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# **Opinion to EU Institutions on a Common Framework for Risk Assessment and Transparency for IORPs**

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# Executive Summary

## Introduction

This Opinion to the EU institutions advises that the IORP Directive is strengthened with a common framework for risk assessment and transparency for Institutions for Occupational Retirement Provision (IORPs).

EIOPA provides this opinion on its own initiative<sup>1</sup> to further the objectives and tasks<sup>2</sup> laid down in its founding Regulation, which include:

- Fostering the protection of pension scheme members and beneficiaries;
- Improving the functioning of the internal market, including in particular a sound, effective and consistent level of regulation and supervision;
- Preventing regulatory arbitrage and promoting equal conditions of competition;
- Ensuring the taking of risks related to occupational pensions activities is appropriately regulated and supervised; and
- Contributing to the establishment of high-quality common regulatory and supervisory standards and practices.

EIOPA has conducted an Impact Assessment concluding that overall the benefits in terms of these objectives are expected to exceed the costs of the common framework, as explained further below.

The opinion is expressly not intended to amend the existing Commission's proposal for the revision of the IORP Directive (IORP II) published on 27 March 2014, which is currently being negotiated in trilogue.

## Public consultation and quantitative assessment

Issuing this opinion concludes a cycle of almost three years of further work on solvency of IORPs. EIOPA initiated the further work in 2013 to resolve issues identified in the quantitative impact study (QIS) on IORPs.

A consultation paper was published in October 2014 outlining improved methods and simplifications for the valuation of technical provisions and sponsor support. The consultation paper also put forward several possibilities to enhance quantitative rules for IORPs at EU level, ranging from supervisory regimes with harmonised capital requirements to a framework for risk assessment and transparency. The feedback received has benefited the drafting of this opinion as well as the technical specifications for the quantitative assessment.

The quantitative assessment was conducted last year in six Member States (BE, DE, IE, NL, PT and UK). The aim was to collect data on the supervisory frameworks discussed in the consultation paper and to test the improved valuation methods and simplifications. A total of 101 IORPs participated in the exercise, representing a market coverage of 41% in terms of assets.

EIOPA would like to thank the stakeholders for their responses to the public consultation and the participating IORPs, national supervisory authorities (NSAs) and the various European and national industry associations for their contributions to the quantitative assessment.

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<sup>1</sup> In accordance with Art. 8(2)(g) and Art. 34(1) of EIOPA Regulation (EU) No 1094/2010.

<sup>2</sup> Art. 1(6) and Art. 8(1) of EIOPA Regulation (EU) No 1094/2010.

## **Risk assessment and transparency framework for IORPs**

In this opinion EIOPA advises introducing a European framework for risk assessment and transparency for IORPs based on common valuation rules and a standardised risk assessment, while refraining from suggesting to harmonise capital or funding requirements for IORPs at this point in time.

The framework applies to all IORPs providing occupational pension schemes in which risks are shared to differing degrees between the sponsor, plan members and the institution itself. IORPs providing pure DC schemes, in which risks are directly and fully borne by the plan members, are not within the scope.

### **Market-consistent balance sheet and standardised risk assessment**

The common framework consists of a market-consistent balance sheet and a standardised risk assessment. IORPs should value the balance sheet using the basic risk-free interest and recognise all available security and benefit adjustment mechanisms, including sponsor support, pension protection schemes, conditional and discretionary benefits and benefit reduction mechanisms. To ensure a consistent application of the principle of market-consistency, guidance should as far as possible be provided at the European level.

IORPs have to conduct a standardised risk assessment, analysing the impact of a set of common, pre-defined stress scenarios on the balance sheet. As such, the risk assessment provides insight to what extent security and benefit adjustment mechanisms can absorb the stress scenarios and to what extent the IORP's excess of assets over liabilities is reduced.

The following risk factors, which are considered to be most relevant for IORPs, should be included: operational risk, risk-free interest rate risk, property risk, equity risk, spread risk, currency risk, concentration risk, counterparty default risk (incl. default risk of the sponsor) and longevity risk. In the quantitative assessment the pre-defined stressed risk factors were calibrated to a 0.5% probability of occurrence over a one-year horizon, and it would therefore be most practical for EIOPA to recommend this confidence level.

The common risk assessment and transparency framework is not intended to replace other risk management tools or techniques currently used by IORPs, such as ALM studies, neither does it replace national regulatory frameworks in this respect. Moreover, NSAs may request additional calculations from IORPs using different assumptions, supplementing the information provided by the common framework.

The common framework's balance sheet and the standardised risk assessment should be calculated regularly and reported to the NSA on an annual basis.

### **Public disclosure**

EIOPA advises that the main elements of the common framework's balance sheet and the outcomes of the standardised risk assessment have to be publicly disclosed. IORPs should make available a report, so that the results will be accessible to plan members, sponsors and any other interested parties.

The outcomes of the risk assessment may not always conclude in unambiguous interpretations. Member States often do not impose market-consistent valuation or an explicit recognition of security and benefit adjustment mechanisms, resulting in differences between the national and the common framework's balance sheet. Moreover, market values of benefit adjustments cannot be translated one-on-one into expected retirement benefits of individual plan members. Therefore, to avoid

misinterpretation, the results of the common framework should be accompanied by appropriate explanation.

Public disclosure of quantitative results may also potentially lead to unintended consequences or a breach of confidentiality. To prevent this, Guidelines would have to be developed at the European level to specify under which circumstances which specific elements may be publicly disclosed in a qualitative manner.

### **Supervisory actions**

Any decision on supervisory actions will be taken at the national level. EIOPA recommends that national supervisory authorities (NSAs) are provided with sufficient powers to take supervisory action based on the outcomes of the common framework, if deemed necessary to achieve their supervisory objectives as defined by EU and national law.

NSAs should be able to direct IORPs to take appropriate measures to improve the financial position, to reduce risk exposure and/or to enhance the management of those risks within a timeframe specified by the NSA.

Any supervisory actions taken by NSAs are likely to take into account considerations other than the results of the standardised risk assessment, such as compliance with national funding requirements and the outcomes of other risk-management tools. Moreover, a given reliance on sponsor support, pension protection schemes and benefit adjustments may be acceptable in some Member States, but deemed inappropriate in other Member States. As a consequence, supervisory responses would depend on national circumstances and the specific situation of individual IORPs.

### **Proportionality and simplifications**

EIOPA considers it essential that the common framework for risk assessment and transparency is applied in a proportionate manner and to allow for simplifications to cater for the differences between IORPs throughout Europe. In that respect, it is particularly important to minimise the burden on and costs for small- and medium-sized IORPs.

The impact assessment shows that the costs of the common framework predominantly relate to the resources needed to value the balance sheet, to calculate the standardised risk assessment and to communicate the results. These costs would fall disproportionately on small- and medium-sized IORPs and Member States with a high incidence of IORPs with limited economies of scale in the absence of measures to mitigate these effects.

To prevent an excessive burden on very small IORPs, Member States should be provided with the possibility not to apply the common framework to IORPs with less than 100 members, in line with the small IORP exemption in the current IORP Directive. Moreover, EIOPA advises to allow for an additional exemption based on a threshold of EUR 25m in terms of assets. In addition, Member States should be allowed to lower the frequency of regular reporting from once every year to once every three years. IORPs would still have to submit an interim report to the NSA, but this would not necessarily involve a full recalculation of all figures.

IORPs should be allowed to use simplified methods if this is proportionate to the nature, scale and complexity of the activities and the underlying risks. IORPs should be able to use their own simplifications or choose from the numerous simplifications already included in the technical specifications for the quantitative assessment, such as the balancing item approach to the valuation of sponsor support, or the additional simplifications proposed in this opinion. Moreover, further simplification of the standardised risk assessment should be considered to make it less burdensome for

IORPs to perform the calculations. The simplification could consider other probabilities of occurrence beyond the one used in the quantitative assessment, recognising that other confidence levels might also be useful for risk assessment purposes.

### **Preparatory phase**

The introduction of the common framework does not have to be accompanied by transitional measures/periods, since EIOPA advises retaining existing funding and capital requirements at this point in time. Still, there will be a need for a preparatory phase, before reporting under the common framework can commence.

Calculating and reporting the outcomes of the common framework's balance sheet and the standardised risk assessment would be a new requirement for IORPs. In particular, IORPs may not be familiar with the valuation of security and benefit adjustment mechanisms, since these mechanisms are generally not explicitly recognised in national frameworks. IORPs therefore need time to acquaint themselves with the common framework, understand the requirements and put in place processes for its technical implementation and public disclosure.

Processing common framework submissions would also be a new activity for NSAs. Therefore, NSAs need sufficient time to implement data collection, data validations and public disclosure requirements.

### **Benefits of the common framework**

#### **Risks and vulnerabilities**

IORPs participating in the quantitative assessment were asked to value the common framework's balance sheet and to perform the standardised risk assessment. The assessment was conducted on end-2014 data against the backdrop of low interest rates, increasing life expectancy and elevated asset prices.

The aggregate results show a 27% increase in the technical provisions (excluding benefit reductions) on the common framework's balance sheet compared to national balance sheets. IORPs in most Member States use a discount rate exceeding the current credit risk-free interest rate. Moreover, the common framework includes all types of benefits, which is not always the case in national frameworks.

European IORPs face an aggregate shortfall of financial assets compared to liabilities (excluding benefit reductions), which needs to be covered by future payments of sponsoring employers amounting to EUR 1,037bn, pension protection schemes amounting to EUR 9bn and future benefit reductions amounting to EUR 363bn.

The aggregate results of the standardised risk assessment indicate that IORPs, sponsors and plan members are vulnerable to severe stress scenarios, occurring with a probability of 0.5% within one year. IORPs have substantial exposure to biometric and financial market risk, most notably to interest rate, equity and longevity risk. This risk is often not borne by IORPs themselves, but instead by sponsors, pension protection schemes or members and beneficiaries.

