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# Regulation of Pension Fund Investment Allocations in Private Equity

Analysis of the IORP Directive of 2003/41/EC Reform

Julia Khort



## **Abstract**

The article scrutinizes the recent developments of the legal framework as to pension fund investment allocations to private equity in the EU, including the proposal of changes to Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision (IORP Directive). This article investigates how pension fund allocations in risky assets should be regulated and whether introduction of the Solvency II regulation to pension funds is a proper policy response to this problem. It concludes with a warning as to the application of the capital funding requirements to pension funds, as it envisaged by the proposal to the art.17 of the IORP Directive.

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Regulation of Pension Fund Investment Allocations in Private Equity: Analysis of the IORP Directive of 2003/41/EC Reform

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## Introduction

Currently, a significant part of the European pension funds is underfunded. The reasons of pension funds underfunding are different, among them are excessive return expectations of pension funds, improper asset allocation and also bad advice in order to meet the valuation expectation of returns<sup>1</sup>.

In the academic literature, it is highlighted the problem of too risky investment activity of pension funds, including alternatives, from which they suffered significant losses in the wake of the financial crisis<sup>2</sup>. This issue is of particular importance in the conditions of the ongoing growth of pension fund allocations to alternatives (in 2012 investments in alternatives made up 19% of all pension fund assets globally, compared with 5% 15 years ago)<sup>3</sup>.

The problem of pension funds proper functioning drew international organizations' and national policymakers' attention to pension fund regulation, especially in the aftermath of the financial crisis, when the whole architecture of the financial market was restructured and new banking and insurance regulation had been adopted (Basel III and Solvency II Directive correspondingly)<sup>4</sup>. Among the main directions of the pension fund reform, international and self-regulatory organizations such, as OECD, IOPS, consider revision of pension fund investment allocation regulation towards strengthening of pension fund supervision and revising a risk-management system<sup>5</sup>. In its turn, the European Commission

<sup>1</sup> Chris Page, *Funding the Solvency Gap*, (November 2010), <http://thewealthsteward.com/wpcontent/uploads/2010/11/Funding-the-Solvency-Gap.pdf>

<sup>2</sup> Keeley Brian, Love Patrick, *OECD Insights: From Crisis to Recovery. The Causes, Consequences and the Great Recession* (2010), <http://www.oecd.org/insights/46156144.pdf>, at p. 71. Values fell by more than 20% in Belgium, Hungary and Iceland. Losses were only around 10% in Germany, the Slovak Republic, Norway, Spain and Switzerland, and smaller still in the Czech Republic.

<sup>3</sup> Boyde Emma, *Pension Funds Press Forward on Alternative Route*, Financial Times (July 8, 2013).

<sup>4</sup> Basel III: A global regulatory framework for more resilient banks and banking systems, (Dec 2010), <http://www.bis.org/publ/bcbs189.pdf>; Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), OJ L 335, 17.12.2009, p. 1–155.

<sup>5</sup> IOPS, *Pension Fund Use of Alternative Investments and Derivatives: Regulation, Industry Practice and Implementation Issues*, IOPS Working Papers on Effective

proposed to amend the Institutions for Occupational Retirement Provisions Directive (the IORP-Directive) and in addition to the above mentioned directions of regulation also to apply a ‘Solvency II type capital regime’ to pension funds<sup>6</sup>.

Despite that fact that prevention pension funds investments in certain categories of assets is not specified among the goals of the IORP Directive reform, in fact, it causes a change of pension fund investment portfolio towards restriction of investments in risky assets. Herewith, the main impact of the proposed regulation will be on private equity (*further – PE*) industry, as currently pension funds are their main investors. If to take into account the fact that recently banks and insurance legislation had been also revised towards the enhancing of capital requirements and in such way their investments in alternatives had been restricted, the consequences of the reform can be catastrophic for PE industry<sup>7</sup>.

*The objective of this study* is to critically analyze how pension funds’ investment allocation and risk management policies in the EU should be regulated and whether introduction of the Solvency II-type reform of the IORP Directive is the proper response to the problem of pension funds underfunding.

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Pension Supervision, 2011, No. 13; OECD/ IOPS Good Practices for Pension Funds’ Risk Management Systems, (January, 2011), <http://www.oecd.org/finance/private-pensions/oecdguidelinesrelatingtoprivatepensions.htm>; *OECD/IOPS Good Practices on Pension Funds’ Use of Alternative Investments and Derivatives* (December, 2011), <http://www.oecd.org/finance/private-pensions/oecdiopsgoodpracticesonpensionfunduseofalternativeinves-mentsandderivatives.htm>. See, also Stewart, F., *Pension Funds’ Risk-Management Framework: Regulation and Supervisory Oversight*”, OECD Working Papers on Insurance and Private Pensions, 2010, No. 40. OECD Publishing, at. p. 3-5, where the author analyzes international guidance and standards of pension fund investments in private equity.

<sup>6</sup> European Commission Directorate General Internal Market and Services from 30.03.2011 Call for Advice from the European Insurance and Occupational Pensions Authority (EIOPA) for the Review of Directive 2003/41/EC (IORP II).

<sup>7</sup> John Broadbent, Michael Palumbo, Julio A. Santaella & George Zanjani, *Institutional Investors and Asset Allocations: Accounting and Regulation of Private Defined Benefit Pension Plans and Other Institutional Investors in the United States, México, and Australia*, (November, 2006), Prepared for the Working Group on Institutional Investors and Asset Allocations of the Committee on the Global Financial System of the Bank for International Settlements, [www.bis.org/publ/wgpapers/cgfs27broadbent2.pdf](http://www.bis.org/publ/wgpapers/cgfs27broadbent2.pdf).

Regarding a prior research a considerable body of literature can be found on the topic. I will focus on the two literature strings that are most important for this paper.

Firstly, I consider the studies, which research the impact of regulatory environment on asset allocation regulation. For example, the impact of the capital requirements on pension funds asset allocation in the Netherlands (Laurens Swinkels (2004))<sup>8</sup>; the influence of the changes in accounting rules on the pension funds asset allocation decisions of institutional investors (shift from equities to bonds) in the USA, Australia and Mexico (Broadbent, Palumbo, Santaella & Zanjani (2006))<sup>9</sup>.

Secondly, I pay attention to the literature, which directly concerns my research objective. In particular, Hubbard (2008)<sup>10</sup>, Möllman (2007)<sup>11</sup> researched the origins of pension fund investments in private equity. A number of studies analyzed whether alternative investments are good or bad for pension funds. For example, Hubbard (2008) and Zelinsky (2012)<sup>12</sup> researched benefits and shortcomings of such investments; CEC special report (2007)<sup>13</sup> investigated a link between private equity investments of pension funds and their insolvency. Myners (2001)<sup>14</sup> and Mayer (2001)<sup>15</sup>

<sup>8</sup> Laurens Swinkels, *The Impact of New Capital Requirements on Asset Allocation for Dutch Pension Funds*, *Pensions, an International Journal* (2004) 10, 75–81.

<sup>9</sup> John Broadbent, Michael Palumbo, Julio A. Santaella & George Zanjani, *Institutional Investors and Asset Allocations: Accounting and Regulation of Private Defined Benefit Pension Plans and Other Institutional Investors in the United States, México, and Australia*, prepared for the Working Group on Institutional Investors and Asset Allocations of the Committee on the Global Financial System of the Bank for International Settlements, (Nov 2006), <http://www.bis.org/publ/wgpapers/cgfs27broadbent2.pdf>.

<sup>10</sup> Pierre Hubbard, *Pension Fund Investments in Private Equity: Implications for the Stewardship of Workers' Capital* TUAC Secretariat, Paris, (Nov 2008). A Hans Böckler Foundation project research paper, [http://www.tuac.org/fr/public/edocs/00/00/03/90/document\\_doc.phtml](http://www.tuac.org/fr/public/edocs/00/00/03/90/document_doc.phtml).

<sup>11</sup> Christian Möllmann, *How to Govern Transitional Pension Provision? The Struggle over the "Prudent Person Standard" in EU Pension Fund Regulation*, Paper presented at the 6<sup>th</sup> Pan-European Conference on International Relations. Turin (12-17 September, 2007). – 21 p.

<sup>12</sup> Edward Zelinsky, *Public Pensions, Private Equity and the Mythical 8% Return*, Oxford University Press's blog, <http://blog.oup.com/2012/03/public-pensions-private-equity-return/>.

<sup>13</sup> *GMB 2007 Private Equity's Broken Pension Promises - Private Equity Companies' Links to Insolvent Pension Funds - a CEC Special Report*, GMB 2007. – 21 p.

