

IORP II Reform Considerations

I. Background

The IORP Directive is aimed at minimum harmonization and allows member states maintaining a high level of flexibility in the design of their occupational pension schemes. When it comes to the asset allocation of IORPs, the investment rules laid down in Article 19 are particularly relevant. First, assets shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole; and secondly, member states shall not prevent IORPs from investing up to 70 % of the assets in shares but may set a lower limit of not less than 35% for IORPs operating pension schemes with a long-term interest rate guarantee. It is not surprising that this provision led member states to set different thresholds. More importantly, however, these are maximum but not minimum investment limits. As a result, the capital market culture of the respective member states appears to be a key factor in asset allocation. While some countries have equity shares of 30-40% of total assets, others have less than 2% (see example below).

As of 2023, European IORPs held €2.72 trillion in total assets (*based on balance sheet statistics according to the EIOPA Pension reporting template PF.02.01,*). Most of these assets are allocated to investment funds (€ 1.04tn, 38%), government bonds (€ 0.60tn, 22%), equities (€ 0.47tn, 17%), and corporate bonds (€ 0.33tn, 12%). The number of new active members has increased in recent years (from 26.1 million in 2020 to 35.5 million in 2023), with a total number of IORP members of 71.7 million in 2023 (54.1 million in 2020). The share of defined contribution (DC) schemes has constantly increased, accounting for around 60 % of new members in 2023. However, the asset exposure is still significantly higher for defined benefits (DB) schemes.

A look at individual countries shows a large variety of investment targets and preferences reflecting the discretion given by the IORP Directive as well as a general underweighting of direct equity investments in pension fund's portfolios:

- Germany: IORPs held €270bn in total assets (58% funds, 30% bonds, only 1.4% equities) and had 11.5 million members.
- Netherlands: IORPs held €1.57tn in total assets (40% funds, 36% bonds, 19% equities) and had 20.1 million members.
- Sweden: IORPs held €273bn in total assets (41% equities, 29% bonds, 20% funds) and had 12.9 million members.
- France: IORPs held €216mn in total assets (46% bonds, 29% funds, only 5% equities) and had 11.5 million members.
- Italy: IORPs held €178bn in total assets (40% bonds, 19% equities, 13% funds) and had 6.7 million members.

When looking at the overall geographical distribution of asset allocation and investment targets of EU IORP funds, evidence shows a significant portion of direct equity investments into non-EU domiciled equities (€ 270bn, with the bulk of these foreign investments consumed by investments into US corporates, €182bn). These figures demonstrate the strong outflow of pension assets which decreases the domestic funding base of EU economies on a large scale and are a clear call for action in light of the Savings and Investments Union.

Therefore, DBG sees merit in targeted amendments and reforms to strengthen the market of IORPs, particularly to increase investments in (EU) equities.

II. Proposals for stronger mobilization of IORP investments

1. Increase investments in EU equities

As already mentioned, investment rules could be specifically adjusted to ensure a higher and minimum investment in European securities, while still allowing investments outside the EU for diversification and return considerations. This could be facilitated by introducing a mandatory minimum investment ratio of 20% into equity investments listed on European exchanges in combination with targeted incentives, e.g., tax exemptions for investments in EU equities, and prudential requirements. To support the goals of the Savings and Investment Union (SIU), such a minimum ratio could be combined with the determination of investment targets to cover funding needs across the entire funding lifecycle (5% VC & Growth and late-stage funding) and with a focus on publicly traded corporates (15% listed companies) to attract more IPOs.

To further support the increasing relevance of DC models, the investment rules should differ between DC and DB models in order to ensure higher diversification and security requirements for DB on the one hand, but to create more room for return opportunities in DC models on the other hand (employees may decide which return-risk-ratio works best for their retirement plans).

2. Increase number of IORPs in Europe by developing new models

According to the EIOPA 2023 Report on cross-border IORPs “the number of cross-border IORPs has stopped increasing since 2010 and is unlikely to experience substantial growth in the near future. As such, the original goal of the IORP Directive to foster a thriving internal market for occupational pension provision has not been achieved.” Only 31 active IORP with cross-border activities; only 14 MS; no increase in number since 2010; only 100k beneficiaries and members, 10.6bn EUR AUM (-9% yoy); ‘quite anaemic with cross-border activities now amounting to 0.2% and 0.4% of IORPs’ total number of members and beneficiaries and assets’ (EIOPA).

The main reasons for the low cross-border activities are distinct social and labor laws between host and home country, which increase costs, complexity, and operational risks associated with managing cross-border IORPs. There is no true passporting regime but complex notification procedures and supervisory practices (e.g., new notification for each new employer; individual consent from a majority of all members and beneficiaries for cross-border transfers, rather than relying on consent from representative entities or assessing the majority on the basis of those members that respond). This is often seen as a potential complication in the process of transitioning to cross-border IORPs. We recommend the introduction of an IORP passporting regime with harmonized registration and authorization process (including prudential assessment) as prerequisite for cross-border activities to increase competition and to enable citizens to invest directly in IORPs in other Member States.

This could happen by the establishment of a single Pan-EU IORP, including universal accessibility for EU-domiciled corporates and employees, DC structure, clear and uniform tax rules, governance and transparency requirements, and investment rules with a strong focus on equities. However, to achieve these objectives, the Commission should consider developing the current regime further in the direction of an “European 401(k) plan”.

To increase the number of IORPs, it should be mandatory for all employers to offer the account to their employees. To keep the additional burden as low as possible, the employer acts merely as

an intermediary between employees and the account providers. Employees can contribute a portion of their salary, incentivized through tax benefits; and employers can be incentivized to make additional contributions in form of a DC model through tax benefits as well. Contributions can be invested in equities, bonds, and funds that are listed on regulated markets or MTFs.

If contributions are paid from net salary, the cash flows from interest, dividends, and capital gains remain tax-free to avoid double taxation. However, if the contributions are deducted from gross salary, these cash flows should be taxed at a low flat tax rate. To ensure sufficient flexibility, the contribution amounts should be adjustable, and the investment strategy as well as the selected products must be able to be changed without any tax disadvantages and at low cost.

Thanks to the Europe-wide standardized account structure neither a change of the employer nor a change of country would represent a significant hurdle for the employee. This would effectively help to increase cross-border IORPs.

3. Scaling up – promote growth of IORP by incentivizing equity investments, increasing transparency and professionalize portfolio management

The current structure of IORP portfolio management reflects a risk-averse approach, leading to less diversification, lower returns, and less commitment to the future of the European economy. The visibility and comparability of IORP performance could be improved through the development of suitable indices that allow for benchmarking the fund performance against relevant indices and peer groups, as well as through performance evaluations of managers and strategies.

With the introduction of ESAP, a suitable platform is already available to provide information on the performance and costs of pension products. This could easily be achieved by amending the IORP Directive, as it is part of the list of legal acts under the ESAP Regulation.

A review of the solvency requirements for IORPs should be considered to incentivize diversification (reduction of solvency charges for well-diversified funds; US approach) and long-term investments in equities (reduction of solvency charges for equities held for over 7 years). SMEs and IPOs with an issue volume of up to €500m should be exempted from any taxes and solvency charges. In a well-diversified fund, these investments usually play a very minor role.

By using professional portfolio management solutions, IORPs could achieve greater diversification and long-term returns, avoid volatility, and take advantage of the proposed tax and solvency incentives. Market-driven solutions are available to support a holistic solution that efficiently consolidates data and operations on a common platform, thus facilitating comprehensive portfolio management given the diverse asset classes and high level of complexity in which IORPs operate.