

# IORP II and the top 10 considerations

*IORP II is the name given to EU Directive 2016/2341. This directive is aimed at the activities and supervision of institutions for occupational retirement provisions (IORPs). It prescribes new requirements on, among others, the provision of information on pension benefit statements, the introduction of 'key functions', and the performance and documentation of risk management activities, while considering Environmental, Social and Governance (ESG) factors. The directive applies to all IORPs based in the EU and came into force on 13 January 2019. With regards to the approaching date of Brexit, UK IORPs must comply with the requirements set out in this directive until the UK exits the EU. The UK Department for Work and Pensions (DWP) has confirmed that it will honour this obligation.*

## The 10 most important issues - a trigger for internal audit

The implementation of the IORP II directive offers a reinforcement of the governance practice, but also leads to various dilemmas. In this instance we focus on the interpretation in the Netherlands. Questions such as: 'how to set up key functions according to the nature and complexity of the fund' or 'what can I expect from the outsourcing of key functions' have yet to be answered. In the chart below you can find the 10 most important themes from IORP II (maturity level included as an example). The most obvious (and perhaps most radical) changes, and their intersection with internal audit, regarding the Dutch market will be discussed in this article.

## Introduction of key functions

Pension funds are first and foremost required to introduce so-called 'key functions'<sup>1</sup>, namely the actuarial function, the risk management function and the internal audit function (IAF), to support the management in ensuring adequate governance and controlled operations. These

key functions are consistent with the 3LoD model.<sup>2</sup> The aim is to create an effective system of checks and balances.

The guidelines from the Dutch Central Bank (DNB)<sup>3</sup> and a Dutch umbrella organisation representing Dutch pension funds provide direction and guidance. According to DNB, the key functions must be organised in proportion to the complexity of the pension fund. Small and medium-sized insurers may deviate from specific criteria if this is proportionate in view of their nature and the complexity of their activities. The size, nature, scale and complexity of the activities



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# 13 Jan 2019

of the pension fund are decisive for the proportional design of the key functions. Independent performance of the key functions must be guaranteed in any event.

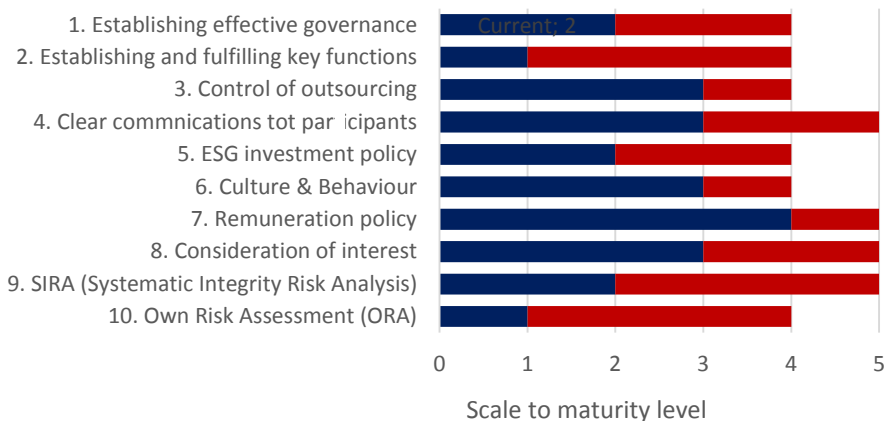
Furthermore, the terms ‘holder of key functions’ and ‘persons who carry out key functions’ are introduced. By ‘holder of key functions’ we mean the person ultimately responsible (usually a director) for the

function, while the ‘person who carries out a key function’ is the actual implementer of the tasks related to the function. Key function holders must meet the DNB requirements of suitability and reliability, as they follow from legislation and regulations. The suitability requirements for key function holders also emerge from a combination of educational level, knowledge, work experience and competencies and have been further substantiated by DNB in a Q & A. DNB screens key function holders for compliance with these requirements.<sup>4</sup>

Within the given framework, the board of the pension fund has to decide on an appropriate

### Proportionality Impact Analysis on IORP II themes

■ Current ■ Future



#### Proportional on the basis of pension fund profile

- Type of pension fund
- Number of affiliated employers in pension fund
- Number of collective schemes
- Number and nature of the schemes
- Participant population
- Size of assets under management
- Supervision classes
- Investment policy, complexity of investments
- Number of implementers versus own management
- Size of board, own administrative office

design of the key functions for the pension fund. The role of key function holder can be executed by a director (with or without the support of a committee), so that embedding of the functions in the board is guaranteed. If the key function holder is a board member the potential conflict of the function in combination with several other board tasks (for instance related to the investment committee) requires the necessary attention. In the case of a 'mixed' or 'one-tier board' in which a non-executive director takes on the role of key function holder, specific attention is required to safeguard a sufficiently independent position of the key function holder. Guaranteeing this independence means that at least three non-executive board members with no key function must be charged with internal supervision.