The materialisation of the pre-defined stress scenarios would roughly double the value of sponsor support to EUR 1,737bn and benefit reductions to EUR 727bn, while reducing the value of conditional/discretionary benefits from EUR 134bn to EUR 69bn. The value of future payments by pension protection schemes would increase from EUR 9bn to EUR 44bn.

### **Enhancing transparency and risk assessment**

The common framework would ensure an objective view of IORPs' pension obligations and other items on the balance sheet by valuing all assets and liabilities on a market-

consistent basis. By including all security and benefit adjustment mechanisms, it also provides a comprehensive view of the extent to which pension promises are supported by financial assets and to what extent future payments by sponsoring employers and pension protection schemes are needed and/or future adjustments of plan members' benefits.

The standardised risk assessment would enhance current risk assessment and, consequently, risk management of IORPs. The risk assessment is based on a fully risk-sensitive balance sheet that recognises all assets and liabilities. As such, the risk assessment offers a comprehensive view of the risk exposure of IORPs, sponsoring employers, members and beneficiaries.

### **Protection of members and beneficiaries**

The information provided by the common framework would allow for a better understanding of the risks and vulnerabilities of occupational pension schemes, contributing to their resilience and sustainability and improving the protection of members and beneficiaries.

The common framework would assist IORPs, employers and/or the social partners in determining whether the IORP's dependence on future sponsor payments and benefit reductions is sustainable and whether measures to resolve shortfalls over time result in an equitable distribution between generations. The standardised risk assessment would help them deciding whether the risk exposure of IORPs, sponsoring employers and plan members is within prudent levels.

Public disclosure of the main elements of the balance sheet and the outcomes of the standardised risk assessment would have a disciplinary effect on IORPs and stimulate a dialogue between the various stakeholders.

The potential for supervisory action by NSAs will encourage the reform of IORPs, pension schemes and national pension arrangements, where this is considered necessary to enhance the protection of members and beneficiaries.

### **Cross-border activity and regulatory arbitrage**

European supervisory coordination relating to cross-border activity of IORPs will be facilitated, as the proposed framework introduces a "common language" for valuing assets and liabilities and measuring risk. This would also contribute to detecting and preventing regulatory arbitrage and promoting equal conditions of competition.

The process of establishing cross-border IORPs also is expected to be facilitated by providing stakeholders with a comprehensive tool to assess the financial situation and risk exposure of IORPs in other host Member States. The social partners and other stakeholders would be able to take well-reasoned decisions to use an IORP in another Member State for providing occupational pensions, thereby encouraging cross-border activity.

The introduction of the common framework would increase cross-sectoral consistency between the IORP Directive and the insurance framework. IORPs would be required to value the common framework's balance sheet on a market-consistent basis and to perform a standardised risk assessment with stresses calibrated to a 0.5% probability of occurrence within a one-year horizon.

### **Conclusion**

The IORP sectors across Europe are very heterogeneous and are experiencing different challenges. EIOPA believes that the introduction of a one-size-fits-all

framework with harmonised capital or funding requirements at this point in time will not be effective to meet these challenges.

To ensure the long-term sustainability of occupational pension promises, EIOPA advises to strengthen the IORP Directive with a common framework for risk assessment and transparency. Improved transparency and risk management would bring significant benefits by enhancing protection of members and beneficiaries, fostering the functioning of the internal market and reducing the scope for regulatory arbitrage. Moreover, the introduction of this common framework would encourage a gradual convergence of national funding regimes.

The costs of complying with the proposed framework could be significant, particularly for small- and medium sized IORPs. To minimise the burden on IORPs, the opinion includes several recommendations to ensure a proportionate application, allowing for simplified methods and approaches. In light of this, EIOPA expects that overall the benefits will outweigh the costs of the common framework.

EIOPA stands ready to cooperate with the European Parliament, the Council and the Commission to implement the common framework for risk assessment and transparency for IORPs into EU legislation.



# 1. Introduction

## 1.1. Basis of opinion

1. EIOPA delivers this opinion to the European Parliament, the Council and the Commission on its own initiative, in accordance with its tasks and powers as described in Article 8 and Article 34 of the EIOPA Regulation.<sup>3</sup>
2. EIOPA advises in this opinion to strengthen the IORP Directive with a harmonised EU-wide common framework for risk assessment and transparency (hereafter referred to as "common framework"). Furthermore, EIOPA advises to refrain at this point in time from introducing harmonised funding or capital requirements for IORPs at the EU level.
3. The common framework ensures a market-consistent and risk-based approach, providing an objective and transparent view of the financial situation of IORPs and further strengthening risk management, including informing asset and liability management.
4. The common framework consists of a market-consistent balance sheet and a standardised risk assessment<sup>4</sup>. IORPs should value on the market-consistent balance sheet all the available resources that can be used to support pension obligations, such as financial assets, sponsor support and pension protection schemes. The balance sheet should also include an indication of the extent to which any types of benefit adjustments, either positive or negative, may occur in the future, based on market-consistent valuation. The other main element of the common framework is the standardised risk assessment applying pre-specified shocks to the market-consistent balance sheet.
5. The main elements of the balance sheet and the outcomes of the standardised risk assessment should have to be publicly disclosed except where full public disclosure would lead to unintended consequences or a breach of confidentiality. National Supervisory Authorities (NSAs) should be provided with sufficient powers to take supervisory action, where deemed necessary, based on the common framework and any other relevant information, to further their objectives of supervision.
6. The principles, methodologies, parameters, etc. presented in this document are valid for EIOPA's opinion on a common framework for risk assessment and transparency. Should the common framework, or elements of it, be used for other purposes, the principles methodologies, parameters, etc. would have to be reconsidered.
7. EIOPA considers that the common framework proposed in this opinion can be established and used in practice. This does not mean that there is no room for further development and future improvement.
8. It is the prerogative of the Commission whether or not to take legislative initiatives to implement the common framework for risk assessment and transparency of IORPs into any future review of the IORP Directive. The European Parliament and the Council have the right to request the Commission

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<sup>3</sup> In earlier documents EIOPA announced to provide an "advice" to the European institutions. This document is now termed "opinion" to be consistent with the terminology used in the EIOPA Regulation (EU) No 1094/2010 and to emphasise that the opinion is on an 'own initiative' basis.

<sup>4</sup> The terms "holistic balance sheet" and "solvency capital requirement" have been replaced by "common framework's balance sheet" and "standardised risk assessment" as these are more appropriate terms to use in the context of risk assessment and transparency.

to submit legislative proposals on this matter. EIOPA stands ready to work with the EU institutions to implement the advice contained in this opinion into EU legislation.

9. EIOPA's opinion is not meant to interfere with the Commission's proposal for the revision of the IORP Directive (IORP II) published on 27 March 2014, which is currently being negotiated in trilogue.

## **1.2. Background**

10. Prior to delivering this opinion, EIOPA performed a Quantitative Assessment (QA) from mid-May to mid-August 2015 to collect data to inform the opinion. The QA followed the Quantitative Impact Study (QIS) on IORPs, which EIOPA conducted as part of its work following from the Call for Advice from the European Commission<sup>5</sup> and the consultation EIOPA performed between 13 October 2014 and 13 January 2015<sup>6</sup> on its own initiative.
11. The QIS raised a number of issues regarding definitions and methodologies for establishing the holistic balance sheet, which had been developed by EIOPA as part of its advice to the European Commission. Moreover, it did not specify an EU-wide supervisory framework that could underlie the holistic balance sheet. EIOPA committed in the QIS final report<sup>7</sup> to seek to resolve these matters.
12. The outcomes of the QIS showed that further work was needed before a European supervisory framework based on the holistic balance sheet could be devised.
13. The outcomes of the QIS also made clear that in order to reflect the nature of IORPs across all member states, a methodology like the holistic balance sheet is needed that allows for the specificities of occupational pension provision.
14. EIOPA concluded in the QIS final report that it was not yet in a position to fully assess the practicality of the holistic balance sheet. The QIS introduced and tested a number of new concepts and approaches and, as expected, considerable practical difficulties were encountered. In many cases it was not possible to satisfactorily resolve all the issues identified before and during the QIS. Moreover, a full assessment of a comprehensive supervisory framework would have required the definition of supervisory responses for that framework.
15. EIOPA identified a number of areas where further work would be necessary in order to better specify or bring more clarity on elements of the holistic balance sheet, and on the use that could be made of it. EIOPA committed on its own initiative to undertake this further work. This resulted in a consultation paper, which was published on 13 October 2014. The consultation paper not only dealt with technical issues relating to various elements of the holistic balance sheet, but also contained six examples of supervisory frameworks, including supervisory responses.
16. The QA performed in 2015 contained additional testing compared to the QIS. It provided quantitative information about the six examples of supervisory frameworks included in the EIOPA consultation paper. It also provided information about the practicality of the approaches presented in the consultation paper which were not included in the QIS, such as new methodologies for

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<sup>5</sup> EIOPA, EIOPA's Advice to the European Commission on the review of the IORP Directive 2003/41/EC, EIOPA-BoS-12/015, 15 February 2012.

<sup>6</sup> EIOPA Consultation Paper on Further Work on Solvency of IORPs, EIOPA-CP-14/040, 13 October 2014.

<sup>7</sup> EIOPA, Report on QIS on IORPs, EIOPA-BoS-13/124, 4 July 2013.

determining the value of sponsor support. In addition, the quantitative information provided by the QA is based on more up-to-date market data than the QIS.

17. The outcomes of the QA were indispensable in formulating this opinion. EIOPA would like to thank the 102 participating IORPs for their contributions to the exercise.