<sup>14</sup> Paul Myners, *Institutional Investment in the United Kingdom: A Review*. London: HM Treasury (2001).

went further and examined the impact of legal regulation (namely, minimum funding requirement) on pension fund investments in private equity. The most recent research, devoted to this topic concerns challenges and risks of pension funds investments in private equity and hedge funds in the USA (conducted by the US Government Accountability Office (GAO) reports (2008-2012)).

However, all these studies cover mainly the period before the financial crisis or analyze pension fund regulation on the national market (e.g. American, British or Dutch ones). I would like to extend this strand of literature and study the regulation of pension fund investments to private equity at the EU market, with the focus on the reform of capital funding requirements of the IORPs.

In this article a method of scientific legal analysis is used. This study of the pension fund investments in the EU is based on the analysis of the EU legislation, law reform materials of the European Commission, the EVCA, the U.S. GAO, as well as relevant industry best practices for pension fund industry and prior most important academic studies in law and economics.

This article is structured as follows. In section one I consider arguments for and against pension fund investments to private equity. In section two I make an overview of the current regulation of pension fund allocations to risky assets in the EU. Then the analysis of the proposed changes of the solvency requirements of the IORPs follows. The principal part of the paper is devoted to the critical assessment of the justifications of revision of capital funding requirements of pension funds.

In this article it is argued that the problem of pension funds underfunding, caused by pension fund investments in private equity can be resolved through: (1) revision of pension funds risk management system but the EU member-states should have an option, which approach for the purpose of pension fund beneficiaries' protection to chose: based on solvency margin or pension protection fund; (2) development of best practices of due diligence and monitoring of pension fund investment allocations to private equity and providing of their compliance at the EU level.

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<sup>15</sup> Colin Mayer, *Institutional Investment and Private Equity in the UK* (May, 2001), [www.finance.ox.ac.uk/Papers/FinancialEconomics/index.htm](http://www.finance.ox.ac.uk/Papers/FinancialEconomics/index.htm).

## Part 1. Why are private equity investments important for pension funds and the role of such investments for private equity?

Currently, there is an ongoing discussion as to pension funds should invest in alternatives. The prevailing point of view is that such investments have a positive impact on pension fund returns and should grow (GAO Reports, Myner Report<sup>16</sup>, Mayer<sup>17</sup>) but other scholars (among which is Edward Zelinski<sup>18</sup>), in contrast, have an opposite view.

That is why, it is necessary to discuss both the arguments in favor and against pension funds investment allocations to private equity and the issue of whether private equity funds are appropriate investment vehicles for pension funds.

First of all, it can be argued that private equity arrangements are unwise investments for public pension plans as they have lack of transparency and are not subject to the discipline of organized markets<sup>19</sup>.

Indeed, these concerns are partly justified. Private equity is a high-risk asset class; they pose a range of additional risks in comparison with conventional investments. They are illiquid investments as private equity funds invest in the companies that are not quoted on public markets, including ‘taking private’ companies that used to be previously quoted, and such investments can be locked for a long-term period. Another concern is that valuation of such investments is quite complicated.

Private equity funds are usually highly leveraged at the level of portfolio companies<sup>20</sup>. Thus, they are more vulnerable to market fluctuations, which were noticed during the financial crisis.

<sup>16</sup> Myners, *supra* note 14.

<sup>17</sup> Mayer, *supra* note 15.

<sup>18</sup> Zelinsky, *supra* note 12.

<sup>19</sup> Zelinsky, *supra* note 12.

<sup>20</sup> Eilis Ferran, *After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU*, EBOR, 09/2011, Vol. 12, No. 3, p. 381. See also, United States Government Accountability Office (GAO) Report to Congressional Requesters, *Private Equity. Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention* (September, 2008).



For a long time private equity had a lack of public transparency and reporting<sup>21</sup> but it doesn't mean a lack of transparency to the institutional investors. Private equity funds usually disclose all information, provided by the limited partnership agreement, to their limited partners<sup>22</sup>.

Herewith, it is necessary to understand that there are no "risk free" assets<sup>23</sup>. Private equity investments are riskier than conventional ones but not all specific private equity investments are riskier than conventional ones<sup>24</sup>.

Moreover, *high risks and illiquidity of investments in private equity are usually compensated by higher returns* expected by investors compared with those from conventional investments<sup>25</sup>. According to the research of Harris, Jenkinson and Kaplan, the US private equity funds show better performance than public markets. Outperformance versus the S&P 500 averages 20% to 27% over a fund's life and more than 3% annually<sup>26</sup>. The study of Ernst & Young experts "Branching out. How do private equity investors create value?" on the European market also demonstrates that PE investments 3.6

<sup>21</sup> Andrew J. Bowden, *Spreading Sunshine in Private Equity*, Private Equity International (PEI), Private Fund Compliance Forum 2014, New York, May 6, 2014, <http://www.sec.gov/News/Speech/Detail/Speech/1370541735361#.VCnA3Ofdh0s>

<sup>22</sup> IOSCO Private Equity Final Report (May, 2008), at p. 11.

<sup>23</sup> John Plender, *No Such Thing as Risk-free Assets*, Fin. Times (Jul 8, 2012), <http://www.ft.com/intl/cms/s/0/52231aea-c5dc-11e1-a3d5-00144feabdc0.html#axzz3JL5oxggG>.

<sup>24</sup> Especially in Scandinavian countries, where business has one of the highest levels of reputation in the world (Sweden – 3<sup>rd</sup> ranking, Finland – 4<sup>th</sup>, Norway – 6<sup>th</sup>, Denmark – 7<sup>th</sup>), see 2014 Country RepTrak The World's View on Countries: An Online Study of the Reputation of 55 Countries The World's Most Reputable Countries, at p. 17 <http://reputationinstitute.com/frames/events/CountryRepTrakWebinar2014.pdf>.

<sup>25</sup> See analysis of GAO reports about risks in private equity and hedge funds United States Government Accountability Office (GAO). Report to Congressional Requesters, *Defined Benefit Pension Plans Guidance Needed to Better Inform Plans of the Challenges and Risks of Investing in Hedge Funds and Private Equity* (August 2008); OECD/IOPS Good Practices on Pension Funds' Use of Alternative Investments and Derivatives (Dec 2011), at p. 2.

<sup>26</sup> Harris Robert S., Jenkinson Tim and Kaplan Steven N., *Private Equity Performance: What Do We Know?* Chicago Booth Research Paper No. 11-44 (July, 2013), at p. 1 [http://papers.ssrn.com/sol3/papers.cfm?Abstract\\_id=1932316###](http://papers.ssrn.com/sol3/papers.cfm?Abstract_id=1932316###).

<sup>26</sup> Ernst&Young. *Branching out. How do Private Equity Investors Create Value? A Study of European exits*, at p. 5 [http://www.ey.com/Publication/vwLUAssets/Private-equity-creates-value-in-Europe/\\$FILE/Euro\\_PE\\_Study\\_2012.pdf](http://www.ey.com/Publication/vwLUAssets/Private-equity-creates-value-in-Europe/$FILE/Euro_PE_Study_2012.pdf).

times outperform investments in comparable public companies<sup>27</sup>. The survey of limited partners of PEFs, conducted by Preqin in June of 2011, also showed that private equity investments had met (68%) or even exceeded (13%) their expectations of limited partners for relatively high returns<sup>28</sup>. The U.S. Government Accountability Office came to the same conclusion. Despite some significant losses during the financial crisis, private equity investments met the expectations of pension funds. According to the survey results half of pension plans representatives indicated that their plans' private equity investments outperformed public equities over the last 5 years<sup>29</sup>.

In the academic literature it is pointed out that most of information about these positive returns comes from the private equity industry itself<sup>30</sup>. However, it is not possible to agree with this statement. Robertson & Wielezynski, researching pension funds performance, found positive correlation between pension fund investments in alternatives and returns from such investments (public pension plans with at least 10% of their assets allocated to alternative investments had significantly higher annual returns in 2004, 2005, and 2006 than pension plans with smaller allocations)<sup>31</sup>. It is important to note that this research showed not promised returns of private equity funds but actual returns of pension funds from such investments and the study was based on the data received not from private equity industry but from the public employee pension system.

<sup>27</sup> Ernst&Young. Ibid.

<sup>28</sup> Preqin Investor Outlook: Private Equity. The Opinions of 100 Leading Private Equity LPs on the Market and Their Plans in 2011; Stephen Taub, *Institutional Investors Warming Up to Private Equity*, (Sep 2011) <http://www.institutionalinvestor.com/Article/2904728/Investment-Strategies-Archive/Institutional-Investors-Warming-Up-to-Private-Equity.html#.U9PhbKiGmmF>.

