

# IORP II: what does it mean for UK pensions?

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Pension briefing

## HIGHLIGHTS

The new directive on occupational pension schemes (IORP II) must be implemented in national law by mid-January 2019. UK pension schemes are already subject to most of the requirements under existing UK legislation. However, there are a few areas where schemes are likely to need to make changes, in particular:

- pension benefit statements, which will have to be sent annually to all active and deferred members;
- obligations for all schemes to have "key functions" in place, including internal audit and risk management;
- requirements to adopt written policies on various matters, including risk management, internal audit and outsourcing;
- a requirement to have a remuneration policy and to disclose publically relevant information about their policy;
- greater supervision by national regulators (in the UK, the Pensions Regulator) of certain activities, including outsourcing, plus an obligation to notify the Regulator before certain functions are outsourced; and
- a requirement that all schemes make their statement of investment principles (SIP) publically available on a website.

This note considers some of these changes in more detail.



## INTRODUCTION

A replacement for the first IORP directive has been long-awaited. As proposals went through the European legislative process, much of the debate focussed on whether occupational pension schemes would have to comply with the stringent funding requirements applicable to insurance companies (and set out in the "Solvency II" directive). Solvency II funding requirements would have had a significant impact in the UK, Ireland and the Netherlands in particular. Following intense lobbying by industry representatives, the Solvency II proposals were dropped.

As IORP II is a directive, it does not have direct effect on schemes but must be implemented into national law by each Member State. Member States have until 13 January 2019 to do this.

The DWP has confirmed that it intends to implement the requirements of IORP II, notwithstanding the imminence of Brexit.

## SCOPE OF IORP II

Like IORP I, IORP II applies to occupational pension schemes. It does not apply to:

- state pension systems;
- unfunded (pay as you go) retirement schemes;
- book reserve occupational pension schemes (common in Germany); or
- personal pension schemes.

Member States may choose not to apply most provisions of IORP II to occupational schemes with fewer than 100 members, provided that they do not operate cross-border. Investment rules and governance requirements must be applied to all occupational schemes with more than 15 members.

Member States may also choose to apply some provisions of IORP II to insurers' occupational retirement provision, in which case certain provisions of Solvency II will not apply. The retirement provision business must be ring-fenced from the insurer's other business.

## INVESTMENT

Most of the investment provisions of IORP I are replicated in IORP II. There are a few areas of difference, as follows.

- IORPS will be required to invest in the "best long-term interests" of members and beneficiaries, as opposed to their "best interests". It is not yet clear what difference the addition of "long-term" will have, although its inclusion is in line with increased emphasis on long-term factors such as environmental and governance issues (see below).
- National regulators will be expected to monitor the adequacy of trustees' credit assessment processes and their use of credit ratings in their investment policies. The concern seems to be to discourage (or mitigate the effect of) "mechanistic" reliance on credit ratings when deciding which companies to invest in.

- Trustees must be allowed, within the "prudent person" principle, to take into account the potential long-term impact of investment decisions on environmental, social and governance factors. How these factors are taken into account in the scheme's investment policy must be included in the statement of investment principles (SIP).
- The SIP must be made publically available. (At present, UK law gives members the right to access their scheme's SIP but they need not be made available publically.)

In practice, most trustee boards will rely heavily on their investment consultants to ensure compliance with the new requirements.

### Current UK consultation on investment

The DWP has already consulted (in June 2018) on regulations which will:

- require trustees' SIP to cover the trustees' policy on financially material considerations. For this purpose, "financially material considerations" includes environmental, social and governance considerations (specifically including climate change), although it is not limited to these factors; and
- require SIPs from most defined contribution (DC) schemes to be made publically available on a website.

In the June 2018 consultation paper, the government made clear that it expects trustees will take financially material considerations into account in all but a limited range of circumstances, for example where the winding up of the scheme is imminent.

According to the consultation paper, the requirement for DC schemes to publish their SIP will have effect from 1 October 2019 (or later, if the proposed regulations cannot be laid before Parliament this autumn). There is also no mention of extending the requirement to defined benefit (DB) schemes.

The DWP's recent proposals therefore seem out of kilter with the timing and extent of the new IORP II requirements.

## KEY FUNCTIONS

IORP II introduces the concept of "key functions" which schemes must have in place:

- a risk-management function;
- an internal audit function; and
- where applicable, an actuarial function.

An individual or organisation may carry out more than one key function, except for the internal audit function – which must be independent of the other functions.

Individuals or organisations may only carry out a key function in relation to both the scheme and a sponsoring employer if this is allowed under national law and provided that the scheme explains how it prevents or manages any conflict of interest.

## Whistleblowing

Key function holders will have a duty to report material findings and recommendations in their particular area to the trustees.

