'All for one and one for all' — The EU Directive allows cross-border pension funds

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Abstract The European Parliament and Council have recently adopted a directive on 'institutions for occupational retirement provision', in practice occupational pension schemes.¹ Where a pension scheme established in one member state satisfies criteria laid down by the Directive, the Directive will permit the schemes to accept members employed by an employer in another member state. This paper examines the conditions that the Directive imposes so that a scheme can accept members from other states. These include funding requirements, conditions that schemes must satisfy in relation to investment of pension fund assets, such as the adoption of the prudent person principle and administrative procedures that schemes must meet to obtain the necessary 'passport'. This paper highlights the extent to which member states may take advantage of derogations from the fundamental principles. It also examines the requirements that the Directive imposes on national regulatory and supervisory institutions to ensure compliance with its requirements.

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Past proposal leads to passed proposal

There is a principle, 'If at first you don't succeed, give up'. The EU Commission must surely have been tempted to follow this advice when trying to implement its proposals for a directive in the pension funds field.

Like the Commission, the author can remember only too well sitting through

interminable working group meetings called to consider the Commission's first abortive attempt to get a pension funds directive adopted. The Dutch were getting exasperated by the Italians explaining to them how pension funds should be run; the French always having to clear with the Prime Minister what they could say for fear of causing more demonstrations in the streets of French

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cities over the pensions issue; the Germans keeping their heads down lest book reserves should be brought within the scope. There was the Luxembourg delegate who insisted that the only supplementary pension scheme in his country was for the fishing industry! And, of course, the Spanish delegate, wondering what on earth she had said to cause such a reaction in those listening to the English translation who had instead just heard over their headphones that Mrs Thatcher had resigned. Perhaps she is still wondering to this day why, having come up with a Spanish remedy for insomnia, the British, Irish and Danes were so suddenly aroused.

As time went on, the Commission came to realise that their original understanding of how a pensions directive should operate was flawed. They recognised that to require investment of 80 per cent in matching currencies and detailed quantitative restrictions on investment would not achieve their objective of a more liberal cross-frontier pensions regime. However, it appeared that, far from adopting the more liberalised regime that the Commission had eventually come to support, member states with minimal funded supplementary pension provision might, under qualified majority voting provisions, impose detailed regulatory rules. These would in practice apply primarily to those three member states that between them had 80 per cent of EU funded pension assets, but which totally rejected the proposed rules. At that point, the ball-game came to an abrupt halt as the Commission took their ball away and withdrew their proposal.

It is to the Commission's credit that they persevered. Their revised version of the Directive ultimately achieved the approval of both the European Parliamentarians and the Council of Ministers, albeit with modifications and

derogations, and was passed into law.

Thus, it is that a decade later, or perhaps a decade late, a pension funds directive has been adopted, but under the grandiose title of a directive 'concerning the activities and supervision of institutions for occupational retirement provision'.

The new Directive — To whom does it apply?

The Directive applies to 'institutions for occupational retirement provision'. These are institutions, irrespective of their legal form, operating on a funded basis and established separately from a sponsoring organisation for the purpose of providing retirement benefits and carrying out directly incidental activities. They operate in the context of an occupational activity on the basis of an individual or collective agreement or contract between one or more employers and one or more employees or their representatives, or, where national legislations so require, with self-employed persons. In a UK context, the Directive applies to employer-sponsored, or multiemployer-sponsored, funded occupational pension schemes, including such schemes that are treated as personal pension schemes for taxation purposes.

Member states may also choose to apply the Directive to the occupational pension business of life insurance undertakings. However, if they do, the pensions assets and liabilities must be ring-fenced, managed and organised separately from the insurance undertaking's other activities and the pension business ceases to be subject to the Life Assurance Directives. The home state regulator must ensure that the pensions business operates separately and that there is no transfer between the different elements of the business.

The Directive does not apply to state

social security schemes covered by Regulation 1408/71, pay-as-you-go schemes, book reserves or schemes, such as German 'Unterstützungskassen', where employees have no legal rights to benefits and the sponsoring employer can take back the assets at any time.² Nevertheless, if a scheme covers both statutory and voluntary elements, with the statutory element within the scope of Regulation 1408/71, the remaining assets and liabilities are covered by the Directive and must be ring-fenced.

Member states may choose to exclude from the scope of the Directive institutions with small schemes that have less than 100 members, but, if they do, the institutions themselves must be given the right voluntarily to apply the Directive to themselves. States may also choose to exclude statutory schemes or schemes with a public authority guarantee from the provisions of the Directive, except those relating to investment issues, which will still apply.