<sup>29</sup> GAO Report, to the Ranking Member, Subcommittee on Health, Employment, Labor, and Pensions, Committee on Education and the Workforce, House of Representatives, *Defined Benefit Pension Plans, Recent Developments Highlight Challenges of Hedge Fund and Private Equity Investing*, GAO-12-324 (February 2012), at p. 33.

<sup>30</sup> Zelinsky, *supra* note 12.

<sup>31</sup> Douglas Robertson & Ellen Wielezynski, *Alternative Assets and Public Pension Plan Performance*, OCC Economics Working Paper 2008-2 August 2008, Washington, DC: Comptroller of the Currency, [2008], at p. 4.

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Hereby, during last two decades a tremendous growth of private equity industry could be noticed; private equity funds were recommended themselves as a high performing asset class, and even the most respected institutional investors started to invest in illiquid assets<sup>32</sup>.

The next argument in favor of private equity investments is that *pension funds need these high returns, which under their assessment should be at least 8%*.

First of all, this problem is especially acute for public pension funds, taking into account *the aging of the population*<sup>33</sup>. With the approaching a baby-boomer generation in 2012, the EU faces a challenge as the pension payments in the due size becomes questionable. Public pension benefits are expected to decrease by on average 25 percent during the coming decades<sup>34</sup>. According to the Green Paper “Towards adequate, sustainable and safe European pension systems” (2010) one of the main tasks of pension fund system is not only to make retirement payments to pensioners but to provide them at the adequate level, enabling them to maintain, to a reasonable degree, their living standards after retirement<sup>35</sup>. The achievement of these objectives in Europe with increasing life expectancies of the population is a major task.

The next reason, why pension funds need high returns is *the necessity to compensate huge losses as a result of the financial crisis of 2008*. As Craig Baker, head of research at Towers Watson, noted that the

<sup>32</sup> Kyle Welch, *Private Equity’s Diversification Illusion: Economic Comovement and Fair Value Reporting*, (January 14, 2014), at p. 7, [https://www.stern.nyu.edu/sites/default/files/assets/.../con\\_045805.pdf](https://www.stern.nyu.edu/sites/default/files/assets/.../con_045805.pdf).

<sup>33</sup> Commission of the European Communities Staff Working Document. *Demography Report 2008: Meeting Social Needs in the Ageing Society*. Brussels, SEC(2008) 2911, [ec.europa.eu/social/BlobServlet?docId=709&langId=en](http://ec.europa.eu/social/BlobServlet?docId=709&langId=en); *The 2009 Ageing Report: economic and budgetary projections for the EU-27 Member States (2008-2060)*. Joint Report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee (AWG), [http://ec.europa.eu/economy\\_finance/publications/publication14992\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication14992_en.pdf)

<sup>34</sup> European Federation for Retirement Provision. *IORP Directive - Securing Workplace Pension*, EFRP paper on Funding and Solvency Principles for IORPs, (May 2008), at p. 8, <http://www.pensionseurope.eu/system/files/EFRP%20paper%20-20Funding%20and%20Solvency%20Principles%20for%20IORPs%20-%20May%202008.pdf>.

<sup>35</sup> European Commission, *Green Paper towards Adequate, Sustainable and Safe European Pension Systems*, Brussels, 7.7.2010 COM(2010)365 final, SEC(2010)830, at p.2.

ongoing global economic crisis has already induced all types of institutional investors to have more diversified investment portfolios with alternatives<sup>36</sup>.

Alternative investment funds can provide pension funds with these high returns. It is worth mentioning that private equity investments are more suitable for pension funds than investments in other alternatives, e.g. hedge funds, which can also provide their investors with high returns. Firstly, private equity funds are less likely engaged in speculative trading activities and market manipulations because they do not usually actively trade in public capital markets<sup>37</sup>. Secondly, private equity funds invest for a long-term period of time; in its turn, pension funds can afford to make long-term investments, taking into account specificities of pension fund liabilities. Thirdly, private equity investments are of great social significance as they invest in real companies and in this way facilitate the growth of economy.

As a counterargument, it can be pointed out that promised PEFs returns in the long-run, and this just keeps the problem in a sleeping condition and in case of PE investments failure, it can be dangerous for the growing baby boomers<sup>38</sup>. It is necessary to note that indeed the investment risk of PE investments is quite high but *they perform an important function of diversification of pension fund assets*, what, in its in turn permits to reduce the risks and enhance the returns of pension funds<sup>39</sup>.

A study of Sharpe (1992) showed that asset allocation across asset classes with different exposures to economic risk is a key driver of portfolio returns<sup>40</sup>. Generally, regulatory and supervisory authorities and industry organizations recognize the need for a diver-

<sup>36</sup> Prosser David, *Special Report An Alternative Way to Invest*, (2013) <http://www.engagedinvestor.co.uk/special-report-an-alternative-way-to-invest/1472270.article>

<sup>37</sup> Martin Cary, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, Delaware Journal of Corporate Law, 2012, vol. 37, at p. 74.

<sup>38</sup> Zelinsky, *supra* note 12.

<sup>39</sup> Hubbard, *supra* note 10, at p. 11.

<sup>40</sup> Citation of William F. Sharpe, *Asset allocation: Management Style and Performance Measurement*, The Journal of Portfolio Management 18(2), 1992, pp. 7–19 in Welch, *supra* note 32, at p. 7.

sified investment strategy<sup>41</sup>. Alternative investments are recognized to be an efficient strategy for portfolio diversification<sup>42</sup>.

Herewith, there arises a question of whether there are any *better options for pension fund assets diversification than alternatives*.

Traditionally it is considered that listed shares and government bonds are the best investment options for pension funds as they are the least risky of any financial assets.

For almost fifty years the listed equity were considered as the best options for pension fund investments. But dotcom crash and corporate scandals in the US, like Enron in 2002/3, showed that listed equities are not so safe investments. With a fall of the “cult of equity” the most significant shift in pension fund asset allocations towards bonds took place<sup>43</sup>. In particular, as the safest bonds are considered those, issued by the US and UK governments, as both of these states have always paid their debts on time and in full<sup>44</sup>.

The agiotage of pension funds for bonds, particularly for gilts, was accompanied by their price growth and drop in their interest rates. In a recent speech Federal Reserve Chairman Bernanke said these low yields partly reflect cyclical factors, including the slow speed of economic recovery, modest inflation rates, and accommodative monetary policy<sup>45</sup>. However, in addition to cyclical variation, yields have registered a longer-run decline, which continues

<sup>41</sup> *OECD/IOPS Good Practices on Pension Funds' Use of Alternative Investments and Derivatives* (Dec 2011) at p.2. The Defined Contribution Institutional Investment Association (DCIIA) directly points that pension plans should make investments in alternatives, as it will help to increase returns and to reduce the volatility that the typical plan participant experiences.

<sup>42</sup> López-Villavicencio Antonia, Rigot Sandra, *The Determinants of Pension funds' Allocation to Private Equity* (November 30, 2013), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2363356](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2363356)

<sup>43</sup> David Oakley, *Cult of Equity Killed off by Pension Funds*, <http://www.ft.com/intl/cms/s/0/c65e011e-28f5-11e2-9591-00144feabdc0.html#axzz3Ei7QCCF1>.

<sup>44</sup> Baptiste Aboulian, *Pension Funds Assess Investments in Government Debt*, October 8, 2012, <http://www.ft.com/cms/s/0/df07bcd6-0c95-11e2-a776-00144feabdc0.html#ixzz3Ei7oYIez>.

<sup>45</sup> Citation of Bernanke, Ben S., *Long-Term Interest Rates*. Speech given at the Annual Monetary/Macroeconomics Conference: The Past and Future of Monetary Policy, FRB San Francisco (2013) in Michael D. Bauer & Glenn D. Rudebusch, *What Caused the Decline in Long-term Yields?* FRBSF Economic Letter 2013-19 (July 8, 2013).

for last 30 years<sup>46</sup>. For instance, from 1990 to 2012, 10-year U.S. Treasury yields fell fairly steadily from just over 8% to around 2%<sup>47</sup>.

As a result, investment professionals recommend their clients to reduce their allocations in government bonds, what in turn may cause the drop of government bonds value even more<sup>48</sup>.

In fact, there appears a vicious circle: listed equities are not as safe as they were expected to be, so a greater diversification of an investment portfolio is necessary but at present government bonds can't provide pension funds with high returns and despite the relaxation of quantitative restrictions on pension fund investments in alternatives in 2003<sup>49</sup>, a great number of restrictions on pension fund investments in alternatives are still significant in the countries of the continental Europe<sup>50</sup>.

