

A Big Year for Pension Funds



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This year is a big one on the calendar of regulators around the world. The G20 committed to achieving much by way of financial market reform by the end of 2012 and whilst several initiatives have been delayed, there has been some progress on a number of fronts. In the United States, the legislation, Dodd-Frank,¹ is in place; what is underway is the massively challenging creation and finalization of detailed rules by the regulatory agencies, including the SEC, CFTC and the Federal Reserve, amongst others. In Europe, the process is different with several legislative initiatives underway by way of Directives and Regulations (Level 1), each of which wends its way through the European Commission, Parliament and Council and once adopted leads to a Level 2 process for detailed rule-making.

So what will have been achieved by the end of year 'deadline'? There is a distinct possibility that the reform program will spill over beyond year end, given the extraordinary scale of regulatory change required. This can be illustrated by looking at the United States where the number of new rules to be made totals 400, according to U.S. law firm Davis Polk. As of end of February 2012, Davis Polk reported that 99 rules have been finalized, 154 rules have been proposed and 147 have not yet been proposed. A number of deadlines (70.2%) for rule-making have not been met. Alongside rule-making, the agencies engage with stakeholders and the number of meetings the agencies reported having with outside participants exceeds 2,800 since July 2010, and in respect of the consultation on the Volcker Rule the number of comment letters reached 17,000. This demonstrates and is testament to the sheer size and complexity of the comprehensive reform program.

For pension funds in Europe, 2012 may prove to be a watershed year. Not only must they mull the impact of EMIR, MiFID 2, MAD 2 and other initiatives, but in addition the Commission is set to table revisions to the IORPs² Directive. At an open hearing

in Brussels on 1 March, Commissioner Barnier said:

'...it seems clear to me that we cannot stand idly by. We are all aware of the demographic trends which oblige us to take action in order to ensure that those who retire in the future will have decent pensions. The succession of crises which we are experiencing brings home to us the need for robust rules to protect pensioners and enable pension funds to perform their role of economic stabilisers.'

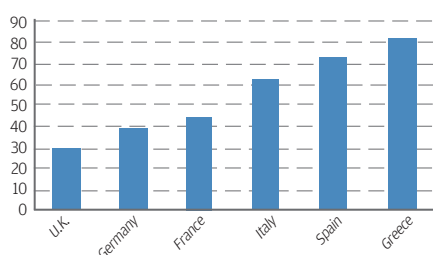
Of course, Europe's demographic outlook is bleak, with fertility rates at unprecedented lows and an aging population. The U.S. also has an aging problem with three workers for every pensioner currently, compared with 45 workers for every pensioner in 1945. However, unlike Europe, the fertility rate in the U.S. is very near to replacement rate³ at 2.06,⁴ whereas in Europe the fertility rate is 1.59.⁵ The Commission is thus rightly concerned; a dynamic growth agenda is hard to sustain with a rapidly graying population and yet growth is essential to raise the revenues to deal with the demands on health care and social security that such an aging population demands.

Additionally, the Commission is disappointed that the original IORPs Directive did not result in the widespread

adoption of cross-border pension fund arrangements. According to the European Commission, of the 120,000 pension funds operating in the EU, only 84 are cross-border funds. The Commission is keen to expand uptake in order to reduce costs, freeing up capital to boost investment and stimulate economic growth while at the same time facilitating cross-border employment mobility. Will a revision to the IORPs Directive change the appetite for cross-border pension schemes? Not according to many employers who believe that because of the complex interplay between nationally determined social security and tax arrangements and pension funding, there are just too many obstacles to be overcome. An example of this is Tesco, the U.K. supermarket chain with pension funds in six EU Member States which cites different social and labor laws in the various countries as an insurmountable obstacle to implement a cross-border pension scheme. Given the recent focus on the state of public finances across the EU, it is unsurprising that the Commission is also keen to ally the revision of the IORPs Directive to relieving the pressure on public spending. According to the Commission's whitepaper on pensions published on 16 February,

European Member States spend on average more than 10%⁶ of GDP on state pensions and this may rise to 12.5% by 2060. In Europe, pensioners make up a significant proportion, currently 24% or 120 million, of the population. As Europe's population will age more dramatically in the years ahead the Commission has been focused on encouraging reform in Member States, such as raising pensionable ages and discouraging early retirement under the auspices of, for example, the Stability and Growth Pact and the Europe 2020 Strategy. Notably, across much of Europe, the state is responsible for most pension provision on a pay-as-you-go basis. In addition, there is wide variation in the generosity of public pension schemes as demonstrated in the following chart.