What are retirement benefits?

For the purposes of the Directive, retirement benefits include not only benefits paid on reaching retirement, but also ancillary benefits payable on death, disability or cessation of employment, and payments or services in case of sickness, indigence or death. Normally such benefits would be payable for life, but they may be paid for a temporary period or as a lump sum. The definition is presumably intended to encompass those early-retirement benefits that are not covered by the Acquired Rights Directive derogation³ as decided in the *Beckmann* judgment.⁴

Operations of pensions institutions

There must be a legal separation

between the sponsoring employer(s) and the pensions institution to safeguard the pension scheme assets in the members' and beneficiaries' interests in the event of the insolvency of the sponsoring employer(s).

Pensions institutions must confine their activities to retirement benefit-related and ancillary activities. Similarly the pensions activities of insurance companies to which the Directive applies must be restricted to their ring-fenced assets and liabilities.

Member states may allow, or require, pensions institutions established in their territory to entrust their management wholly or partly to other organisations acting on their behalf, eg outsourced administration organisations.

Requirements that member states must impose

Member states must require each pensions institution established in the state to be registered or authorised by the state's competent regulatory body. Where the institution is to operate in other member states, it requires prior authorisation by the home state's regulator and the register must indicate in which states it operates.⁵

Member states must also ensure that pensions institutions established in the state meet the following requirements:

- the institution is operated effectively by 'persons of good repute' who either themselves have appropriate professional qualifications and experience, or employ advisers who have;
- scheme rules for the operation of the institution have been implemented with the details disclosed to members;
- where the sponsoring employer undertakes to guarantee payment of retirement benefits, eg a pensions

promise under a defined benefit scheme, it also undertakes regular financing;

- scheme members are informed of the applicable conditions, including the rights and obligations of the parties involved, financial, technical and other risks and their nature and distribution;
- each pensions institution draws up annual accounts and an annual report for each scheme it operates. These should give an accurate view of its assets, liabilities and financial position; they should be consistent, comprehensive and fairly presented and approved by authorised persons;
- each pensions institution prepares, and, at least every three years, reviews, or after a significant change in policy revises, a written statement of investment policy principles. This should at least cover investment risk measurement methods, risk management processes implemented and strategic asset allocation with respect to the nature and duration of scheme liabilities.

In addition, member states may impose other requirements on pensions institutions so as to ensure that members' and beneficiaries' interests are suitably protected.

If employers and employees, or their representatives, agree, member states may provide that additional retirement, disability and survivors' benefits and contribution refunds should be offered to members, while taking account of the level of social security benefits.

Disclosure to members and other beneficiaries

Member states must ensure that pensions institutions established in the state must provide at least the following information

to members and other beneficiaries (or where applicable, their representatives):

- the annual accounts and annual report of the relevant scheme, where a member or beneficiary requests them;
- the statement of investment policy principles, where a member, beneficiary or representative requests it;
- relevant information about changes to scheme rules, to be provided within a reasonable time;
- detailed and substantial information on both the target level of benefits, where applicable, depending on the nature of the scheme, and the level of benefits payable where a member ceases employment to which the scheme relates, to be provided to each member on request;
- the arrangements concerning the transfer of pension rights to another pensions institution following the member's ceasing employment to which the scheme relates;
- brief details annually of the situation of the institution, including the current level of financing of members' accrued individual entitlement;
- on request, where members bear the investment risk, eg under a defined contribution scheme, the range of investment options available, where applicable, the scheme's actual investment portfolio and information about risk exposure and costs;
- on retirement, or whenever other benefits become due, details of the benefits due and payment options.

Provision of information to the national regulator

Whereas member states must ensure that their pensions institutions must provide at least the information to members and other beneficiaries either automatically or

on request, they must also ensure that the national regulator has the powers and means to obtain specified information. The regulator must be able to:

- require the pensions institution, trustee board (or equivalent) members and directors, other managers and administrators to supply information about the institution's business matters, or to provide documents;
- supervise relationships between the institution and other companies and institutions, including organisations to which it outsources functions, which may have an impact on the pensions scheme's financial situation or in some other material way affect the supervision of the scheme;
- obtain on a regular basis the statement of investment policy principles, the annual accounts and annual reports and other relevant documents, including interim reports, actuarial valuations and assumptions, audit reports, asset-liability studies, evidence that the investment policy principles are being applied and that the payment of contributions are in accordance with the planned schedule;
- carry out on-site inspections at the premises of the pensions institution and any organisation to which it outsources functions to check that activities are carried out in accordance with the statutory requirements.