However, the government is planning to go further and put severe restrictions on capital requirements of pension funds, what will make it even more difficult for them to diversify their portfolio and induce to invest in bonds at the expense of reduction in pension fund investment allocations to private equity. Thereby, there arises a question of how justified the proposed government interference in the pension fund asset allocation policy is? Let us start firstly from the overview of the current requirements to the capital funding of pension funds.

<sup>46</sup> Anatole Kaletsky, *Now May not be the Time to Buy Bonds*, June 6, 2014, <http://blogs.reuters.com/anatole-kaletsky/2014/06/06/now-may-not-be-the-time-to-buy-bonds/>.

<sup>47</sup> Richard Barley, *Bond Yields: Even Lower for Even Longer. Central-Bank Policy, Geopolitics and Lackluster Economies Keep Rates Low*. Aug. 28, 2014 12:54 p.m. ET, <http://online.wsj.com/articles/bond-yields-even-lower-for-even-longer-heard-on-the-street-1409244850>

<sup>48</sup> Helen Pridham, *Fears Government Bonds Could Decrease in Value as Investors Advised to Reduce Holdings* (6 April 2013), <http://www.heraldscotland.com/business/personal-finance/fears-government-bonds-could-decrease-in-value-as-investors-advised-to-reduce-holdings.20546768>

<sup>49</sup> Hubbard, *supra* note 10.

<sup>50</sup> OECD, *Annual Survey of Investment Regulation of Pension Funds* (2014). – 164 p., <http://www.oecd.org/daf/fin/private-pensions/2014%20Survey%20of%20Investment%20Regulations%20of%20Pension%20Funds%20FINAL.pdf>.

## Part 2. Overview of the current regulation of pension fund investment allocations to risky assets in the EU

Two major approaches to the regulation of pension fund asset allocation and risk management that have been singled out world-wide: “quantitative portfolio regulations”, which restrict holdings of certain types of assets within the portfolio and “the prudent person rule”, which gives to pension fund managers a broad discretion as to portfolio diversification. Both pursue to provide adequate diversification of the asset portfolio, but in completely different ways<sup>51</sup>.

It is worth noting that in the basis of the quantitative restriction there was a wish of the policymaker to provide safety of pension fund investments but as the welfare of population improved, the financial market grew and life expectancy of the population increased, the problem of not only providing the safety of pensions but also an adequate payments rises to the fore. Thus, appeared the necessity in a broader diversification of assets and in such a way to provide higher returns to pension fund beneficiaries. It resulted into a gradual relaxation of quantitative restrictions and establishment of the prudent investor rule, which gives more freedom to pension fund managers. In the UK, legislation was made more flexible in 1961, and all investment restrictions were removed in 1995. In the US, the prudent person rule was made more flexible for pension funds in 1974, but restrictive standards prevailed for non-pension trusts until the late 1980s<sup>52</sup>. The development of private equity industry is connected directly with the abolishment of such restrictions.

As a rule, prudent person rules are considered more preferable to quantitative restrictions for pension funds<sup>53</sup>. Currently, it is

<sup>51</sup> Davis, E. Philip, *Portfolio Regulation of Life Insurance Companies and Pension Funds*, OECD's journal on financial markets, 2001, Issue 3, at p.133.

<sup>52</sup> Trusted Sources Research & Networks, *Insurance companies and pension funds as institutional investors: global investment patterns*. Report prepared for the City of London Corporation (November 2011), at p. 9, <http://www.cityoflondon.gov.uk/business/support-promotion-and-advice/promoting-the-city-internationally/china/Documents/Insurance%20companies%20and%20pension%20funds%20report.pdf>.

<sup>53</sup> Franzen, D. (2010), *Managing Investment Risk in Defined Benefit Pension Funds*, *OECD Working Papers on Insurance and Private Pensions*, No. 38, OECD Publishing, at p. 24; Davis, *supra* note 50, at p.134.

widely accepted both in the US and EU (the IORP Directive of 2003). However, in the countries of the continental Europe some quantitative restrictions still remain, especially, this concerns public pension funds.

With substantial weakening of quantitative restrictions for pension fund investments in alternatives, protection tools to pension fund beneficiaries have been revised in favor of the risk management system strengthening. In pension funds, it involves measurement and assessment of pension fund risks and design, monitoring and revision of the fund's parameters (contributions, benefits, and investments) in order to address these risks in accordance with the funds' objectives<sup>54</sup>.

Currently, the IORP Directive takes a principles-based approach in regulation of pension funds risk management. The art.17 of the IORP Directive requires pension funds to hold sufficient assets to liabilities. However, it is left to Member States to define the appropriate funding rules at the national level for the protection of pension fund beneficiaries<sup>55</sup>.

In general, the EU member-states use two ways of protection of pension fund investments from the risks that pension fund assets will be insufficient to cover benefit promises if the plan is terminated.

In the first group of countries, funding rules are characterized by flexibility (as a rule, minimum solvency funding rules are absent (e.g. the UK), or insignificant (e.g. the USA); solvency margin is also absent (the UK, the USA<sup>56</sup>). Herewith, pension fund beneficiaries' protection is entrusted to risk-based pension insurance fund, which makes pension payments possible in case of pension fund insolvency (pension protection fund – in the UK; pension benefit guaranty corporation – in the USA)<sup>57</sup>. In this case we can talk about *ex post protection* of pension fund beneficiaries.

<sup>54</sup> OECD (2007), *Protecting Pensions: Policy Analysis and Examples from OECD Countries*, Private Pensions Series, No. 8, OECD Publishing, at p. 163-164.

<sup>55</sup> EFRP paper on Funding and Solvency Principles for IORPs, *supra* note 35, at p. 3.

<sup>56</sup> Yermo, J. and C. Severinson (2010), *The Impact of the Financial Crisis on Defined Benefit Plans and the Need for Counter-Cyclical Funding Regulations*, OECD Working Papers on Finance, Insurance and Private Pensions, No. 3, OECD Publishing, at pp. 30-31.

<sup>57</sup> See, a detailed study of Stewart about problems of regulation of pension protection fund. Stewart, F. (2007), *Benefit Security Pension Fund Guarantee Schemes*,



In the second group of countries, there is no explicit insolvency insurance but there are strict funding rules, high requirements are set out on solvency margin, when prescribed levels of capital should be required to be maintained, according to the nature of risks, in order to ensure a high probability that the entity can meet its commitments in all circumstances<sup>58</sup> (e.g. the Netherlands). As a matter of fact, funding rules can serve a certain limiting factor of pension fund allocations to risky assets. Herewith, we can talk about *ex ante protection* of pension fund beneficiaries, when risky investments are limited and risks of pension funds insolvencies are reduced<sup>59</sup>.

There are also pension systems, which are characterized by a mixed approach to the pension fund beneficiaries' protection as they contain elements of both systems (strict funding rules and pension protection fund), e.g. Sweden<sup>60</sup>.

Assessing the advantages of the system, it is necessary to take into account such considerations as economic efficiency of such regulation. The system, which puts pension fund beneficiaries' protection on pension protection fund, as a rule, doesn't contain quantitative restrictions of pension fund asset allocations and prescriptive funding rules. It gives more flexibility in the diversification of assets to pension fund managers and responsively it allows maximizing the yield on those assets within the appropriate level of risk. That is why from the point of view of economic efficiency, an ex post system of the protection of pension fund beneficiaries is superior to an ex ante one.

At the same time, ex ante protection (which is based on solvency margin) works quite well in a range of countries. For instance, in

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OECD Working Papers on Insurance and Private Pensions, No. 5, OECD Publishing.

<sup>58</sup> Christopher D. Daykin, *Risk Management and Regulation of Defined Contribution Schemes*, International Social Security Association Seminar for Social Security Actuaries and Statisticians: Actuarial Aspects of Pension Reform Moscow, Russian Federation, 3-5 July 2002, at p.10.

<sup>59</sup> Firstly, the OECD makes a distinction between ex ante and ex post funding rules for the protection of insurance (life and non-life) beneficiaries, see in OECD (2013), *Policyholder Protection Schemes: Selected Considerations*, OECD Working Papers on Finance, Insurance and Private Equity, No. 31, OECD Publishing, at pp. 7, 32.

<sup>60</sup> Sec. 2 of Finansinspektionen's regulations regarding Swedish occupational pension funds' obligation to report data from the annual report, decided on 30 June 2008.

the countries of continental Europe, which have a more conservative investment pension fund investment policy and a not highly developed stock market, impact of strict funding rules on pension fund returns is limited and costs of such regulation are insignificant.