### **1.3. Stakeholder responses**

18. Both the QA and the opinion have benefited from responses from stakeholders on the public consultation that EIOPA performed between 13 October 2014 and 13 January 2015.
19. EIOPA received stakeholder responses to the consultation paper from 77 respondents, including EIOPA's Occupational Pensions Stakeholder Group (OPSG). EIOPA would like to thank all stakeholders again for providing their feedback to the consultation paper. A high-level overview of the stakeholder responses was provided in the technical specifications for the QA<sup>8</sup>.

#### **EIOPA's take-up of stakeholder responses**

20. EIOPA has greatly benefited from (re)considering stakeholder responses when drafting this opinion, since it has allowed EIOPA to consider a range of issues associated with its proposal and to identify mitigating actions.
21. Most respondents questioned whether EIOPA should proceed with its work. According to respondents, there is insufficient justification for EIOPA to continue the work, even on its own initiative, since the European Commission decided not to include solvency rules in its IORP II proposal. Furthermore, stakeholders considered additional solvency rules to be unnecessary, since members and beneficiaries are already protected by national prudential regimes and social and labour law. In addition, most were of the view that introducing harmonised solvency rules using the holistic balance sheet could have significant detrimental impact on IORPs, sponsors, members and beneficiaries, and long-term investments.
22. EIOPA recognises the reservations of respondents with regard to the added value of a harmonised solvency regime for the protection of members and beneficiaries. EIOPA concurs with the view that harmonised solvency rules should not be introduced at this point in time. The IORP sectors in member states are very heterogeneous and experiencing varying challenges. As a consequence, a one-size-fits-all solvency regime would not be appropriate and less effective than the common framework proposed by EIOPA in this opinion, due to the potential significant negative impacts and the need for transitional periods. Hence, EIOPA advises to refrain at this point in time from introducing harmonised funding or capital requirements for IORPs at the EU level.
23. Most respondents indicated that, should the holistic balance sheet be used at all, it would be preferable for it to be used as a risk management and risk assessment tool. It was also stated that more effective instruments for risk management and risk assessment are available, such as ALM models and the risk evaluation for pensions in the IORP II proposal.
24. EIOPA agrees that instruments for risk management and risk assessment are currently available. However, EIOPA considers that the common framework adds

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<sup>8</sup> EIOPA, Technical Specifications Quantitative Assessment of Further Work on Solvency of IORPs, EIOPA-BoS-15/070v2, 11 May 2015.

value to these existing instruments, not least because it also provides a common, comparable transparency tool. Therefore, EIOPA proposes that the common framework supplements existing risk assessment tools but does not replace them. In the event that the common framework becomes a requirement, there would also be a need for NSAs to have sufficient powers to take supervisory action, based on the common framework and any other relevant information, where deemed necessary and in line with their objectives of supervision, since they are well-placed to take into account the specificities of national IORP sectors.

25. There were strong and diverging views on public disclosure, either emphasising the potential adverse consequences for sponsoring employers or the benefits for IORPs as institutional investors. EIOPA has taken the view that public disclosure of comprehensive and objective information on pension obligations and the associated security and benefit adjustment mechanisms could have a disciplinary effect on IORPs and stimulate dialogue between the various stakeholders. Therefore, EIOPA advises that IORPs should be required to publicly disclose the main elements of the balance sheet and the outcomes of the standardised risk assessment. Where full public disclosure would lead to unintended consequences or a breach of confidentiality, the NSA should have the power to allow an IORP on the basis of guidelines to be established at the European level to disclose specific elements of the common framework in a qualitative manner only. These guidelines should also specify the circumstances in which the NSA could make use of that power.
26. Other areas where EIOPA has taken up stakeholder responses include:
- Valuation of sponsor support: in line with stakeholder comments, EIOPA advises to not fully prescribe valuation of sponsor support, although IORPs must be able to demonstrate to their NSA that the value calculated can be considered to represent the market-consistent value;
  - Proportionality: EIOPA advises to include measures in the common framework which enable its proportionate application where the nature, scale and complexity of the IORP and its activities justify this;
  - Mixed benefits: the overwhelming majority of respondents opted for mixed benefits to be classified either as conditional or discretionary benefits, based on a member state decision. EIOPA has decided not to distinguish mixed benefits as a separate category of benefits, for the sake of simplicity, considering that adding the category of mixed benefits in addition to conditional and discretionary benefits did not add much value. Still, all types of benefits continue to be recognised and disclosed in the common framework.

### **Publication of (second part of) reasoned feedback**

27. EIOPA has published the reasoned feedback on the responses to questions 1-71 of the consultation paper, which deal with valuation, together with the technical specifications of the QA<sup>9</sup>. The reasoned feedback to the general comments and to questions 72 – 111 of the consultation paper is published together with this opinion<sup>10</sup>. In respect of questions 72 – 111, it should be noted that the feedback is relatively limited, considering that EIOPA is not advising that the holistic balance sheet is used to establish solvency capital requirements (where the first

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<sup>9</sup> See EIOPA, Resolutions on Comments on Consultation Paper on Further Work on Solvency of IORPs – EIOPA-CP-14/040 – Q1-Q71, EIOPA-BoS-15/095, 11 May 2015.

<sup>10</sup> See EIOPA, Resolutions on Comments on Consultation Paper on Further Work on Solvency of IORPs – EIOPA-CP-14/040 – General Comments + Q72-Q111, EIOPA-BoS-16/076, 14 April 2016.

five examples of supervisory frameworks presented in the consultation paper were designed in the context of funding and capital requirements).

#### **1.4. Structure of this paper**

28. The next chapter of this document presents an overview of EIOPA's opinion on a common framework for risk assessment and transparency for IORPs. This is followed by a chapter with a justification of the opinion and an overview of the impact assessment. Chapter 3 contains a more detailed description of EIOPA's advice.
29. Annex 1 provides additional information about certain technical aspects of the common framework, focusing on the most relevant technical issues where the QA and further technical work by EIOPA led to amendments or additional reasoning and explanation compared to the technical specifications of the QA.
30. Annex 1 does not constitute a draft legislative text to implement the common framework in the IORP Directive. Rather, the additional information included in Annex 1 constitutes technical considerations which EIOPA proposes should be taken into account when developing the relevant EU legislation, if the EU institutions decide to pursue the advice in EIOPA's opinion.
31. Annex 2 presents in detail the numerical results of the QA. The results of the QA are presented at an aggregate level, grossed up to a member state level and without making individual participants in the QA identifiable.
32. Annex 3 contains EIOPA's impact assessment of the common framework for risk assessment and transparency for IORPs.

## **2. Opinion: overview**

33. This chapter presents an overview of the common framework for risk assessment and transparency for IORPs advised by EIOPA. The advice is based on Example 6 included in the EIOPA consultation paper on further work on solvency of IORPs and in the QA.

### **2.1. Scope**

34. Should the common framework become a requirement, EIOPA is of the view that it should apply in principle to all European IORPs providing schemes where financial market, longevity and other risks are shared to different degrees by the sponsor, members and the IORP. This means that a significantly larger number of member states in addition to those which participated in the QA would be affected by the common framework. The common framework would not apply to IORPs operating only pure DC schemes, in which IORP members and beneficiaries purely bear all risks.
35. The current IORP Directive stipulates that member states "may choose not to apply [that] Directive, in whole or in part, to any institution located in their territories which operates pension schemes which together have less than 100 members in total"<sup>11</sup>.
36. The same option, based on the same condition, should be provided to member states with regard to applying the common framework, assuming that the option

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<sup>11</sup> Article 5 of the IORP Directive. Note that this so-called small IORP exemption does not apply to article 19 of the Directive, which concerns (investment) management and custody.

will remain unchanged in the revised IORP Directive.<sup>12</sup> Moreover, EIOPA advises to allow for an additional exemption based on a threshold of EUR 25m in terms of assets to ensure that smaller IORPs are not disproportionately affected by the new requirements in view of the fixed nature of some of the costs associated with producing the common framework.

## **2.2. Common framework for risk assessment and transparency**

37. EIOPA advises to introduce a harmonised European common framework for risk assessment and transparency for IORPs, consisting of 1) a market-consistent balance sheet incorporating all assets (including security mechanisms) and liabilities (including benefit adjustment mechanisms), and 2) a standardised risk assessment based on common, pre-defined stress scenarios.
38. Furthermore, EIOPA advises to refrain at this point in time from introducing harmonised funding or capital requirements for IORPs at an the EU level.
39. IORPs should include all security and benefit adjustment mechanisms in the common framework, including:
  - Legally enforceable and non-legally enforceable sponsor support;
  - Pension protection schemes;
  - Conditional benefits;
  - Discretionary benefits;
  - Ex ante benefit reductions;
  - Ex post benefit reductions;
  - Benefit reductions in case of sponsor default.
40. Thus, the common framework would provide an assessment of the risks pension schemes operated by an IORP are exposed to, and an overview of who bears those risks, based on market-consistent valuation.
41. Technical provisions as used in the common framework should be calculated using a risk free discount rate and include a risk margin for liabilities that cannot be replicated on financial markets.
42. A standardised risk assessment applying pre-specified shocks to the balance sheet is part of the common framework. The standardised risk assessment analyses the aggregate impact of a common set of stress scenarios on each of the items on the common framework's balance sheet, and correspondingly the excess of assets over liabilities. A probability of occurrence of 0.5% over a one-year horizon was used in the QA, and it would therefore be most practical for EIOPA to recommend this confidence level. Further simplification of the standardised risk assessment should be considered to make it less burdensome for IORPs to perform the calculations for the standardised risk assessment. The simplification could consider other confidence levels beyond the one used in the QA: it is recognised that other confidence levels might also be useful for risk assessment purposes.
43. The common framework should regularly be calculated and reported annually, with additional reporting as occasion demands. Member states should have the right to allow a lower frequency of regular calculation and reporting, with a maximum of three years.
44. EIOPA advises that NSAs should have the powers to require additional calculations using the methodology of the common framework to further enhance

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<sup>12</sup> It might be worth considering applying the small IORP exemption based on the number of members of distinguishing parts of an IORP, depending on available risk-sharing mechanisms (see section 4.7).

the framework in cases where such additional calculations could assist IORPs in managing risks around the prevailing national funding standard.