Duties of the national regulator

The national regulator in each member state must require each pensions institution established in the state to have 'sound administrative and accounting procedures' and adequate internal control mechanisms. It must have the power to be able to take measures to prevent or remedy any irregularities in the operation of the scheme, which are prejudicial to

members' and other beneficiaries' interests. Such measures, which must be appropriate and necessary, may be of an administrative or financial nature and must be in relation either to the institution itself, or to those responsible for running the institution.

The national regulator may restrict or prohibit the disposal of scheme assets where the pensions institution has failed to establish an adequate actuarial basis, or has insufficient assets to meet its liabilities. Where the institution itself, and not the sponsoring employer, guarantees the level of benefits (see below), the regulator may similarly restrict or freeze the assets, where the institution's own funds are insufficient. The regulator may also prohibit or restrict the activities of a pensions institution established in its state if it:

- fails adequately to protect members' and beneficiaries' interests;
- no longer fulfils the conditions under which it should operate;
- fails seriously in applying the obligations under scheme rules;
- where it is engaged in operations in one or more other member states, fails to apply the requirements of another state's social and labour law in their application to occupational pensions.

Where the interests of the members and beneficiaries require, the national regulator may appoint a suitable special representative, eg an independent trustee, to take over and exercise all, or some, of the powers which a pensions institution's administrative (or trustee) board may exercise under the state's legislation.

Member states must, however, ensure that there is a right of appeal to the national courts against a decision taken by the national regulator in respect of a

pensions institution under powers implementing the Directive.

Actuarial issues

The member state in which a pensions institution is established must ensure that, if the institution operates a defined contribution pension scheme or schemes, it must establish that its liabilities correspond to the assets arising out of its portfolio. Similarly, in respect of schemes that provide cover against old age, death and/or disability, or provide a guarantee of investment performance or defined benefit level, the member state must ensure that the institution provides sufficient actuarially-calculated cover for the whole scheme.

The actuarial valuation must take place either annually, or, if the home state permits, every three years, provided that in the intervening years the pensions institution provides to either members and/or the regulator a certificate or report of adjustments, including in relation to changes in risks covered, for those years. The valuation must be undertaken and certified by an actuary, or exceptionally another qualified professional, eg auditor, on the basis of actuarial guidelines approved by the state's competent authorities.

The assumptions to be made in conducting actuarial valuations must be chosen prudently, taking into account all benefit liabilities and contributions due, and should cover benefits in payment and accrued rights. The assumptions for valuing the liabilities must also be prudent, allowing, where applicable, an appropriate margin for adverse deviation. Maximum rates of interest must be determined prudently in line with national rules, taking account of the yield on the institution's assets and projected future investment returns and/or market yields of government or other high

quality bonds. Demographic and other biometric tables that are followed must take account of the main characteristics of the membership and expected changes in risk. The actuarial methods adopted should remain constant from year to year, except where the underlying legal, demographic or economic circumstances change. Member states may, however, impose more detailed requirements to protect members' and beneficiaries' interests.

Funding requirements

In principle, member states must require all pensions institutions established on their territory to be fully funded, but provision is made, except in relation to liabilities in another member state (see below), to cover the position where, for a limited period, a scheme is in deficit. In such cases the institution must adopt a funding plan to return the scheme to being fully funded within a specified period. The funding plan must be disclosed to members and their representatives and/or be subject to approval by the national regulator. It must take account of the individual provisions of the scheme, such as its asset/liability structure, risk profile, liquidity plan and the age profile of the members. Where a scheme is moving from an unfunded or partially funded arrangement to a fully funded basis, an analogous funding plan must be drawn up.

If the scheme winds up before the scheme has become fully funded, the pensions institution must make arrangements for the scheme's assets and liabilities to be transferred to another financial institution. It must notify the home state regulator both of the procedure for the transfer and of the winding up, and notify the members and their representatives of the procedure.

Where a pensions institution takes on liabilities for pensionable service in member states other than the state in which it is established, either the scheme must be fully funded, or the home state regulator must intervene to require the assets and liabilities arising for such service to be fully funded and ring-fenced.

Where the institution, rather than the sponsoring employer(s), provides a guarantee against risk or of a given investment return or benefit level, it must hold additional assets, calculated in accordance with provisions of the Life Assurance Directives, above those required in accordance with the actuarial valuation to act as a buffer.