Average Pension Level as % of Economy-wide Average Earnings



OECD (2011), *Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries*, OECD Publishing. http://dx.doi.org/10.1787/pension_glance-2011-en

The Commission intends to revise IORPs Directive and it is expected that this will result in a level playing field for regulatory competition between pension funds and insurance companies.

So far, the principal debate on revising the IORPs Directive has centered on the application of solvency – or capital – requirements to pension funds. When Solvency 2 was passed it was agreed that its scope would be limited to insurance companies but its application would be considered separately and at a later stage for pension funds. The insurance industry has lobbied for this extension. However, many pension fund trade associations are opposed, citing the fact that the Solvency 2 framework is inappropriate and could undermine the continued commitment of employers to this important element of

the employment benefit mix.

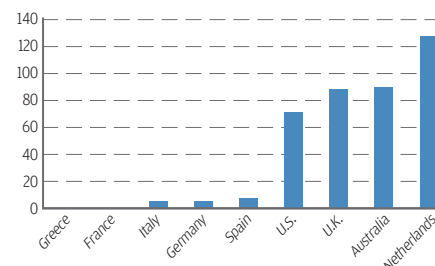
The Commission issued a *Call for Advice* on revising the IORPs Directive to EIOPA⁷ and following a consultation with stakeholders it submitted its advice on 15 February this year. It suggests that the Commission should adopt an approach it calls the ‘holistic balance sheet’ to ‘integrate not only the market value of the assets, but also the economic value of the liabilities’.⁸ EIOPA’s Chairman believes that the elements of Solvency 2 that deal with governance, risk management and transparency could be applied in a proportionate way. Many trade associations are unhappy with EIOPA’s proposals; on 1 March no fewer than nine trade associations⁹ issued a release saying,

‘We believe it is dangerous to apply legislation made for insurance companies to IORPs. There are fundamental differences between them. Any effort to harmonise the regulatory regime is based on flawed logic and could have unintended consequences on pension plan members, IORPs and the economy as a whole by impeding growth and job creation.’

At its Investment Conference in Edinburgh in March, the National Association of Pension Funds’ Investment Council Chairman, Martin Mannion claimed that the Commission’s approach could add £300 billion to the liabilities of U.K. pension funds, a daunting prospect.

EIOPA will now undertake a Quantitative Impact Assessment, but given the absence of privately funded pensions in most countries (see following chart) it will be limited to those seven countries¹⁰ in which defined benefit schemes are most relevant.

Private Pension Assets as % GDP



OECD (2010), ‘Pensions statistics’, OECD Pensions Statistics (database). <http://dx.doi.org/10.1787/data-00517-en>

Some might say that, on the basis that the Commission refers in the whitepaper to ‘enhancing the opportunities for safe complementary retirement savings’, and the considerable gap in such provision in many large European economies illustrated above, the focus should be much more radical than a revision of the IORPs Directive. That is to say the diversity of existing privately funded pension arrangements in Europe is not the problem; where such options do not (or barely) exist is. Indeed, the nine trade associations that urged caution on 1 March (referred to above) urged the European Commission ‘to reconsider its plans and to create an environment that stimulates workplace pension provision.’

So, pension funds, their sponsors and other stakeholders will need to ensure their voices are heard in the months ahead as the Commission refines its approach, as well as keep a watchful eye on the many other developments streaming from regulators at home and abroad.

1. Wall Street Reform and Consumer Protection Act 2010.
2. Institutions for Occupational Retirement Provision.
3. Replacement rate is 2.1.
4. Source: CIA World Factbook.
5. Source: Eurostat.
6. This average masks wide variation from country to country with Ireland spending just 6% of GDP while Italy spends 15% of GDP.
7. European Insurance and Occupational Pensions Authority.

8. Interview with EIOPA Chairman Bernardino, Institutional Money March 2012.

9. EFAMA, EFRP, Business Europe, ETUC, CEEP, CES, AEIP, UEAPME, EVCA.

10. United Kingdom, Ireland, Germany, Netherlands, Portugal, Sweden and Belgium.

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