### **2.3. Public disclosure and powers for supervisory action**

45. EIOPA advises that IORPs should be required to publicly disclose the main elements of the common framework's balance sheet and the outcomes of the standardised risk assessment<sup>13</sup>. Public disclosure of comprehensive and objective information on pension obligations and the associated security and benefit adjustment mechanisms could have a disciplinary effect on IORPs and stimulate dialogue between the various stakeholders.
46. Where full public disclosure would lead to unintended consequences or a breach of confidentiality, the NSA should have the power to allow an IORP on the basis of guidelines to be established at the European level to disclose specific elements of the common framework in a qualitative manner only. These guidelines should also specify the circumstances in which the NSA could make use of that power.
47. NSAs should be provided with sufficient powers for possible supervisory action so as to be able to achieve their objectives of supervision, based on the results of the common framework and any other relevant information. Any decision on supervisory actions, including whether supervisory actions will be taken or not, will be taken at the national level.
48. EIOPA believes a European, one-size-fits-all approach to supervisory actions is not feasible given the wide range of differences between IORPs in different member states.

### **2.4. Relation to currently applied practices**

49. The common framework is not intended to replace other risk assessment tools and techniques currently used by IORPs, such as ALM studies. Rather, it supplements those tools, which means that IORPs would be expected to continue to take into account the results provided by other risk assessment tools and techniques in their risk management decisions.
50. The information on the common framework which EIOPA advises to be publicly disclosed is not meant to replace any other information which is currently publicly disclosed by IORPs. It is also not meant to replace any information currently provided by IORPs to members and beneficiaries or any other stakeholders. It will rather supplement this information.
51. Using the common framework as a tool for risk assessment and transparency would not require any changes to current funding requirements (including those based on Art. 17-17d of the current IORP Directive). This means that the valuation standards of the current IORP Directive, as well as the existing rules (whether European or on a member state level) requiring IORPs to hold additional assets above technical provisions as a buffer, can be maintained.
52. The IORP Directive puts forward minimum rules regarding the valuation of technical provisions and the funding of technical provisions with financial assets and regulatory own funds. These rules can be supplemented by member states in national regulation. Such supplementary rules could be particularly relevant to prevent regulatory arbitrage in cases where IORPs themselves are responsible

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<sup>13</sup> It might be worth considering public disclosure on the level of distinguishing parts of an IORP, depending on available risk-sharing mechanisms (see section 4.7).

for risks and no security or benefit adjustment mechanisms are available by law and the IORPs are in effect operating like insurance companies.

### **3. Justification and impact assessment**

#### **3.1. Objectives of the Opinion**

53. According to Article 1(6) of the EIOPA Regulation, EIOPA's objectives are as follows:

"The objective of the Authority shall be to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses. The Authority shall contribute to:

(a) improving the functioning of the internal market, including in particular a sound, effective and consistent level of regulation and supervision,

(b) ensuring the integrity, transparency, efficiency and orderly functioning of financial markets,

(c) strengthening international supervisory coordination,

(d) preventing regulatory arbitrage and promoting equal conditions of competition,

(e) ensuring the taking of risks related to insurance, reinsurance and occupational pensions activities is appropriately regulated and supervised, and

(f) enhancing customer protection."

54. For the purpose of meeting these objectives and fulfilling those tasks, its regulation enables EIOPA to provide opinions to the EU institutions<sup>14</sup>, specifically in Article 8(2)(g) "(...)issue opinions to the European Parliament, the Council, or the Commission as provided for in Article 34." Article 34 further specifies "The Authority may, upon a request from the European Parliament, the Council or the Commission, or on its own initiative, provide opinions to the European Parliament, the Council and the Commission on all issues related to its area of competence."

#### **3.2. Considerations**

##### **3.2.1. Heterogeneity of national regimes**

55. The current IORP Directive lays down minimum rules with regard to the valuation of assets and liabilities and funding requirements. The minimum harmonisation approach enables a wide variety of valuation standards and funding requirements in the different member states.

56. The IORP Directive does not provide standards for the valuation of assets, and IORPs in EU member states may use discount rates for the valuation of technical provisions ranging from risk-free market rates to the expected return on assets. Moreover, the IORP Directive prescribes that technical provisions should be funded with assets. Only IORPs where the institution itself, and not the employer, underwrites risks are subject to a regulatory own funds requirement. This regulatory own funds requirement takes into account biometric risks to some extent, but is insensitive to operational, counterparty and market risks.

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<sup>14</sup> Art. 1(6), Art 8(2)(g) and Art. 34(1) of EIOPA Regulation (EU) No. 1094/2010.

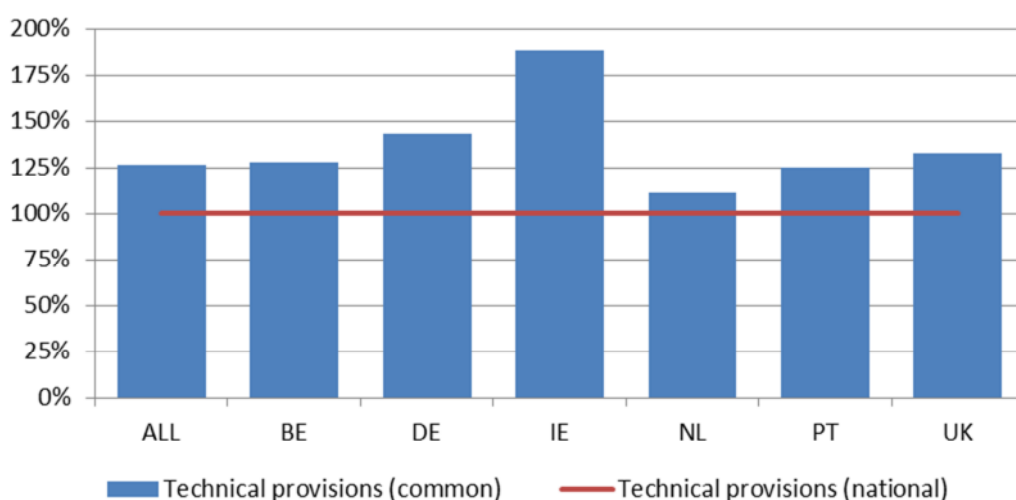


Only a minority of member states supplement the regulatory own funds requirement with national risk-based buffer requirements.

57. The QA made clear that IORPs in most member states use a discount rate exceeding current risk-free market rates. In addition, the common framework includes all types of benefits which is not the case in all national frameworks (for instance with regard to inflation compensation of pensions). In consequence, aggregate technical provisions (excluding benefit reductions) under a common, market-consistent approach are 27% higher in the QA than national technical provisions (see Figure 1).

Figure 1: Technical provisions (excl. benefit reductions) on common framework's balance sheet compared to national balance sheet

% technical provisions national balance sheet



Source: EIOPA

### 3.2.2. Recognition of security and benefit adjustment mechanisms

58. The results of the QA show that the values of technical provisions, provided according to the standards for valuation and explicit recognition of those elements in the current national regimes, may deviate significantly from the respective comprehensive and market-consistent values provided by the common framework.
59. In all participating member states, the QA shows that the standards for valuation and recognition of items to be included in the national regime do either not explicitly recognise the expected payments from security mechanisms (mainly sponsor support, but also pension protection schemes), or the potential extent of future benefit increases or reductions, or both.
60. The QA results show that, based on the QA technical specifications, in aggregate the future payments by sponsoring undertakings would amount to a market value of EUR 1,037bn (see Table 1 and Figure 2), which is equivalent to 24% of technical provisions. The estimated market value of future benefit reductions amount in aggregate to EUR 363bn, which corresponds to 9% of technical provisions.
61. The results of the QA show that information about the potential extent of support from sponsors and pension protection schemes, as well as of potential benefit reductions may currently not be explicitly recognised in national regimes

(although they may be implicitly be taken into account in IORPs' existing risk assessment).

*Table 1: Aggregate value technical provisions and security and benefit adjustment mechanisms on national balance sheet, common framework's balance sheet and under standardised risk assessment, end 2014, billion EUR*

	National balance sheet	Common framework's balance sheet	Standardised risk assessment
Technical provisions (excl. benefit reductions)	3,358	4,257 (+27%)*	na
of which: conditional/discretionary benefits	0	134	69
Benefit reductions	0	-363	-727
Sponsor support	0	1,037	1,737
Pension protection schemes	0	9	44

\* Percentage change compared to national balance sheet.

### 3.2.3. Risk exposure of IORPs

62. The QA results of the standardised risk assessment<sup>15</sup> show that IORPs have substantial exposure to biometric and financial market risk, most notably to interest rate, equity and longevity risk. After allowing for diversification effects the gross risk (based on a probability of occurrence of 0.5%) amounts to 31% of total liabilities (see Figure 3).