In some cases, key function holders must also report to the Pensions Regulator, in particular where:

- the key function holder has notified the trustees or managers of a substantial risk that the scheme will not comply with a "materially significant statutory requirement", which could have a significant impact on members' interests, and the trustees or managers have not taken prompt and appropriate action to address this; or
- where the key function holder has observed a "significant material breach" of legislative or regulatory requirements in relation to its key function and has reported this to the trustees.

We can expect that the DWP and the Pensions Regulator may give some indication of the circumstances likely to trigger these requirements in regulations, a code of practice, or guidance.

## Outsourcing

Trustees may outsource the management of the scheme, or any key functions. Outsourcing of any activity covered by IORP II must be notified to national regulators – where the outsourcing is of key functions or scheme management, the regulator must be notified before the outsourcing contract has effect.

National regulators must have power to request information about outsourced key functions or other activities from schemes and from service providers at any time.

The notification requirement is new and potentially onerous. It is to be hoped that the Pensions Regulator will develop an easy to use process for notification, potentially through the annual scheme return where the outsourcing is not of a key function or scheme management.

## Internal audit

Schemes will need to have an internal audit function, whose remit should include evaluating the scheme's internal control system and other elements of scheme governance, including any outsourced activities.

## Risk management

Schemes will be required to have an effective risk management function, to identify and manage risk in various areas, including: asset-liability management; liquidity; investment; and administration.

## Actuarial function

Defined benefit (DB) schemes will have to designate at least one independent person, inside or outside the scheme, to be responsible for the actuarial function. In practice, this is likely to be the scheme actuary.

It appears that the actuarial function requirements will also apply to life assurance only schemes, and DC schemes which provide defined death benefits, potentially even when the only defined benefits are fully covered by insurance.

## GOVERNANCE

Member States must require pension schemes to have an "effective system of governance which provides for sound and prudent management of their activities". In addition, schemes will have to adopt policies and carry out assessments in various areas. For many of these, the measures must be

proportionate to the size, nature, scale and complexity of the scheme's activities.

How these requirements will be interpreted by the DWP and the Pensions Regulator remains to be seen.

Trustees of well-run schemes will already be carrying out many, if not all, of the tasks required – for such schemes it may be that only minor adjustments, or documenting of existing arrangements, will be needed.

### Governance policies

Trustees will need to have written policies in relation to:

- risk management;
- internal audit;
- actuarial matters (where relevant); and
- outsourced activities.

The policies must be reviewed at least every three years and adapted in view of any significant change.

### Fit and proper management

Trustees and others who effectively run a scheme, plus persons who carry out key functions must be "fit" and "proper". To meet the "fitness" requirement:

- those carrying out actuarial or internal audit key functions must have adequate professional qualifications, knowledge and experience;
- those carrying out other key functions must have adequate qualifications, knowledge and experience; and
- trustees' qualifications, knowledge and experience must be "collectively adequate" to enable them to ensure a sound and prudent management of the scheme.

Individuals will meet the "proper" test if they are of "good repute and integrity".

Whether a person meets the fit and proper requirements will be for national regulators to determine. In the UK, there are already restrictions on who may become a trustee – for example, anyone convicted of an offence involving dishonesty or deception, or who has been made bankrupt and not yet discharged from bankruptcy, is automatically disqualified from trusteeship of a pension scheme. It is to be hoped that complying with these restrictions, combined with meeting the existing trustee knowledge and understanding (TKU) obligations, will be deemed sufficient to satisfy the new "proper" person requirement.

Earlier versions of IORP II caused concern that individual trustees would have required professional qualifications – potentially, meaning the end of the road for lay trustees. Fortunately, the requirement now applies to the trustees collectively, leaving scope for trustee boards with a range of qualifications and experience.

### Own-risk assessment

Trustees will be required to assess risks facing the scheme at least every three years, plus without delay following any change in the scheme's risk profile. Areas the own-risk assessment should cover include:

- the scheme's overall funding needs, including any recovery plan;
- where key functions are carried out by a sponsoring employer, how conflicts of interest will be prevented;

- risks to members and beneficiaries relating to the payment of benefits;
- assessment of any guarantees, covenants or other financial support;
- operational risks;
- the effectiveness of the scheme's risk management system; and
- new or emerging risks, including climate change, use of resources and the environment, social risks and regulatory change risk.

Schemes will also be expected to develop contingency plans, to ensure continuity and regularity in the performance of their activities.

Trustees should take the own-risk assessment into account when making strategic decisions concerning the scheme.

### Annual report and accounts

IORP II contains two new requirements:

- a scheme's annual report and accounts will have to be publically disclosed; and
- the report and accounts must disclose significant investment holdings.