In contrast the UK, which has liberal regulation of the pension fund asset allocation and a developed stock market, introduction of strict solvency funding rules, will have an extremely negative impact. First of all, such regulation will be incompatible with the principle of liberal regulation of the financial market, which is a cornerstone of the British economy, and introduction of this heterogeneous element will have a particularly negative influence on the stock market. In the UK legislative attempts to introduce minimum funding requirement had already been made, but it didn't remain in effect for a long time (1995-2004) and were soon abolished under the pressure of criticism among the academics and pension fund industry<sup>61</sup>. That is why, the UK provides ex-post protection of pension fund beneficiaries (based on pension protection fund).

### Part 3. Overview of the proposed amendments to the art. 17 of the IORP Directive

Since 2008 the European Commission started the consultation process as to the replacement of Solvency I pension funds' capital funding regulations by solvency rules similar to Solvency II rules, which work for insurance companies<sup>62</sup>, and in 2012 it presented a

<sup>61</sup> The UK Pension Act 1995 introduced the minimum funding requirement (MFR) for pension schemes and the UK Pension Act 2004 abolished it. Myners, *supra* note 14, at p. 115, 125 and Mayer, *supra* note 15, at p. 11-12 criticized such a requirement. In particular, Myners asserts that MFR distorted investment decision-making and didn't provide effective protection of pension fund investors. He recommends introduction of pension funds' public disclosure on their current financial state and on future funding plans. Mayer also points out that MFR is ineffective for pension fund investors' protection and too expensive (the most cost-effective protection that can be provided to investors against risks of fraud is for clients' assets and monies to be held by separate, well-capitalized custodians).

<sup>62</sup> European Commission, Internal Market and Services DG, *Consultation on the Harmonization of Solvency Rules applicable to Institutions for Occupational Re-*

responsive legislative proposal to review the art.17 of the IORP Directive. It was offered to introduce two levels of capital requirements: the minimum capital requirement (MCR) – a minimum level below which the financial resources should not fall; (SCR) – an additional capital that must be held with a view to their specific risk profile. Herewith, solvency over the next year will be guaranteed with a confidence level of 99.5%<sup>63</sup>. As we can see, it is proposed that ex-ante protection should be implemented by all EU member-states.

The European Parliament supposes that financial markets can function efficiently, when there are solid prudential rules for financial institutions, including IORPs<sup>64</sup>. Among the main justification of the adoption of new solvency requirements to pension schemes is strengthening of the financial stability and ensuring more efficient outcomes for pensioners after the financial crisis; providing the EU single market cross-border activity; avoidance of the regulatory arbitrage between financial services sectors. Thus, the motivation for the revision of pension fund regulation is the same as for other financial institutions (banks and insurance companies).

The policymaker tries to ensure in such way that all pension institutions comply with minimum standards of risk management and hold appropriate levels of capital<sup>65</sup>.

At the same, it can be noticed a harsh criticism of pension funds' funding rules and it is not surprising. It is worth mentioning

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*irement Provision (IORPS), covered by article 17 of the IORP Directive and IORPS operating on a cross-border basis. Ref: Ares (08) 14767 3 (September 2008), [http://ec.europa.eu/internal\\_market/consultations/docs/occupational\\_retirement\\_provision/consultation\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/occupational_retirement_provision/consultation_en.pdf); European Commission Internal Market and Services DG, *Feedback Statement Consultation on the Harmonization of Solvency Rules applicable to Institutions for Occupational Retirement Provision (IORPS) covered by article 17 of the IORP Directive and IORPS operating on a Cross-Border Basis*, Brussels, March 16, 2009; European Commission White Paper. *An Agenda for Adequate, Safe and Sustainable Pensions (Brussels), 16.2.2012 COM(2012) 55 final.**

<sup>63</sup> Solvency II for pensions (January 2012), at p.6, [http://ec.europa.eu/internal\\_market/insurance/docs/solvency/solvency2/faq\\_en.pdf](http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/faq_en.pdf)

<sup>64</sup> Report on the consultation on the Green Paper: Towards adequate sustainable and safe European pension systems, Presentation by the Commission, at p.3, [ec.europa.eu/social/BlobServlet?docId=6625&langId=en](http://ec.europa.eu/social/BlobServlet?docId=6625&langId=en).

<sup>65</sup> Gregory Brunner, Richard Hinz & Roberto Rocha, *Risk-Based Supervision Of Pension Funds: A Review Of International Experience And Preliminary Assessment of The First Outcomes*, World Bank Publications, 2008, at p. 9.

that the proposed pension funds capital funding requirements are high even for those countries, which have solvency margin regulation (e.g. the Netherlands)<sup>66</sup>. For the UK, which is the main opponent of this regulation, the costs of the regulation will be extremely high, as it recently introduced pension protection fund for pension fund beneficiaries' protection.

As a result, the European Commission postponed the introduction of this reform and requested EIOPA to conduct a quantitative impact study (QIS) of a harmonized risk-based prudential regime.

The EIOPA proposed to the European Commission the usage of the holistic balance sheet approach. However, it does not address to all of the IORP-characteristics<sup>67</sup>.

Currently, the reform of pension fund funding rules is suspended again. As the EU Commissioner Barnier stated that 'further technical information' were needed before deciding on the solvency of pension funds<sup>68</sup>. The EIOPA on its own initiative started a worked out technical specifications in view of its QIS and, subsequently, technical advice to the European Commission on EU solvency rules for IORPs<sup>69</sup>. The consultation process is going on now.

As the proposed regulation of pension funding requirements is very strict, it is necessary to look at the regulatory environment of the adoption of the proposal to the IORP Directive.

First of all, the IORP Directive reform started at once after the financial crisis of 2008. Moreover, a range of the EU program documents and politicians' statements directly indicate the necessity of the IORP directive revision as a result of the financial crisis<sup>70</sup>.

<sup>66</sup> In the Netherlands funding is likely to increase by between 20% and 30%. See, Punter Southall, *Solvency Funding in Pension Schemes* (2007), at p. 2, <http://www.puntersouthall.com/Insights%20and%20views/Insight%20Attachments/Solvency%20Funding%20executive%20summary.pdf>

<sup>67</sup> BASF Germany – EIOPA (2013), [https://eiopa.europa.eu/fileadmin/tx.../Panel\\_I\\_Withhold\\_Galinat.pdf](https://eiopa.europa.eu/fileadmin/tx.../Panel_I_Withhold_Galinat.pdf).

<sup>68</sup> European Commission, Occupational Pension Funds (IORP): Next Steps, Memo/13/454, 23 May 2013.

<sup>69</sup> EIOPA Consultation Paper on Further Work on Solvency of IORPs, EIOPA-CP-14/040 13 October 2014, <https://eiopa.europa.eu/.../consultations/consultation-papers/index.html?...>

<sup>70</sup> Green Paper towards adequate, sustainable and safe European pension systems, *supra* note 36. Michel Barnier. Towards a real single market for occupational pensions offering greater choice and better protection for pensioners. Public hearing on the revision of the Directive on occupational pensions. Brussels, 1st March 2012, at

On the one hand, the financial crisis always reveals problems, that exist in the system and shows what went wrong and should be revised. In fact, the financial crisis was precisely that impetus, which raised the question of the necessity of improving market efficiency and safety of pension schemes. Indeed, it is necessary to reconsider risk management of pension funds, taking into account the last reform had place more than 10 years ago (adoption of the IORP Directive in 2003) and after the financial crisis the EU policymaker revised capital requirements of banks and insurance companies. On the other hand, as a rule, in the wake of the post crisis reforms are accompanied with high political pressure when politicians try to regulate everything and as strictly as possible; usually reforms are adopted in a hurry and without a thorough analysis. Concerning, the reform of the IORPs' funding requirements, there is lack of research as to costs of such regulation and its impact on the financial market as a whole.

Regulation of the financial market and protection of pension fund beneficiaries are politically sensitive issues. Pension is an issue that worries every citizen. That is why, providing a strict regulation, politicians in such a way ensure themselves support of the electorate.

It is also worth noting one more political explanation of the Solvency II proposal to pension funds. As it was mentioned above, investors stopped increasing their allocations to the government bonds because of drop in interest rates and diversified their investment portfolio in other directions, in particular, by means of increasing investments in alternatives. That is why, introducing Solvency II regulation to pension funds, the policymaker tries in such a way to push pension funds to invest in government bonds and to reduce the state debt. However, the problem is that such regulation is not appropriate for pension funds as government bonds offer low-to-negative real returns that will increase those funds' deficits<sup>71</sup>.