Figure 2: Aggregate common framework's balance sheet, end 2014

Billion EUR

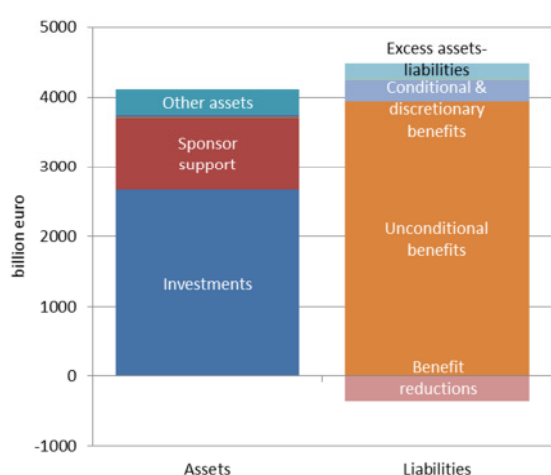
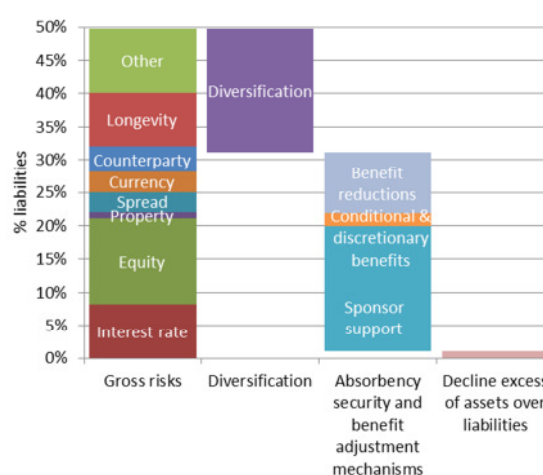


Figure 3: Aggregate outcomes standardised risk assessment, end 2014

% total liabilities



Source: EIOPA

<sup>15</sup> In the QA this has been presented as the calculation of a "solvency capital requirement", but this term would not be appropriate here, since EIOPA advises to refrain at this point in time from introducing harmonised funding or capital requirements at EU level.

63. Most IORPs do not bear these risks themselves, but instead the sponsoring undertakings and members and beneficiaries do. The materialisation of the pre-defined stress scenario which is calibrated to a 0.5% probability of occurrence and uses a risk-free rate would roughly double the value of the sponsor support to EUR 1,737bn and the value of benefit reductions to EUR 727bn, while reducing by half the value of conditional/discretionary benefits from EUR 134bn to EUR 69bn. The value of future payments by pension protection schemes would increase from EUR 9bn to EUR 44bn (see Table 1). Often these risks are not or not comprehensively recognised in national regimes.

#### **3.2.4. Implications for functioning of the internal market and potential regulatory arbitrage**

64. The heterogeneity in national funding requirements and valuation standards means that currently the balance sheets and other information provided by IORPs are not comparable between IORPs in different member states. This makes it difficult for employers and other stakeholders, where they are interested in using an IORP in another member state, to compare IORPs.
65. On the other hand, the heterogeneity in national funding requirements and valuation standards raises the possibility of regulatory arbitrage between member states. At the moment, this does not seem to be a major issue as the level of cross-border activity of IORPs is low. The number of active cross-border IORPs currently only amounts to 76, of which 45 provide non-DC schemes.<sup>16</sup>
66. The absence of a market-consistent and risk-sensitive prudential regime for IORPs in most member states may also contribute to cross-sectoral regulatory arbitrage between IORPs and insurance undertakings.

### **3.3. Supporting EIOPA's objectives**

#### **3.3.1. Enhancing transparency**

67. The common framework would enhance transparency, because it provides an explicit and objective view of the values of all available resources, such as financial assets, sponsor support and pension protection schemes, which can be used to support pension obligations. It also includes a useful indication of the expected value of benefit adjustments, either positive or negative, which may occur in the future based on market-consistent valuation.
68. This means that by including all security and benefit adjustment mechanisms, the common framework provides information about the extent to which not only the IORP, but other stakeholders like sponsors and pension protection schemes might be expected to contribute to fulfilling the pension obligation based on market-consistent valuation, and the extent to which members and beneficiaries might expect to receive non-unconditional benefits or face benefit reductions. The common framework also provides insight about the extent to which pension obligations are currently funded by financial assets and to what extent the IORP depends on investment returns in excess of the risk-free rate, payments by sponsors or pension protection schemes and/or benefit adjustments in the future. This information is currently often not readily available.
69. The common framework provides objective values for all resources, obligations and the potential extent of benefit adjustments, because it is based on market-

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<sup>16</sup> EIOPA, 2015 Market development report on occupational pensions and cross-border IORPs, EIOPA-BoS-15/144, 9 July 2015.

consistent valuation. However, a certain element of subjectivity will be unavoidable, e.g. when setting assumptions around future behavior, in modelling and the valuation of some items of the balance sheet such as sponsor support.

70. The comprehensive information provided by the common framework would also supplement the information already available to stakeholders to help them make informed decisions.
71. For sponsors the value of sponsor support shown in the common framework might be useful information to be taken into account in their financial and liquidity planning.
72. By providing for public disclosure, the common framework would make this explicit and objective information available not only to the IORP itself, the NSA, etc., but also to the general public, which is another aspect of transparency.
73. Social partners or employers are in general responsible for arranging pension schemes. They could use the common framework, both at the start of the contract and regularly during the contract, to assess the extent to which the use of benefit adjustment mechanisms and the reliance on security mechanisms as expected according to the results of the common framework (based on market-consistent valuation) may be different from what had been expected when setting up the pension scheme or IORP, and whether any differences are acceptable. If this is not the case, scheme rules, including the financial commitment of the sponsor(s), could be amended.
74. The results of the common framework could be used by NSAs to feed into their wider considerations with regard to analysis of the landscape, risk assessment and supervisory actions (e.g. a reduction of surplus sharing could be required to lower the extent of expected benefit reductions).
75. Institutions responsible for setting general conditions for IORP systems, whether in member states or at a European level could use the information provided by the common framework at an aggregate level when considering how IORP systems should be arranged.

### **3.3.2. Improving risk assessment**

76. Risk assessment is part of risk management, which can be understood as identifying, measuring, monitoring, managing and reporting risks. IORPs will already have strategies and processes for risk management in place. The management of risk may vary widely between different IORPs, due to differences in the risk profile, available resources, legal requirements, etc. IORPs will usually use a set of different methods and approaches for their risk management, reflecting the different objectives of risk management. The results of all of those methods and approaches is taken into account when taking decisions and managing risks.
77. Appropriate risk management needs to be based on a comprehensive view of all relevant factors, as well as on objective data. Therefore, the common framework could play a part in identifying, measuring, monitoring and reporting risk, as a basis for managing risk.
78. The information provided by the common framework, which includes all available security and benefit adjustment mechanisms, could further strengthen risk assessment and risk management, irrespective of how capital and funding requirements are defined.
79. The common framework would require assigning a market-consistent value to all assets (including security mechanisms) and liabilities (including the effects of

benefit adjustment mechanisms) related to the pension promise. This information is currently often not readily available. Having this information would contribute to identifying, measuring, monitoring and reporting all relevant risks (some of which are currently only taken into account implicitly), including whether the pension contract may be subject to an inappropriate level of risk in the long run.

80. IORPs could use the common framework when a new pension scheme or section of a scheme is established, to assess the nature of the risks associated with the contract that social partners intend to bring to the IORP, or the extent to which the likelihood of security mechanisms or benefit adjustment mechanisms (based on market-consistent valuation) having to be used would be unacceptably high. Based on this information, the IORP may reject to operate that specific pension scheme as proposed and/or require social partners to amend the terms before it can accept to operate the scheme.
81. Where the market-consistent value of technical provisions is higher than the value currently included in the IORP's accounts or used for risk assessment and management (the "gap"), this might be an indication that more resources might be needed for fulfilling the obligations than represented by the technical provisions included in accounts or used for risk assessment and management.
82. This "gap" can in principle be closed by a risk premium to be earned over the risk free rate, or by making use of security and benefit adjustment mechanisms. There should be an assessment whether the required value of risk premium is realistic and/or how much risk would have to be taken to earn it. Values of security and benefit adjustment mechanisms indicate how much sponsors and pension protection schemes might have to contribute to fulfilling the obligation, and to which extent members and beneficiaries might have to expect benefit reductions in terms of the market value of the pension promise.
83. The common framework provides information about the current risk sharing, but does not say anything about whether the current risk sharing is the intended risk sharing. In other words, the value of a specific security or benefit adjustment mechanism in the common framework does not mean that this mechanism would or should have a certain impact on the pension promise, it just says that a certain impact is expected (using market-consistent valuation).

### **3.3.3. Improving functioning of internal market and avoiding regulatory arbitrage**

84. Since the common framework would be valued based on the same principles of market-consistent valuation in all member states, the data it would provide would be comparable between all IORPs and between all member states. This means that NSAs and other stakeholders could use it to assess and better understand the differences and commonalities between European IORP systems. International supervisory coordination (e.g. when required in the context of cross-border activity) would become easier, because there would be a "common language" for valuing liabilities and measuring risks. This would also help to detect and possibly prevent regulatory arbitrage and promote equal conditions of competition.
85. Even though the values included in the common framework would in principle be comparable between IORPs and between member states, interpretation or explanation of the values would still be necessary to understand differences related to different available security and adjustment mechanisms and the interaction between those.

86. Since the data included in the common framework would be comparable, it would be possible to aggregate results of the common framework at the European level (although care needs to be taken when interpreting aggregated results as there is no cross subsidy between IORPs).
87. The common framework would also facilitate the process of starting cross-border activity by providing stakeholders with a comprehensive tool to assess the financial position and risks of IORPs when providing pension schemes in other host member states. The market values of the different security and benefit adjustment mechanisms used in member states would be made transparent. A pension scheme would be described in the common framework in the same way, irrespective of the home member state of the IORP and of the host member states in which it operates. This would make it easier for employers and other stakeholders to take a well-reasoned decision to use an IORP in another member state for providing occupational pensions, which might lead to increase in cross-border activity.
88. Because of the market-consistent and risk based approach, the common framework would increase consistency with the prudential framework of insurers, reducing the potential for cross-sectoral regulatory arbitrage. IORPs would have to value the common framework's balance sheet on a market-consistent basis, very similar to Solvency II. There are also similarities between the standardised risk assessment and the calculation of the solvency capital requirement in Solvency II, although the standardised risk assessment will not lead to (additional) capital requirements.