Investment, management and custody

Member states must require pensions institutions established in their territory to invest in accordance with the 'prudent person' rule.⁶ This requires that:

- the assets are invested in the members' and beneficiaries' best interests. Where there is a conflict of interest, the pensions institution or fund manager must ensure that the assets are invested in their sole interest;
- the assets are invested so as to ensure the security, quality, liquidity and profitability of the overall portfolio and in a manner appropriate to the nature and entitlement of expected future benefits;
- the assets are predominantly invested on regulated markets and to the extent that they are not invested in such markets, investment must be restricted to a prudent level;
- investment in derivatives is permitted for the purpose of reducing investment risk and facilitating efficient management of the portfolio,

but excessive risk exposure to a single counterparty and other derivative operations must be avoided. Any derivatives must be included in the valuation of the institution's assets, being valued on a prudent basis, taking the underlying asset into account;

- the assets are properly diversified to avoid excessive reliance on any particular asset, issuer or group and accumulations of risk in the overall portfolio. However, member states may decide not to impose this obligation in relation to investment in government bonds;
- except where member states do not impose the restriction in relation to government bonds, investment in employer-related investment is restricted to no more than 5 per cent of the overall portfolio or to 10 per cent, where investment is in another company in the same group. Where the pensions institution has a number of sponsoring employers, employer-related investment must be undertaken prudently to ensure adequate diversification;
- the pensions institution may not borrow or act as guarantor for a third party, except in so far as borrowing is temporary and solely for reasons of liquidity.

Member states may not require pensions institutions established on their territory to invest in particular asset categories, nor may they impose any requirement for prior approval for, or systematic notification of, investment decisions.⁷

Nevertheless, member states may impose more detailed rules, including quantitative rules, where these are prudentially justified. This includes the option of applying the investment provisions of the Third Life Assurance Directive.⁸ Where they do impose more

stringent requirements, pensions institutions retain the right to invest:

- up to 70 per cent of the assets needed to meet the actuarial obligations under defined benefit schemes, or of the whole portfolio of defined contribution schemes, in shares, negotiable securities treated as such and corporate bonds traded on regulated markets, and the asset allocation within the portfolio. However, where the institution provides a long-term interest guarantee and bears the investment risk, member states may impose a limit lower than 70 per cent;
- up to 30 per cent of the assets needed to meet actuarial obligations in securities denominated in non-matching currencies;
- in risk capital markets.

Nevertheless member states may impose on pensions institutions more stringent investment rules on an individual basis, provided that they are prudentially justified.

Where a pensions institution takes on liabilities for pensionable service in member states other than the state in which it is established, the regulator in that other state may require additional requirements to apply to the pensions institution. However, the state may impose such requirements only in relation to the assets in respect of its activities in that other state and only if the same or more stringent rules apply to pensions institutions established in the state concerned. The rules concerned are that the pensions institution:

- either may not invest more than 30 per cent of the relevant assets in shares, securities treated as shares and debt securities not traded on a regulated market, or must invest at

least 70 per cent of them in shares, etc traded on a regulated market;

- must not invest more than 5 per cent of its assets in employer-related investments or 10 per cent in shares or other instruments issued by companies in a single group;
- must not invest more than 30 per cent of its assets in non-matching currencies.

The state where the scheme is established may require the relevant assets to be ring-fenced to meet these requirements.

Member states must not prevent pensions institutions from appointing fund managers established in another member state and authorised for fund management under the Undertakings for Collective Investment in Transferable Securities (UCITS), Life Assurance, Investment Services or Banking Directives.

Nor may member states prevent pensions institutions from appointing custodians established in another member state and authorised for fund management under the Investment Services or Banking Directives, or accepted as a depositary under the UCITS Directive. However, the member state where the pensions institution is established may make the appointment of a custodian or depositary mandatory. Member states must ensure that their own legislation allows them to prohibit a depositary or custodian in its territory from disposing of assets if the regulator in the state where the pension institution is established so requests.

Cross-border activities

Member states must permit employers in their territory to sponsor pensions institutions authorised in another member state. Similarly they must permit pensions

institutions authorised in their territory to accept sponsorship from undertakings in other member states. However, this provision is without prejudice to a member state's social and employment legislation, including, where applicable, requirements as to compulsory membership and following collective bargaining agreements.