The independence of the IAF can, in our opinion, be properly ensured by appointing an independent director as the holder of the key function. The key function holder could also be outsourced, while maintaining independence, under the conditions that there is insufficient audit expertise on the board and the IAF is well embedded in the governance arrangements of the fund.

Furthermore, outsourcing of the IAF – the implementer – to an independent external professional party, not being the IAF of an outsourcing party of the pension fund, is in our

opinion also a fitting solution. This method is, for example, common in the insurance sector.

For various pension funds, the implementation of the IAF – in particular – prompts dilemmas and questions, because the key functions are not yet common practice (as opposed to common practice in the insurance sector, for example). Outsourcing of the IAF can be an appropriate method to shape the IAF of the pension fund in a flexible and professional manner and may be necessary if the pension fund does not have an administrative office at its disposal or doesn't have sufficient scale for an in-house function.

### **Own-risk Assessment**

Pension funds are also responsible for carrying out the 'own-risk assessment' (ORA) under the supervision of the Dutch Central Bank. The ORA can be executed and documented on the basis of an 'integral risk management framework'.<sup>5</sup> This ORA must be performed once every three years by the pension fund. Significant changes in the risk profile of the pension fund or pension schemes operated by the pension fund also require an (interim) ORA.

### **ESG**

Not entirely new, but further elaborated upon in this context are the ESG

requirements. Pension funds must demonstrate how the environment and climate, human rights and social relations considerations are included in their investment policy or public investment principles. Alternatively, they are required to give a reasoned account of why these factors are not taken into consideration. Pension funds should also include these ESG risks in their risk management and decision-making.

### **No right or wrong**

By adopting a national implementation bill for the IORP II Directive, the Dutch Government ensured the transposition of appropriate measures for the Dutch market by 13 January 2019. The desired application of IORP II, however, needs to be focused on the specific characteristics of the pension fund, because there simply is no 'right/best way' answer due to the scope of the. Sharing best practices is the recommended scenario.

### **In conclusion – the value of the IAF**

IORP II strengthens the governance of pension funds with key functions. Focusing in on the additional requirement to set up an IAF: the challenge is to be of added value and not to be seen as an 'imposed obligation'. This added value lies in aspects such as the offering of an overview and

providing management insight of the most important risks (i.e. improving the level of 'being in control'), the provision of a positive impulse to the controlled operation and integrity (i.e. increased risk awareness) of a pension fund, and providing more transparency and greater comfort to stakeholders (and participants) through interaction with management, the other key functions and the external auditor.

The IORP II directive applies to all IORPs based in the EU. Mazars has significant experience and expertise to deliver internal audit services in this sector. Contact us for the peace of mind that you're compliant.

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#### Sources

<sup>1</sup>The Data Protection Officer and Compliance Officer are also part of this second line of defence, but are not mentioned in IORP II.

<sup>2</sup>See also: <https://www.iaa.org.uk/resources/audit-committees/governance-of-risk-three-lines-of-defence/>

<sup>3</sup>Concerning non-binding regulations from the DNB guidelines for key functions: <http://www.toezicht.dnb.nl/binaries/50-237328.pdf>

<sup>4</sup>On December 18, 2018, DNB published 'Q&A's' in which the interpretation of the key function holder screening is clarified: <http://www.toezicht.dnb.nl/3/50-237398.jsp>, <http://www.toezicht.dnb.nl/3/50-237400.jsp> and <http://www.toezicht.dnb.nl/3/50-237401.jsp>

<sup>5</sup>See for further explanation: <http://www.toezicht.dnb.nl/3/50-223998.jsp>. See also COSO Enterprise Risk Model: <https://www.coso.org/Documents/COSO-WBCSD-ESGERM-Executive-Summary.pdf>