#### **3.3.4. Enhancing protection of members and beneficiaries**

89. The market-consistent and risk-based approach of the common framework, and the uses made of it by IORPs and stakeholders, would improve risk assessment and contribute to the resilience and viability of IORPs. This would mean that protection of members and beneficiaries would improve.
90. The information provided to members and beneficiaries by the common framework about the potential extent of conditional and discretionary benefits or benefit reductions based on a market-consistent valuation, could complement the information members and beneficiaries already receive to help them plan retirement provided the information is contextualised and the possible implications are explained clearly. The reliance on sponsor support and pension protection schemes might also be relevant for this type of member considerations, although the extent to which this would be useful would depend on the format in which it is presented to members and beneficiaries.
91. The common framework provides a market-consistent and risk-based view of the financial situation of IORPs and the schemes operated by them and of who bears the risks related to a pension scheme or promise. This transparency and the potential for supervisory action by NSAs could encourage reforms of national legislation, IORPs and/or pensions schemes, where this is considered necessary to improve protection of members and beneficiaries.

#### **3.4. Impact Assessment overview**

92. The six examples of supervisory frameworks presented in the EIOPA consultation paper on solvency of IORPs and tested in the QA represented a broad range of possible uses of the holistic balance sheet. EIOPA took this broad approach to get a comprehensive overview of what an appropriate supervisory framework might look like.

93. A detailed impact assessment is included in Annex 3. The results of the QA, which are presented in Annex 2, show that each of the examples 1 to 5, which use the holistic balance sheet to determine capital and funding requirements, lead to very different results in different member states and could have significant negative impacts on IORPs, sponsors and members. The differing results are mainly a consequence of the different national funding requirements and security and benefit adjustment mechanisms available across member states. EIOPA proposes to refrain at this point in time from introducing harmonised funding or capital requirements for IORPs at EU level. A one-size-fits-all regime would not be appropriate due to the potential significant negative impacts. Moreover, extensive transitional periods and transitional measures may be required, which could appropriately take into account the differences between member states' IORP systems.
94. EIOPA advises that the common framework be used as a tool for risk assessment and transparency based on the approach included in example 6 of the potential supervisory frameworks that were presented in the EIOPA consultation paper on solvency of IORPs. The assessment of impacts outlines some significant benefits the common framework would bring to the IORP sector in terms of greater transparency with regards to IORP's risk exposure which in turn would provide IORPs with a useful risk assessment tool to complement those they are already using. Improved transparency and risk management would lead to better protection of member benefits, enhance the functioning of the internal market and reduce the scope for regulatory arbitrage. The positive impacts of this opinion would be even more important for IORPs which do not already use effective risk assessment tools.
95. The impact assessment recognises that the set up and ongoing costs associated with complying with the requirements related to the common framework could be particularly important for some IORPs and in some member states. The opinion includes several recommendations to reduce the burden on particularly small- and medium-sized IORPs and further work can be done to develop additional simplifications and European-wide guidance which facilitate the proportionate application of the common framework. The benefit to cost ratio could also be significantly different in countries where there is less consistency between the proposed framework and the national funding standard. In view of this, EIOPA believes that the benefits of the common framework are likely to outweigh the costs. However, EIOPA recognises that benefits are difficult to quantify and that this impact analysis is mainly qualitative in nature.

## **4. Opinion: detailed description**

### **4.1. Market-consistent balance sheet**

96. Under the common framework, IORPs would have to value the common framework's balance sheet on a market-consistent basis and include all security and benefit adjustment mechanisms, including:
- Legally enforceable and non-legally enforceable sponsor support;
  - Pension protection schemes;
  - Conditional benefits;
  - Discretionary benefits;
  - Ex ante benefit reductions;
  - Ex post benefit reductions;
  - Benefit reductions in case of sponsor default.

97. Technical provisions as used in the common framework should be calculated using a risk free discount rate and include a risk margin for liabilities that cannot be replicated on financial markets.

### **Robustness/reliability of data**

98. For many items within the common framework, the general underlying principle of market-consistent valuation can be clearly specified. Other items may be more difficult to value, especially sponsor support, as pension arrangements vary widely between member states and between IORPs within each member state.

99. Even within market-consistent valuation, there is a significant reliance on the quality of assumptions and methodologies, e.g. with regard to long term cash-flows that are not replicable in the market, non-unconditional benefits, use of discretionary powers, etc. This is likely to be the key risk regarding to robustness and reliability of the data.

100. To provide consistency, guidance for establishing the common framework should, as far as possible, be provided at European level. Where additional national guidance is provided by NSAs to address national specificities, this should be consistent with the general principles of the common framework and the guidance provided at European level.

### **4.2. Standardised risk assessment**

101. IORPs should, as part of the common framework, conduct a standardised risk assessment, analysing the aggregate impact of a set of pre-specified common stress scenarios on each of the items on the common framework's balance sheet, and correspondingly the excess of assets over liabilities on the balance sheet.

102. In the event that the common framework becomes a requirement, the standardised risk assessment would provide insight in what the effects of a stressed situation could be and the extent to which the available security and benefit adjustment mechanisms are able to absorb shocks. Where guarantees are provided, it would show whether IORPs and/or sponsors providing those guarantees can deliver on them with a high degree of certainty.

103. The following risk factors should be included in the standardised risk assessment:

- Operational risk;
- Market risk, distinguishing the following factors:
  - Interest rate risk (differentiating between real interest rate and inflation risk);
  - Property risk;
  - Equity risk;
  - Spread risk;
  - Currency risk;
  - Concentration risk;
- Counterparty default risk (including default risk of the sponsor);
- Longevity risk.

104. To implement the standardised risk assessment, it would be most practical to make use of the calibrations of the (sub-)modules of the calculation of the solvency capital requirement in Solvency II which are based on a 0.5% probability of occurrence over a one-year horizon, although it recognises that



other confidence levels might also be useful for risk assessment purposes. Further simplification of the standardised risk assessment should be considered to make it less burdensome for IORPs to perform the calculations for the standardised risk assessment. The simplification could consider other confidence levels beyond the one used in the QA. Due allowance should be made for diversification effects between risk factors.

105. Although the opinion is about risk assessment and transparency (rather than about solvency requirements), consistency with the insurance framework would also be improved through this choice.
106. However, the term "solvency capital requirement" (SCR) would be inappropriate here, since EIOPA does not advise that capital or funding requirements for IORPs would change, nor that the outcomes of the standardised risk assessment should lead to additional funding or capital requirements.
107. The standardised risk assessment comprises risk factors that are most relevant for IORPs in Europe. However, EIOPA advises that further simplification of the standardised risk assessment should be considered to reduce the burden and complexity of the calculations and to allow especially small- and medium-sized IORPs to conduct the assessment at a smaller cost.
108. The standardised risk assessment would measure the expected change in excess of assets (including the value of security mechanisms) over liabilities (including the value of benefit adjustment mechanisms) with and without the overall capacity of sponsoring undertakings, pension protection schemes and benefit adjustment mechanisms/technical provisions to absorb shocks. IORPs would have to make transparent as part of the standardised risk assessment, to which extent shocks could be absorbed by each of those security and benefit adjustment mechanisms.<sup>17</sup>
109. When using the common framework as a tool for risk assessment and for NSAs to decide (alongside other relevant information) whether to apply supervisory responses, and which, the common framework's balance sheet, as well as the results of the standardised risk assessment would be taken into account. Whether all pieces of those data would be considered equally relevant or not by NSAs and IORPs would depend on national or IORP specificities.

### **4.3. Public Disclosure**

110. Should the common framework become a requirement, IORPs would have to use the complete results of the common framework as part of their own risk management framework. The full results of the common framework should also be disclosed to the IORP's NSA.
111. In respect of public disclosure, EIOPA supports the general principle that relevant information needs to be publicly disclosed. Within that general principle, EIOPA considers that disclosure needs to be aligned with the interests of the (groups of) people that receive or have access to this information. This means that publicly disclosed information should be accompanied by proper explanation.
112. A proper explanation is particularly important since the interpretation of the values on the common framework's balance sheet and the results of the standardised risk assessment may not always be unambiguous. Member states often do not impose market-consistent valuation standards. In consequence, the values on the national balance sheets and the common framework's balance

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<sup>17</sup> Or by other items on the common framework's balance sheet, like deferred tax assets.

sheet will likely be different. This will also result in different outcomes for frequently used metrics like the excess of investment assets over technical provisions or the funding ratio. Under the common framework IORPs also have to explicitly recognise the value of sponsor support on the asset-side of the balance sheet, where under national frameworks sponsor support is usually only implicitly accounted for. This implies that the common framework may give a more favourable impression of the financial situation of IORPs compared to the national framework. As a last example, IORPs have to report the market value of non-unconditional benefits and benefit reduction mechanisms on the common framework's balance sheet, which is most often not the case under national frameworks. However, a market value of such benefit adjustment mechanisms cannot be translated one-on-one into (an impact on) expected retirement benefits of individual plan members. A (public) misinterpretation of the results of the common framework may have negative implications for national IORP sectors in general and plan members, sponsors and NSAs in particular.