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p. 4; European Commission. Directorate General Internal Market and Services from 30.03.2011. Call for Advice from the European Insurance and Occupational Pensions Authority (EIOPA) for the Review of Directive 2003/41/EC (IORP II), at p.3.

<sup>71</sup> Baptiste Abouilan, *Pension Funds Assess Investments in the Government Debt*, Financial Times (October, 2012), <http://www.ft.com/intl/cms/s/0/df07bcd6-0c95-11e2-a776-00144feabdc0.html#axzz3Ei7 QCCF1>

As one of the possible explanations of the adoption of the Solvency II regulation proposal to pension funds it is possible to consider the impact of interest groups on it<sup>72</sup>. The adoption of Solvency II Directive, which strengthened capital requirements of insurance companies, proceeded to the reform of the IORP Directive. It is well known that in many countries of the EU pension arrangements were managed through insurers. Moreover, some insurance companies set up branches to market pension funds<sup>73</sup>. The pressure from the insurance industry, which is now subject to Solvency II, to make pension schemes subject to similar regulatory requirements, is high and it seems quite possible that the real reason for the IORP Directive review is more closely connected with a drive for a more harmonized regulatory landscape across the EU following the financial crisis<sup>74</sup>. Herewith, much of the pressure to treat IORPs in the same way as insurance companies comes from the countries where either there are no IORPs or IORPs are not the dominant method of pension provision<sup>75</sup>.

#### Part 4. Analysis of economic justifications for the revision of the IORPs funding requirements in the EU

The European commissioner Barnier points the following reasons for the revision of the capital funding rules of the IORPs, among which are protection of pension fund beneficiaries, prevention of regulatory competition between pension funds and insurance com-

<sup>72</sup> Feedback Statement Consultation of the Harmonization of Solvency Rules Applicable to Institutions for Occupational Retirement Provision (IORPS) Covered by Article 17 of the IORP Directive and IORPS operating on a Cross-Border Basis. - P. 4.

<sup>73</sup> Robert Elison, Pinsent Masons, *Pension Fund Investment Law*. Tottel Publishing Ltd. 2008, at p. 252.

<sup>74</sup> DWP Select Committee Inquiry into EU pensions policy. Submission by National Association of Pension Funds (March, 2012), P.3, [www.napf.co.uk/.../0226\\_DWP\\_Select\\_Committee\\_told\\_that\\_EU\\_rules\\_...](http://www.napf.co.uk/.../0226_DWP_Select_Committee_told_that_EU_rules_...)

<sup>75</sup> Comments Template on EIOPA\_CP\_11/001 Draft response to Call for Advice on the review of Directive 2003/41/EC Scope, cross border activity, prudential regulation and governance, <https://eiopa.europa.eu/...draft-response-to-call-for-advice-on-the-review>.

panies, promotion of long-term investment of the economy and strengthening of the EU single market of the IORPs<sup>76</sup>.

As the proposed reform has an extremely negative impact on private equity industry, I would like to question how justified such arguments for the revision of the IORP Directive are.

*Argument 1. The Necessity of the protection of pension fund beneficiaries.*

The starting point of the IORP Directive reform is the protection of pension fund beneficiaries. The EIOPA points that the most important issue is that all occupational schemes throughout Europe should have sufficient resources to meet their pension promises<sup>77</sup>.

Analyzing this justification for regulation, it is important to understand what the main concerns as to the protection of pension fund beneficiaries are and whether the proposed regulation will rectify the problem.

First of all, pension fund beneficiaries are interested in pension funds solvency; pension funds should be able to fulfill their obligations to them and made pension payments in due time. So the main interest of pension fund beneficiaries is safety of pension payments. But in the current economic conditions (with the growth of the financial market and a greater involvement of individuals in the investment activity), the adequacy of pension payments plays even more important role.

The next issue concerns the risks, from which pension fund beneficiaries should be protected. I consider two of them: (1) the risk of pension fund underperformance as a result of breach by pension fund managers of their fiduciary duties (improper pension funds asset allocation because of negligence or fraud, committed by pension fund managers; (2) the risk of pension fund underperformance as a result of market risk.

Policymakers pointed out on improper asset allocation frauds of pension fund managers, failures in due diligence and monitoring of

<sup>76</sup> Michel Barnier, *supra* note 70.

<sup>77</sup> Opening Speech of Gabriel Bernardino (Chairman of EIOPA), EIOPA – Reflecting on the achievements and preparing for the new challenges, EIOPA 2<sup>nd</sup> Annual Conference (Frankfurt, 21 November 2012), at p.3, [https://eiopa.europa.eu/fileadmin/tx\\_dam/files/Press-Room/speeches/2012-11-21\\_GB\\_EIOPA\\_conference.pdf](https://eiopa.europa.eu/fileadmin/tx_dam/files/Press-Room/speeches/2012-11-21_GB_EIOPA_conference.pdf).

PE investments by pension funds<sup>78</sup>. From this point of view, a direct response to the problem and revising doctrine of fiduciary duties of pension fund managers, development of good practices of due diligence and monitoring of pension fund investments in alternatives as it has been recently done in the USA sound a more proper solution than strengthening of capital funding rules<sup>79</sup>. At the international level several guidances as to institutional investors' allocations in alternatives (e.g. OECD/IOPS good practices on pension funds' use of alternatives and derivatives (December 2011), UNEP FI and the UN Global Compact Principles for Responsible Investment in Private Equity. A Guide for Limited Partners (June 2011)) were developed. At the same time it is important to identify the specific problems of due diligence and monitoring of PE investments at the EU market and develop a responsive guidance for it. Another problem that arises is provision of the adoption of these standards consistently across the pension fund industry; that is why it is important to provide compliance of these standards by pension fund managers. For this purpose, it would be rational to incorporate the best practices of investments in alternatives into the national legislation of the EU member-states.

The second risk is pension fund losses, resulting from below average investment performance or a market risk, which refers to changes in the value of an investment due to changes of market factors, such as interest rates, exchange rates or stock markets<sup>80</sup>. On the one hand, the market risk is a normal constituency of the

<sup>78</sup> Jonathan Williams, Instances of fraud at UK pension funds more than double, Investment & Pensions Europe (June 12, 2012), <http://www.ipe.com/instances-of-fraud-at-uk-pension-funds-more-than-double/46095.fullarticle>.

<sup>79</sup> The SEC Office of Compliance Inspections and Examinations. Investment Adviser Due Diligence Processes for Selecting Alternative Investments and their Respective Managers. Volume IV, Issue 1 January 28, 2014, [www.sec.gov/about/.../adviser-due-diligence-alternative-investments.pdf](http://www.sec.gov/about/.../adviser-due-diligence-alternative-investments.pdf); Bruce Karpati, Enforcement Priorities in the Alternative Space (2012), <http://www.sec.gov/News/Speech/Detail/Speech/1365171492012#.VEep9Ofdh-U> Bruce Karpati, Private Equity Enforcement Concerns Private Equity International Conference, New York, January 23, 2013, <http://www.sec.gov/news/speech/2013/spch012313bk.htm>; Luis A. Aguilar, Speech by SEC Commissioner: Market Upheaval and Investor Harm Should Not be the New Normal. Compliance Week 2010 Washington, D.C. (May 24, 2010), <http://www.sec.gov/news/speech/2010/spch052410laa-1.htm>; SEC Charges Private Equity Firm and Money Manager for Defrauding Detroit-Area Public Pension Funds. Release 2010-64, <http://www.sec.gov/news/press/2010/2010-64.htm>.

<sup>80</sup> Franzen D., *supra* note 53, at p. 7.



investment process and it shouldn't be avoided<sup>81</sup>. On the other hand, the well-designed risk management system allows minimizing this type of risk. The main issue is whether Solvency II regulation an adequate response to the management of pension funds' market risks.

Analysis of the sustainability of pension fund risk management system to the market fluctuation if of particular importance as recently the financial crisis of 2008 has place. In fact, it proved that modern risk management tools and regulatory frameworks, which were implemented by many countries after the first crisis of 2001-2002, failed to prevent the reappearance of pension funds' funding gaps<sup>82</sup>. In response to this problem the policymakers emphasize on the necessity to discourage pension funds from excessive risk-taking and inappropriate speculation in order to help restore investor confidence in financial market and prevent possible bailouts for taxpayers' money<sup>83</sup>.

As Solvency II reform of pension funds is, in fact, directed on restriction of pension fund asset allocations in private equity, it is important to investigate the role of the last ones in pension funds underfunding.