What will constitute a "significant investment holding" is not specified, so it is likely that this will be left to Member States to determine. At present, some larger schemes make their report and accounts publically available but most do not – although members and beneficiaries have the right to a copy on request.

### Remuneration policy

Pension schemes will be required to have a remuneration policy for:

- trustees and anyone else who effectively runs the scheme;
- those who carry out key functions (please see above); and
- any other categories of staff whose professional activities have a material impact on the scheme's risk profile.

The policy must also apply to outsourced service providers.

Various requirements will apply to the policy, including that it must include measures aimed at avoiding conflicts of interest and that it must not encourage risk taking which is inconsistent with the scheme's risk profile and rules.

Schemes will have to disclose publically relevant information about their remuneration policy, except where this is provided for under the General Data Protection Regulation (GDPR).

The remuneration policy must be reviewed and updated at least every three years.

### INFORMATION FOR MEMBERS

IORP II sets out certain information which must be given to members, beneficiaries and prospective members. It specifies that the information must be written in a clear manner, avoiding jargon and technical terms wherever possible. Much of the information must already be disclosed under the UK disclosure regulations.

## Pension benefit statement

Each active and deferred member must be given a pension benefit statement at least annually. At present, UK schemes only need to send annual benefit statements to members of DC arrangements. IORP II will extend this requirement to DB members as well.

The statement may be in electronic form, including being made available on a website, although members must be given a paper copy on request. The statement must:

- clearly indicate any material change to the information in the previous year's statement;
- set out certain information, including: the scheme's retirement age (or retirement age set by the member); information on any guarantees; and contributions over the previous year;
- include a pension benefit projection which, for DC arrangements, must include a best estimate and an unfavourable scenario;
- give a breakdown of costs deducted over the previous year; and
- include information on the funding level of the scheme as a whole.

## CUSTODY OF ASSETS

Member States may choose to require DB and / or DC schemes to appoint one or more "depositories" for the safe-keeping of scheme assets. Where a depository is appointed, various further requirements set out in the directive must be complied with.

Where no depository (custodian) is appointed, schemes must:

- ensure that financial instruments are subject to due care and attention;
- keep records enabling all assets to be identified at all times;
- take steps to avoid conflicts of interest in relation to the safe-keeping of assets; and
- on request, inform the Pensions Regulator about how assets are kept.

Trustees who have appointed a custodian should ask it to confirm in due course that it meets the IORP II requirements.

## CROSS-BORDER SCHEMES

### Transfers

IORP II provides for transfers of pension liabilities from one IORP to another subject to various safeguards, including a requirement for authorisation by the home regulators of both the transferring and the receiving scheme. In addition, the transfer must have been approved by a majority (as defined in national law) of affected members.

There has been mixed commentary as to whether the authorisation requirement applies on all transfers, or only to those operating cross-border. Hogan Lovells' view is that the authorisation requirement applies only to cross-border transfers between IORPS in different Member States.

### Funding

The starting point is that cross-border schemes must be fully funded on their technical provisions basis at all times. However, unlike IORP I, the new directive makes provision for a cross-border scheme not being fully funded – implying that deficits can be allowed.

Under IORP II, where a cross-border scheme is not fully funded, the national regulator in the home Member State must require the scheme to put in place appropriate measures to protect members and beneficiaries without delay.

## BREXIT

In March 2018 DWP stated it was "mindful" that IORP II is due to be transposed by January 2019 and that proposals would be published for consultation "in due course". If the government intends to meet the implementation deadline, we would expect to see draft regulations in autumn 2018.

There are very few UK cross-border schemes, with most of those being based in Northern Ireland with members both sides of the Irish border. At present, the position is that cross-border schemes based in the UK will not be "cross-border" after Brexit. It remains to be seen whether any general agreement will be reached with the Irish government about treatment of Northern Irish cross-border schemes.

Otherwise, a notice in April this year from the European Commission has stated that active cross-border schemes affected by Brexit will need to contact the other Member State to determine whether and under what conditions they might be allowed to continue to operate.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

## KEY HOGAN LOVELLS PARTNERS

<b>Katie Banks</b>	<b>+44 20 7296 2545</b>	<b>katie.banks@hoganlovells.com</b>
<b>Duncan Buchanan</b>	<b>+44 20 7296 2323</b>	<b>duncan.buchanan@hoganlovells.com</b>
<b>Claire Southern</b>	<b>+44 20 7296 5316</b>	<b>claire.southern@hoganlovells.com</b>
<b>Edward Brown</b>	<b>+44 20 7296 5995</b>	<b>edward.brown@hoganlovells.com</b>
<b>Faye Jarvis</b>	<b>+44 20 7296 5211</b>	<b>faye.jarvis@hoganlovells.com</b>



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