113. EIOPA therefore advises that IORPs should be required to publicly disclose the main elements of the common framework's balance sheet and outcomes of the standardised risk assessment in a report containing also appropriate explanation, in order to minimise the risk of misinterpretations by the general public with regard to the financial position of the IORPs and the value of the security and benefit adjustment mechanisms. The explanation should include, for example, specific references to potential consequences for members and beneficiaries, and sponsors. Furthermore, the report should include information about the standardised risk assessment performed, the scenarios used and the way such a scenario could affect the financial position of the IORP and consequently the pension rights of members and beneficiaries and/or the sponsor's commitments.
114. Public disclosure of comprehensive and objective information on pension obligations and the associated security and benefit adjustment mechanisms could have a disciplinary effect on IORPs and stimulate dialogue between the various stakeholders.
115. The IORP's members and beneficiaries would thus have access to relevant information around the financial position of the IORP and on how their IORP (and their own pension rights) might respond under specific scenarios. This information would complement the specific information that members and beneficiaries receive regarding their individual pension entitlements through other communication channels like the annual pension benefit statement.
116. The report would also contain useful information for the plan sponsor(s). Where the sponsor(s) provide(s) legally enforceable or non-legally enforceable sponsor support, the common framework's balance sheet and the standardised risk assessment contain information regarding the additional funding that may have to be provided to the IORP at some point in the future (assuming that investments only return the risk-free rate). And even where the sponsor does not provide sponsor support, the outcomes of the balance sheet may lead to a conclusion that the pension scheme's risk exposure is too high, in which case the scheme rules or the financial set-up of the scheme might be changed (either by the sponsor on its own or in negotiations with employees or their representatives, or between social partners).
117. Where full public disclosure would lead to unintended consequences or a breach of confidentiality, the NSA should have the power to allow an IORP on the basis of guidelines to be established at European level to disclose specific elements of the common framework in a qualitative manner only. These guidelines should also specify the circumstances in which the NSA could make use of that power.

118. The report should be drawn up and publicly disclosed each time the common framework is calculated. The IORP must at least make the report available on its website and ensure that the information can easily be found there. If an IORP does not have a website, it should provide the report on request in printed or (preferably) electronic form. Furthermore, national rules may require a more active approach to publication of the report (e.g. for competing IORPs in member states where competition exists in the occupational pensions sector).
119. Even though the scope of this opinion is restricted to IORPs, it must be noted that the information that is available to members, beneficiaries, sponsors and other interested parties through the report on the common framework is not only relevant in the context of occupational pension schemes managed by IORPs but might also be relevant when such schemes are managed by insurance undertakings.
120. Especially in situations where the insurance contract does not fully or not exactly insure the pension promise made by the employer, it is useful for members, beneficiaries and sponsors to have the same type of information available as it would be in the case of IORPs after implementation of the common framework. As such, members, beneficiaries and sponsors might benefit from the same level of transparency (and comparability), irrespective of whether their pension scheme is managed by an IORP or by an insurance undertaking.

#### **4.4. Supervisory responses**

121. EIOPA believes that a one-size-fits-all approach to supervisory responses at an EU level is not feasible given the differences between IORP systems of member states, including national funding requirements. As such, any decision on supervisory actions based on the results of the common framework or any other relevant information, including whether supervisory actions will be taken or not, will be taken at the national level. NSAs should therefore be provided with sufficient powers to take supervisory action based on outcomes of the common framework, if deemed necessary by the NSA to achieve its supervisory objectives as defined by EU and national law.
122. Any decision about supervisory actions, including whether supervisory action will be taken or not, is expected to take into account other factors than the common framework, such as for instance whether an IORP complies with national funding requirements or the results of other risk management tools, etc. Depending on national circumstances, available security and benefit adjustment mechanisms, etc., NSAs might consider other factors to be more important than the results of the common framework when considering whether supervisory responses are appropriate (including whether supervisory actions will be taken or not), in particular because the common framework may not necessarily be consistent with the existing funding standards for some IORPs.
123. The nature of supervisory actions taken may depend on whether they are triggered by the common framework's balance sheet or by the results of the standardised risk assessment or any other relevant information. NSAs may also have to consider other European or national law, e.g. related to collective labour agreements or to employer insolvency.
124. Without prejudice to considering other factors as described above, a typical indication for a risk of not achieving the NSAs objectives of supervision might be that the IORP has insufficient assets, including security mechanisms, on the common framework's balance sheet or in the standardised risk assessment to cover liabilities, since this might mean that the pension promises provided by an

IORP could not be fulfilled if current or stressed circumstances would remain unchanged. This "gap" may be reduced or closed by a risk premium which may be earned over the risk free rate, and/or by making use of security and benefit adjustment mechanisms.

125. The NSA's objectives of supervision might furthermore provide a basis for the NSA to consider, based on the results of the common framework, that there could be an excessive reliance on sponsor support, pension protection schemes or benefit reductions in current and/or stressed circumstances.
126. Based on their assessment of the IORP's risk profile, using the common framework and any other relevant information, NSAs should have the powers, where they deem it appropriate, to direct IORPs to take measures to improve their financial position, reduce risk exposure and/or enhance the management of those risks within a timeframe specified by the NSA, leaving it to the IORP to decide on the appropriate measures. Measures taken by the IORP or the stakeholders may include:
  - Improving governance arrangements, including strengthening of internal controls and risk management processes
  - Reduction of mismatch risk between assets and liabilities (for example, by changing the asset allocation, hedging risks on financial markets, transferring non-hedgeable risks to another institution);
  - Increasing contributions from employers and/or employees or improving the security of the IORP through contingent assets;
  - Adjusting benefits;
  - Reduction of level of surplus sharing, to lower the extent of expected benefit adjustments;
  - Modifying the pension scheme, e.g. by adjusting the future accrual rate of benefits.
127. It might be the case that national law does not have to be amended to provide NSAs with sufficient powers to act on the basis of the results of the common framework, e.g. in cases where national law provides that NSAs can take all measures which are necessary to achieve their objectives of supervision, based on all information available to them. In such a case it might be sufficient to add into national law only the obligation for IORPs to report the results of the common framework to the NSA.

#### **4.5. Simplifications and proportionality**

128. The application of a harmonised comprehensive framework at a European level requires a proportionate approach to cater for the many differences between IORPs in Europe, both with regard to the size as well as the types of pension systems that exist within Europe.
129. Especially for small and medium-sized IORPs a proportionate approach is essential, given that establishing the common framework without simplifications will be associated with material implementation and ongoing costs. The impact assessment that accompanies this opinion points out that member states with on average smaller-sized IORPs in terms of assets have on average higher costs relative to the size of their IORP sector. If a similar amount of resources is needed to perform the calculations irrespective of the size of the IORP then member states with the highest incidence of small- to medium-sized IORPs will bear the largest burden. This has substantial implications: the costs as a percentage of assets for the member state with the smallest IORPs are 25 times as high as for the member state with on average the largest IORPs.

130. Valuing all elements of the common framework and assessing their interconnectedness may be challenging for small to medium-sized IORPs, because of the complexity of the calculations and the level of sophistication needed in combination with a lack of resources. As a result, the implementation of the common framework may not be effective in terms of costs and benefits without a proportionate application, allowing for simplified methods and approaches.
131. In the context of proportionality, a rule or principle may only be applied differently depending on the circumstances with regard to the nature, scale and complexity of the activities and the underlying risks. Applying proportionality should not lead to compromise the main objectives and principles of the common framework.
132. A proportionate approach could for instance be achieved by allowing for simplifications that enable IORPs that are proven to be sufficiently funded with financial assets to only value certain items within the common framework, or to enable IORPs to conduct the standardised risk assessment in a less burdensome manner, to the extent justified by the nature, scale and complexity of the activities and underlying risks.
133. The common framework includes as such already an overall simplified standardised risk assessment compared to the Solvency II framework. The standardised risk assessment comprises risk factors that are most relevant for IORPs in Europe. Of course, depending on the risk profile, IORPs and NSAs may consider to include some of these excluded risk factors to better reflect the risk exposure of the IORP. Still, EIOPA advises that further simplification of the standardised risk assessment should be considered to reduce the burden and complexity of the calculations and to allow especially small- and medium-sized IORPs to conduct the assessment at reasonable cost.
134. The technical specifications of the QA already included many possible simplifications with regard to the calculation of the best estimate (biometric risk factors, financial options and guarantees, economic conditions for the types of benefits, expenses, ...), the reinsurance recoverables, the valuation of other assets and liabilities, sponsor support and with regard to the determination of the shocks (on bonds, counterparty default risk and longevity risk). Furthermore, shocks for a particular risk were not applied when the exposure to that risk was considered to be negligible by the IORP<sup>18</sup>.
135. One of the most important simplifications is the possibility of using the balancing item approach, in particular for determining the value of sponsor support. This approach is only available for IORPs with strong sponsors. Nevertheless the balancing item approach is a cost effective manner to determine the value of sponsor support in the common framework.
136. EIOPA advises that specific attention should be paid to the eventual consequences of the application of the common framework to pension provisioning and the significant burden it could put on small and medium-sized IORPs.
137. For very small IORPs (i.e. those with less than 100 members) a complete exemption to the application of the common framework could be envisaged. This simplification could be introduced by a member state whether or not it applies the current IORP exemption, or it could be decided by the NSA on a case by case

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<sup>18</sup> See Section I.8 and Annex 4 of the Technical Specifications.

basis on request of the IORP and depending on the risk profile. Moreover, EIOPA advises to allow for an additional exemption based on a threshold of EUR 25m in terms of assets to ensure that smaller IORPs are not disproportionately affected by the new requirements in view of the fixed nature of some of the costs associated with producing the common framework.