Analyzing the problem of pension fund losses, firstly, it is necessary to pay attention to the fact that the financial position of pension funds worsened as a whole after the financial crisis. The losses are primarily related to the harshness of the crisis; it appears that significant losses were predominately due to the global decline in asset prices<sup>84</sup>. The study of Healey, Hess & Nicholson (2012), which is based on a comparison of the price of the Standard & Poor's 500 index (S&P 500) and Wilshire Consulting's calculation of the funded ratio public pension plans, also shows a strong corre-

<sup>81</sup> Franzen D., *supra* note 53, at p. 4. The author aptly points out that the risks of pension funds take need to get managed. But managing risk is not equivalent to avoiding risk.

<sup>82</sup> Franzen D., *supra* note 53, at p. 4.

<sup>83</sup> Press release of the United States Committee of Finance, Committee Leaders Call For Oversight Of Pension Investments In Hedge Funds, Private Equity (September 10, 2008),

<http://www.finance.senate.gov/newsroom/chairman/release/?id=cc7131e0-5203-4458-97fb-8bbccdad3614>.

<sup>84</sup> IOPS (2011), "*Pension Fund Use of Alternative Investments and Derivatives: Regulation, Industry Practice and Implementation Issues*", IOPS Working Papers on Effective Pension Supervision, No. 13, at p. 4.

lation between the performance of the stock market and the funding ratio of public pension plans<sup>85</sup>.

The core reason, of such a reaction of private equity funds to the financial crisis is high dependency of private equity funds on leverage. It is necessary to note that leverage is not a true risk factor by itself, but a measure of the rapidity with which other factors affect valuation and the resulting margin of safety a manager has to ride out market volatility<sup>86</sup>. It exacerbates liquidity problems in market downturns. In particular, dependence on leverage creates the risk that the fund will be unable to meet its obligations<sup>87</sup>. This picture could be observed in the financial crisis of 2008, which was mainly a banking crisis. Thus, such losses are caused by the problems of the banking system but not by private equity industry by itself. The legislative response followed and Basel III was adopted. In addition, the AIFMD also regulates leverage of private equity funds.

It is worth noting that these pension fund losses in the wake of the financial crisis came not only from private equity investments but they were even higher from publicly traded securities<sup>88</sup>. In comparison a private equity index measured losses throughout most of 2008, with losses of a little more than 15 percent in the last quarter; the stock market, as measured by the Standard and Poor's 500 index, declined in value by close to 40 percent in 2008<sup>89</sup>.

Moreover, direct failures of the IORPs are rarely observed. In the spring of 2007 the GMB Central Executive Council conducted a comprehensive study to establish the links between insolvent pension funds and private equity companies. This research found that the role of private equity in pension fund insolvency was insignificant: only 10% of those company pension schemes are from the companies owned by PEFs-with 59 PEF linked companies in

<sup>85</sup> Thomas J. Healey Carl Hess & Kevin Nicholson, *Underfunded Public Pensions in the United States: The Size of the Problem, the Obstacles to Reform and the Path Forward*, M-RCBG Faculty Working Paper No. 2012-08, at p.26.

<sup>86</sup> Report of the Investors' Committee to the President's working group on financial markets, Principles and best practices for hedge fund investors (January 15, 2009), at p. 31.

<sup>87</sup> David P. Belmont, *Managing Hedge Fund Risk and Financing: Adapting to a New Era*, 2011, 320 p.

<sup>88</sup> The Education Committee of the Greenwich Roundtable. *Best practices in the Alternative Investing: managing complexity* (2011). - p. 54, [www.grbestpractices.org](http://www.grbestpractices.org).

<sup>89</sup> GAO report No. GAO-12-324, *supra* note 29.

the Financial Assistance Schemes, and 38 in the Pension Protection Fund<sup>90</sup>. That is why from this point of view the change of risk management system is not justified.

The next question, which this paper aims at answering, is whether Basel III provides sufficient protection of pension funds investments in alternatives from the market risk or an additional one should be provided. Considering this issue, in my view, three indicators should be taken into account: firstly, the growth of the private equity industry, which has its result the complication of PEFs structures and used investment strategies; so PE investments became difficult for valuation even for professional investors; secondly, internationalization of PE investments and the volatility of different markets; thirdly, the scale of pension fund investments in alternatives (their ongoing growth), especially for the last decade. The above-mentioned facts prove the necessity of the revision of the risk management system of pension funds. However, the issue is in which extent risk management system should restrict pension funds investment allocations in private equity in order to protect pension fund beneficiaries from the market risk and whether it should be applied the unified approach of risk management regulation to all EU member-states. That is why let's look at other arguments for introduction of Solvency II regulation to pension funds.

*Argument 2. Regulatory competition between insurance companies and pension funds.*

As it has already been mentioned, pension arrangements can be managed through both insurance companies and pension funds. That is why it can be argued that there should be the same regulation for the both institutions<sup>91</sup>.

The principle of fair competition is an important principle of the EU market<sup>92</sup>. But in my view, applying the same Solvency II-like funding rules both for insurance companies and pension funds, the EU policymaker breaches another, not less important, principle of the financial market regulation - principle of its economic efficiency.

<sup>90</sup> GMB 2007 Private equity's Broken Pension Promises - Private Equity Companies' Links to Insolvent Pension Funds - a CEC Special Report, GMB 2007.

<sup>91</sup> Michel Barnier, *supra* note 70.

<sup>92</sup> Articles 101 to 109 of the Treaty on the Functioning of the European Union. See also, OECD, Competition and Financial Markets: Key Findings, (2009). – 48 p.

Firstly, the IORPs and insurance companies have completely different structures and hence require separate regulatory regimes<sup>93</sup>. The payments of the IORPs are possible to predict; insurance companies, on the contrary, can face unexpected demands of their capital<sup>94</sup>. Insurance companies and pension funds use different investment strategies. The introduction of Solvency II regulation to insurance companies and IORPs will have a different impact on the further design of the investment policy of these financial institutions. If for insurance companies it will cause slight change (their investments in PE were 10.7% in 2013), then in the case of the IORPs it will cause their complete change (their investments in PE were 37.2% in 2013)<sup>95</sup>. Thus, funding rules for insurance companies should not be applied in the same way to pension funds.

Secondly, it is disputable whether these restrictions are justified from the insurance companies perspective. In particular, Keller (2011) points out that Solvency II Directive is not beneficial for long-term interests of the insurance industry and, moreover, such regulation can introduce incentives for increased systemic risk in the insurance industry<sup>96</sup>. Braun, Schmeiser & Siegel (2012) also provide the convincing evidence that underrepresentation of asset classes with favorable risk-return profiles such as private equity will have a negative effect for insurance companies' portfolio diversification as well<sup>97</sup>.

Thirdly, one of the main objectives of enhancing of capital requirements of insurance companies is prevention of systemic risk in the economy. However, if to consider systemic risk, as the Financial Stability Board defines it<sup>98</sup>, the IORPs didn't cause a chain

<sup>93</sup> European Federation for Retirement Provision, *supra* note 34, at p. 15.

<sup>94</sup> EIOPA, Summary of Comments on Consultation Paper Draft Response to Call for Advice on the review of Directive 2003/41/EC - EIOPA-CP-11/001.

<sup>95</sup> EVCA. 2013 European Private Equity Activity. Statistics on Fundraising, Investments & Divestments, at p. 15, <http://www.evca.eu/media/142790/2013-European-Private-Equity-Activity.pdf>

<sup>96</sup> Keller Philipp, Solvency II and Incentives for Systemic Risk Exposures, Progress, 2011, No. 54,

<sup>97</sup> Braun Alexander, Schmeiser Hato, and Siegel Caroline, The Impact of Private Equity on a Life Insurer's Capital Charges under Solvency II and the Swiss Solvency Test, Working Papers on Risk Management and Insurance, No. 91 – February 2012. – 43 p.

<sup>98</sup> International Monetary Fund Bank for International Settlements. Financial Stability Board. Report to G20 Finance Ministers and Governors. Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations (2009). The Financial Stability Board (FSB) defines systemic risk as

reaction, when failure of one pension fund causes the failure of other one, so they didn't cause any systemic risk at all. If to consider systemic risk in a broader meaning, when pension funds are solvent but suffer significant losses, when there arises the danger of bailout at the expense of taxpayers money appears, risk management system should be revised but not in the same way as of those financial institutions, which create systemic risk in its generally accepted meaning.

Fourthly, it can be argued that a different regulation of pension funds and insurance companies can cause regulatory arbitrage<sup>99</sup>. However, the European Court of Justice already considered similar legal action when the IORP Directive was at the stage of adoption. France sued against the European Commission and the European Court of Justice found that such regulation would not imply unequal competition for insurance companies on the single market<sup>100</sup>.

