions in the event of delay. Similarly, Article 20.7 would require the disclosure regulations of the employer’s State to apply to the pension plan in respect of members in that State. These requirements will be contained in UK regulations authorised by Part 7 of the Pensions Act 2004.

4. Disclosure of information

Article 11 requires domestic regulations to include disclosure provisions. These are broadly in line with existing UK requirements for disclosure of regular information to members, or those forecast by the UK government’s June 2003 Action Paper. Article 13 requires regulations enabling competent authorities to obtain information from pension plans. Most of this is also in line with current UK requirements, although additionally the regulations *may* require asset-liability studies to be submitted.

5. Registration and regulation

There are numerous detailed provisions that Member States either must or may choose to incorporate in domestic regulations. On the whole, they are not relevant to the purpose of this book, which is to identify risk areas. However, the following specimen provisions give an outline picture.

Article 4 would enable the pension business of insurance companies to be regulated specifically, but paragraph 2.19 of the UK consultation paper indicated that the government was inclined not to apply the provision.

Article 9 provides for national registers, similar to that already in operation in the UK. It also provides, in Article 9.1(b) that pension plans are “effectively run by persons of good repute who must themselves have appropriate professional qualifications and experience or employ advisers with appropriate professional

qualifications and experience". The UK consultation paper, at paragraph 3.7, considered that the UK's existing statutory provisions already complied.

Article 9.1(e) states that where the employer "guarantees the payment of the retirement benefits, it is committed to regular financing". The consultation paper believed that the scheme-specific funding basis to be introduced in the UK in the year 2005 will fall within this provision; Part 3 of the Pensions Act 2004 authorises the necessary regulations.

Article 10 will require that annual plan accounts give a true and fair view of the "assets, liabilities and financial provision". It seems likely that this will include the actuarial liabilities, and paragraph 3.17 of the consultation paper indicated in effect that this is the government's interpretation too. In paragraph 3.20 the government sought views as to whether it will suffice to rely upon three-yearly actuarial valuations together with annual reports of adjustments during the interval-valuation period, and that is the regime legislated by Section 224 Pensions Act 2004.