The procedure for accepting members in another member state

The procedure to be followed when a pensions institution wishes to accept an employer in another member state as a sponsoring employer is as follows:

- it must be authorised by the regulator in the member state in which it is established;
- it must inform that regulator that it intends to accept the foreign employer as a sponsoring organisation and notify to the regulator the member state(s) in which the sponsoring organisation is located, the name of the organisation and the nature of the pension scheme to be operated for it;
- unless the home state regulator doubts whether the structure, financial situation of the institution or the good repute, qualifications and experience of its administrators are compatible with its operations in the other member state, it must notify the particulars to the comparable regulator in the other state(s) concerned within three months. At the same time it will notify the pensions institution that it has done so;
- the regulator within the other member state must within two months inform the home state regulator of any requirements of its national social or employment law, which the pensions institution must

apply for a sponsoring employer there;

- the home state regulator must pass on the information to the pensions institution;
- once the pensions institution has obtained the information from the regulator, or, if no details are provided by the other state's regulator, after five months, the pensions institution may begin to operate in relation to the foreign sponsoring employer, subject, where appropriate, to the rules notified by the regulator.

The pensions institution must then comply with the statutory disclosure requirements of the other state in respect of members employed in that state.

Supervision where a pensions institution accepts members in another member state

If there is any significant change in the social and labour law of a member state (the host state) with employees who are members of a scheme established by a pensions institution in another member state, the regulator in the host state must notify the regulator of the state where the pensions institution is established. This notification must take place if the change could affect the provisions of the scheme and any of the rules that it must apply.

The regulator of the host state will continue to supervise the activity of the pensions institution as regards its compliance with the provisions of the state's labour and social law that are applicable to occupational pension schemes. If the regulator comes across irregularities, it must immediately inform the regulator in the state where the pensions institution is established. That regulator, together with its opposite number, must take the measures

necessary to ensure that the pensions institution no longer continues to breach the relevant statutory provisions.

If, nonetheless, the pensions institution continues in breach, the regulator of the state whose law is breached, may, after informing the regulator of the state where the pensions institution is established, take measures to prevent further breaches or penalise the institution. These may ultimately include, where necessary, prohibiting it from continuing to have members in that state.

Implementation

Member states have two years in which to bring into force all laws and regulations needed to bring the provisions of the directive into force. By Autumn 2005 at the latest, pensions institutions will be able to include members in other member states and employers will be able to include their employees in all member states in a single pension scheme.

Taxation

There is still one loose end that remains to be tied up. The Directive does not deal with taxation of pension arrangements for cross-border membership. Until this is formally resolved, there could be problems for members in one member state and their employers being denied tax relief on contributions to a pensions institution in another member state. However, it is unlikely that this problem will persist.

First, a succession of judgments by the European Court of Justice (ECJ) in the insurance field, most recently the Swedish case of *Försäkringsaktiebolaget Skandia v Riksskatteverket*,⁹ are likely to lead to a ruling that for a state to provide tax relief on contributions to a

home state scheme, but not to a scheme established in another member state, is contrary to the EC Treaty. The issue in the *Skandia* case concerned whether Swedish tax relief on contributions to a Swedish insurance company for an occupational pension scheme was compatible with Community law, when comparable tax relief was not permissible on contributions to a non-Swedish insurer. The ECJ ruled that:

‘Article 49 EC precludes an insurance policy issued by an insurance company established in another Member State which meets the conditions laid down in national law for occupational pension insurance, apart from the condition that the policy must be issued by an insurance company operating in the national territory, from being treated differently in terms of taxation, with income tax effects which, depending on the circumstances in the individual case, may be less favourable.’

It seems unlikely that the ECJ's ruling would have been different if the contributions had been paid to a pensions institution, rather than to an insurance company.

Secondly, even if ECJ judgments do not bring about a tax relief regime requiring member states to provide the same tax relief on contributions to a pensions institution in whichever member state it is established, it is probable that member states themselves will resolve the issue. Previously the difficulty in reaching an agreement arose at least partly from member states' desire to ensure that direct taxation was kept outside EU competence and so was not an issue on which the EU could draw up Directives or Regulations. However, member states could, as an alternative, include within their respective bilateral, or in multilateral, double taxation conventions provisions for tax relief on cross-border contributions to pension schemes.

There is a problem in that for most pension arrangements the tax regime is EET (exempt, exempt, taxed), ie exempt from tax on contributions and investment income, but with pensions taxed, but for certain (eg some German arrangements) the regime is TTE (taxed, taxed, exempt), ie contributions and investment income taxed and pension tax free. The problem is surely not insuperable.

Conclusion

So, when a decade ago the previous draft Directive was withdrawn, what appeared then to be a disappearing mirage is at long last likely to be accomplished. The directive should lead to administrative and cost savings for multinational employers and will avoid unnecessary pension complications for employees who are seconded across EU state frontiers. One may only congratulate the Commission on the fact that, when at first they did not succeed, they did try, try and try again — this time they succeeded.

Note

The views expressed in this paper are those of the author and it should not be assumed that they necessarily represent the views of Lane Clark & Peacock LLP as a firm.

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