*Argument 3. Promoting long-term investment of the European economy.* The financial crisis of 2008 was shaken the foundation of the financial market and highlighted the necessity of its reform towards the long-term investment goals<sup>101</sup>. The European Commissioner Barnier singles out promoting long-term investment as one of the reasons for revision the IORP Directive. Herewith, he defines long-term investment referring to investors<sup>102</sup>. He asserts that the reliable protection of pensioners, provided Solvency II-like regulation of the IORPs, will facilitate the inflow of investments to pen-

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'the risk of disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy'.

<sup>99</sup> Michel Barnier, *supra* note 70.

<sup>100</sup> Brunet/d'Yvoire 1999:11, at p. 10 in Christian Möllmann, How to govern transitional pension provision? The struggle over the "prudent person standard" in EU pension fund regulation, Paper presented at the 6<sup>th</sup> Pan-European Conference on International Relations. Turin (12-17 September, 2007).

<sup>101</sup> The long-term financing goal of the European economy is defined in many policy documents at the EU level: Green Paper Long-term Financing of the European Economy. COM/2013/0150 final; Communication from the Commission to the European Parliament and the Council on long term financing of the European economy from 27.03.2014, COM/2014/0168 final.

<sup>102</sup> Rapporteurs Mirzha de Manuel Aramendia & Karel Lannoo, Allan Polack, Report of the CEPS-ECMI Task Force on Long-Term Investing and Retirement Savings, Savings for Retirement and Investing for Growth, Brussels, (2013), at p. 13-14. In this report the authors discuss the different approaches to the definition of the long-term investment.

sion funds; and in such a way a long-term investment and sustainable development of the economy will be provided<sup>103</sup>.

At the same time, such understanding of the long-term investment does not fully reflect its essence. The more correct approach is that one, which uses asset class approach to its definition. In particular, long-term investment policy assumes investments of the financial institutions for a long period of time and in the assets with a high long-term economic profile (which can subject to higher volatility in a short-term but also give higher returns in the long-term)<sup>104</sup>. Joanne Segars, the NAPF chief executive, asserts that, giving too much protection to pensioners can have the opposite effect and will cause the movement of pension funds away from long-term assets, first of all, private equity ones<sup>105</sup>. The EVCA supports the same point of view and additionally in its [position paper](#) of 2011 pointed out that this move from private equity style assets would harm pension fund's ability to meet their liabilities and also reduce the amount of investment in European companies, particularly SMEs<sup>106</sup>.

Thus, in fact Solvency II regulation of the IORPs creates the situation of short-termism, which is particularly dangerous as pension funds are, first of all, long-term investors and play the key role in promoting long-term investment<sup>107</sup>.

*Argument 4. Strengthening of the EU single market of the IORPs.*

The next justification for the revision of the IORP Directive is strengthening of the EU single market of the IORPs and providing equal protection of retirement savers across the EU<sup>108</sup>.

At the same time, serious concerns exist as to the economic efficiency of harmonization of the IORPs' funding rules at the EU level. In particular, the Minister for Pensions Steve Webb points that despite the fact that it is important to ensure secure and af-

<sup>103</sup> Michel Barnier, *supra* note 70.

<sup>104</sup> World Economic Forum Report in the collaboration with Oliver Wyman, *The Future of Long-term Investment* (2011), at p. 9.

<sup>105</sup> NAPF Press Release, *New EU Pensions law threatens UK economy and jobs* (January 4, 2012),

[http://www.napf.co.uk/PressCentre/Press\\_releases/0168\\_New\\_EU\\_Pensions\\_law\\_threaten\\_UK\\_economy\\_and\\_jobs.aspx](http://www.napf.co.uk/PressCentre/Press_releases/0168_New_EU_Pensions_law_threaten_UK_economy_and_jobs.aspx).

<sup>106</sup> EVCA, Position Paper on IORP Directive review, (November 7, 2011).

<sup>107</sup> OECD, Annual Survey of Large Pension Funds and Public Pension Reserve Funds. Report on pension funds' long-term investments (October 2013), at p. 8.

<sup>108</sup> Michel Barnier, *supra* note 70.

fordable pensions, there is no such “one size fits all” model for all EU pension systems<sup>109</sup>.

In support of this point of view, I would like to emphasize that across Europe pension fund systems are quite diverse<sup>110</sup>. Regulation of pension funds capital funding and protection of pension fund beneficiaries are the reflection of a set of factors: first of all, of social values (e.g. providing pensioners with an adequate pension is a cornerstone of the Swedish society) and is closely connected with the regulation of labor markets and development of stock markets, which are rather different across Europe.

The next concern is connected with the costs of conducting Solvency II-like regulation to the IORPs. As it was mentioned above, the UK has recently introduced a strong protection of pension fund investors through the Pension Protection Fund<sup>111</sup>. If in addition to the existing regulation enhanced capital funding rules are introduced, in fact, on the one hand, protection of pension fund investors will be strengthened, but on the other hand, additional costs will be necessary for conducting the reform, which according to the EIOPA estimations for the UK are around £500 bn.<sup>112</sup> At the same time, increased costs of the regulation will automatically cause less returns to pension fund managers. The question is whether pension fund beneficiaries are interested in strong protection of their investments for such a price. Moreover, as it was mentioned in part II of this article the establishment of high capital funding requirements to pension funds, as it is envisaged in the art. 17 of the proposal to the IORP Directive, is incompatible with the liberal traditions of the regulation of the British financial market (which supposes the wide discretion of the financial market actors to define their investment policy and the minimum government interference in their activity). Additionally, decreasing of pen-

<sup>109</sup> Press release of the Department for Work and Pensions, Britain says no to European Solvency II rules for pensions as Commission announces delay (June 21, 2012), <https://www.gov.uk/government/news/britain-says-no-to-european-solvency-ii-rules-for-pensions-as-commission-announces-delay>.

<sup>110</sup> The European Commission Green Paper "Towards adequate, sustainable and safe European pension systems" A response by The National Association of Pension Funds (2010), at p. 2, [http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~media/Policy/Documents/0151\\_EC\\_Pensions\\_Green\\_Paper\\_November\\_2010\\_NAPF\\_response\\_181110.ashx](http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~media/Policy/Documents/0151_EC_Pensions_Green_Paper_November_2010_NAPF_response_181110.ashx).

<sup>111</sup> The Pension Act of 2004 firstly introduced it in the UK.

<sup>112</sup> EIOPA, *supra* note 94, at p. 10.

sion funds investments in private equity as a result of the enhancing of pension funding rules will have the most negative impact on the UK, as currently it has the biggest private equity industry in Europe.

Thus, the proposed harmonization of pension capital funding requirements for the purpose of strengthening of the EU single market is not desirable as it puts disproportionate and unequal burden of regulation costs on some EU member-states.

Analysis of the arguments in favor of Solvency II regulations for pension funds showed that application of the “one size fits all” approach is not justified. *The danger of overregulation* in favor of pension fund beneficiaries’ protection appears. Herewith, principles of proportionality and economical efficiency of regulation are breached. It is quite important that the 'cure' for pension fund investor protection and systemic risk wouldn't kill the economy<sup>113</sup>. By increasing the level of capital that will have to be held by pension funds against private equity and other types of investments, the European Commission and the EIOPA increase the costs of pension and reduce the returns and attractiveness of these assets for retirement savers. This, in turn, can have a negative impact on the growth of the economy and employment.

## Conclusion

Preserving financial stability of pension systems in the EU is a key public policy issue. This paper answers the question of how asset allocation and risk management policy of pension funds in the EU should be designed to ensure that they stay proper and do not create disincentives to the investment in one particular type of assets. The impact of the proposed amendment to the art.17 of the IORP Directive was assessed from the perspective of the role of private equity investments in pension fund underfunding, the necessity of harsh capital requirements for pensioners’ protection and some other justifications for such regulation. Taking into account the growth of pension fund investments in risky assets and significant losses from such investments, regulation of pension fund asset al-

<sup>113</sup> Luke Zubrod, *Will the 'Cure' for Systemic Risk Kill the Economy?* The Atlantic (June 20, 2011) <http://www.theatlantic.com/business/archive/2011/06/will-the-cure-for-systemic-risk-kill-the-economy/240600/>.



locations to alternatives, including risk management system, should be revised, but the EU member-states should have an option, which approach for the purpose of pension fund beneficiaries protection to chose: based on solvency margin or pension protection fund (or use both of them). Moreover, as a significant share of losses from pension fund investments in alternatives was also caused by failures in due diligence and improper monitoring of such investments, fiduciary duty standards of pension fund managers should be revised, best practices of due diligence and monitoring of pension fund investment allocations to private equity at the EU level should be developed, and their compliance should be provided.