138. As part of this opinion EIOPA proposes the following supplementary simplifications:

- mixed benefits do not need to be valued as a separate category of benefits<sup>19</sup>;
- surplus funds do not need to be identified in the common framework;
- IORPs do not need to calculate the value of security and benefit reduction mechanisms if the IORP has sufficient financial assets to cover liabilities including the impact of the standardised risk assessment;
- flexibility has been given to member states to set the frequency for establishing the common framework to every three years, conditional on circumstances not having changed substantially.

139. Together with the simplifications that were already foreseen in the technical specifications of the QA, EIOPA believes that the common framework as advised in this opinion could be applied in a proportionate manner and adapted to the specific situation of IORPs, not only for small to medium-sized IORPs but depending on their complexity and risk profile. With time and through the experience both the IORPs and the NSAs will have gained, it will become clearer where and how further simplifications would or would not be appropriate.

140. NSAs have an important role in ensuring that all members and beneficiaries benefit from the same level of transparency and that all IORPs manage risk appropriately, so that they can provide the pension benefits as foreseen. NSAs should therefore have the power to impose the full or simplified application of the common framework to individual IORPs. NSAs should always be able to disallow the application of simplifications if it is considered not to be appropriate for that IORP. NSAs could also assess beforehand and at a national level, the appropriateness of certain simplifications for the type of IORPs operating in their country. Consistency with the main principles and objectives of the common framework should be guiding in any such decisions. IORPs and NSAs should remain aware of the impact of the use of simplifications on the reliability of the outcome.

141. In any case, any “principle-based” or simplified approach should be accompanied by sufficiently consistent guidance at European level in order to ensure a level playing field, enhance transparency and ensure comparability. In the technical specifications for the QA EIOPA proposed several simplifications (see section 13 in Annex 1). It is important to note that the relevance and materiality of certain risks could be very much IORP-specific, and therefore it should be assessed on a case-by-case basis if such simplifications are justified. Therefore IORPs should be able to explain to their NSA how they have applied simplifications and to justify the appropriateness of the approach they have adopted in the context of the nature, scale and complexity of its activities and its underlying risks.

#### **4.6. Relation to currently applied practices**

142. While the common framework would play an important part in the risk assessment and management of an IORP, it has to be clear that it does not seek

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<sup>19</sup> See section 1.3

to replace, but rather supplement existing risk management framework, which will usually be IORP and/or member state specific.

143. The conclusions drawn from the common framework, whether by IORPs or by NSAs, would highly depend on the national circumstances and legal framework and on the circumstances of the individual IORP. IORPs and NSAs would have to be flexible in deciding whether they should take any decisions based on the results of the common framework, and which decisions, if any.
144. For instance, the common framework might show a certain reliance on pension protection schemes. If the objective of supervision in a member state is that IORPs should avoid placing any reliance on potential future compensation from a pension protection scheme, then NSAs could require IORPs to disregard the value of the pension protection scheme included in the common framework when taking their risk management decisions, while other NSAs would not do this.
145. The same holds true with regard to sponsor support: the common framework might show a certain reliance on sponsor support, which may be in line with the regulation and objectives of supervision in some member states, but should be avoided in other member states. In this case, how the value of sponsor support included in the common framework should or should not be considered in risk management decisions would probably differ between member states, and could also be subject to guidance or specific requirements by NSAs.
146. The same applies to benefit reductions.
147. Resulting differences in the use of the common framework for risk management between different IORPs and different member states would not only be acceptable, but even necessary to reflect the differences in IORP systems and objectives of supervision.
148. Improving risk assessment and enhancing transparency of risks (and therefore comparability between IORPs) are two key objectives of the proposal in this opinion.
149. The common framework is specified on a harmonised basis to facilitate consistency of approach and comparability between IORPs and between member states. As far as IORPs focus their risk management on the risk of not meeting the existing funding standards, the common framework may have even greater value for risk assessment purposes when it is supplemented with calculations based on discount rates which are aligned with prevailing funding standards.
150. For these IORPs, a standardised risk assessment calculated on technical provisions valued at a discount rate consistent with that used for the national funding standard may also be useful.
151. Similarly, whilst the calibration of the stressed risk factors to be used in the standardised risk assessment to a 0.5% probability of occurrence within a one-year horizon provides a common and comparable level of certainty as well as consistency with the insurance framework and has the advantage of using existing and well-developed calibrations, it is recognised that, in the context of consideration of further simplification, other confidence levels might also be useful for risk assessment purposes.
152. EIOPA advises that NSAs should have the powers to require additional calculations using the methodology of the common framework, including different discount rates or valuation standards; instruct IORPs to disregard some elements of the common framework when it is being used for risk management purposes; or require calculations to be performed at the level of the distinguishing parts of the IORP (see below). This would help enhance the

relevance and usefulness of the common framework also towards checking compliance of the IORP involved against national funding requirements. NSAs should be completely free to decide whether they make use of such powers, and in which way.

#### **4.7. Level of aggregation of the calculations**

153. The common framework enables members and beneficiaries to assess the value of their benefits on a market-consistent basis, including the potential of benefits being increased or reduced, and enables sponsors to assess the potential cost of fulfilling their pension obligations assuming that investment returns are at the risk free rate.
154. There may be cases where it could be appropriate to establish the common framework on the level of distinguishing parts of the IORP. How these parts should be identified, i.e. the distinction of parts for which it would be more relevant to establish the common framework on that level instead of only with regard to the IORP as a whole, will depend on the risk-sharing mechanisms within and between the distinguishing parts of the IORP.
155. NSAs should therefore have the powers to require calculations of common frameworks at the level of distinguishing parts of an IORP, based on the assessment of available risk-sharing mechanisms. These could replace or supplement the common framework calculated at the level of the IORP. NSAs should be completely free to decide whether they make use of these powers and in which way.
156. The assessment of whether it would be appropriate to establish the common framework at a level of distinguishing parts rather than for IORP as a whole should be guided by the main principles and objectives of the common framework.

#### **4.8. Frequency of calculation and reporting**

157. EIOPA advises that the common framework should regularly be calculated and reported annually.
158. EIOPA notes the current position regarding the calculation and reporting of technical provisions as set out in Art. 15.3 of the IORP Directive:
159. "The calculation of technical provisions shall take place every year. However, the home Member State may allow a calculation once every three years if the institution provides members and/or the competent authorities with a certification or a report of adjustments for the intervening years. The certification or the report shall reflect the adjusted development of the technical provisions and changes in risks covered."
160. EIOPA therefore advises that a similar regime should be adopted as regards the frequency of calculating and reporting the results of the common framework, i.e. the home member state may allow
  - a full report of the main elements of the common framework's balance sheet and the outcomes of the standardised risk assessment submitted to the NSA only every three years
  - provided that an annual "interim" report is submitted to the NSA
  - and there is continuous monitoring by the IORP (without reporting)
  - and additional reporting as occasion demands, e.g., when required by the NSA, or owing to a material change in the risk position.



161. However, it should be noted that EIOPA is of the view that the frequency of calculations and reporting of the common framework is not necessarily linked to the calculation of technical provisions.
162. EIOPA's view is that the annual interim report mentioned above should have the same format as a full report, but does not necessarily need to involve a full recalculation of all figures, i.e., the interim report's preparation should be significantly less onerous than the full triennial report.
163. The interim report should contain updated figures where they have changed materially, where needed on a roll-forward basis.
164. The report should contain an update on the results of the continuous monitoring carried out by the IORP and a narrative description of how the common framework is likely to have developed.

#### **4.9. Preparatory phase**

165. Since EIOPAs advises to introduce a common framework for risk assessment and transparency, and to retain at this point in time existing funding and capital requirements, EIOPA believes that neither a transitional period nor grandfathering arrangements are required. However, there will be a need for a preparatory phase.
166. Apart from those IORPs and NSAs directly participating in the QA and similar exercises, IORP managers, advisers and supervisors may not be familiar with some aspects of the common framework.
167. In particular, there may be a lack of familiarity with the consideration or valuation of security and benefit adjustment mechanisms, since these mechanisms are generally not explicitly recognised in national frameworks.
168. For IORPs, calculating and reporting the common framework would be a new requirement in addition to their current disclosure and valuation requirements under current national law. IORPs therefore need sufficient time to acquaint themselves with the common framework, understand the requirements and put in place processes for the calculation of the common framework and arrangements for public disclosure.
169. For NSAs, processing common framework submissions from IORPs would be an additional activity. NSAs need sufficient time to implement data collection and data validation and adapt their operational frameworks to the extent required.
170. Therefore, looking at the effects the introduction of the common framework would have on IORPs and NSAs, EIOPA believes that a preparatory phase would be required before reporting under the common framework can commence.
171. The availability of prescribed bases, valuation tools and examples, either from EIOPA or from national authorities, would assist in reducing the calculation and reporting burden for IORPs. Some NSAs may therefore decide to provide a calculation tool for IORPs to use, including simplifications.

## List of country abbreviations

AT	Austria
BE	Belgium
BG	Bulgaria
CY	Cyprus
CZ	Czech Republic
DE	Germany
DK	Denmark
EE	Estonia
ES	Spain
FI	Finland
FR	France
GR	Greece
HR	Croatia
HU	Hungary
IE	Ireland
IS	Iceland
IT	Italy
LI	Liechtenstein
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NL	Netherlands
NO	Norway
PL	Poland
PT	Portugal
RO	Romania
SE	Sweden
SI	Slovenia
SK	Slovakia
UK	United Kingdom

## List of other abbreviations used

ALM	Asset and liability management
bn	Billion ( $10^9$ )
DC	Defined contribution
EIOPA	European Insurance and Occupational Pensions Authority
EU	European Union
EUR	Euro
IORP	Institution for Occupational Retirement Provision
m	Million ( $10^6$ )
NSA	National supervisory authority
OPSG	Occupational Pensions Stakeholder Group
QA	Quantitative assessment
QIS	Quantitative impact study
SCR	Solvency capital requirement