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EC review of the IORP Directive

Solvency II for Pensions Working Party

Matthew Pearlman, Celene Lee, Jethro Green

Political background

Some names and faces



Political background

Another name and face



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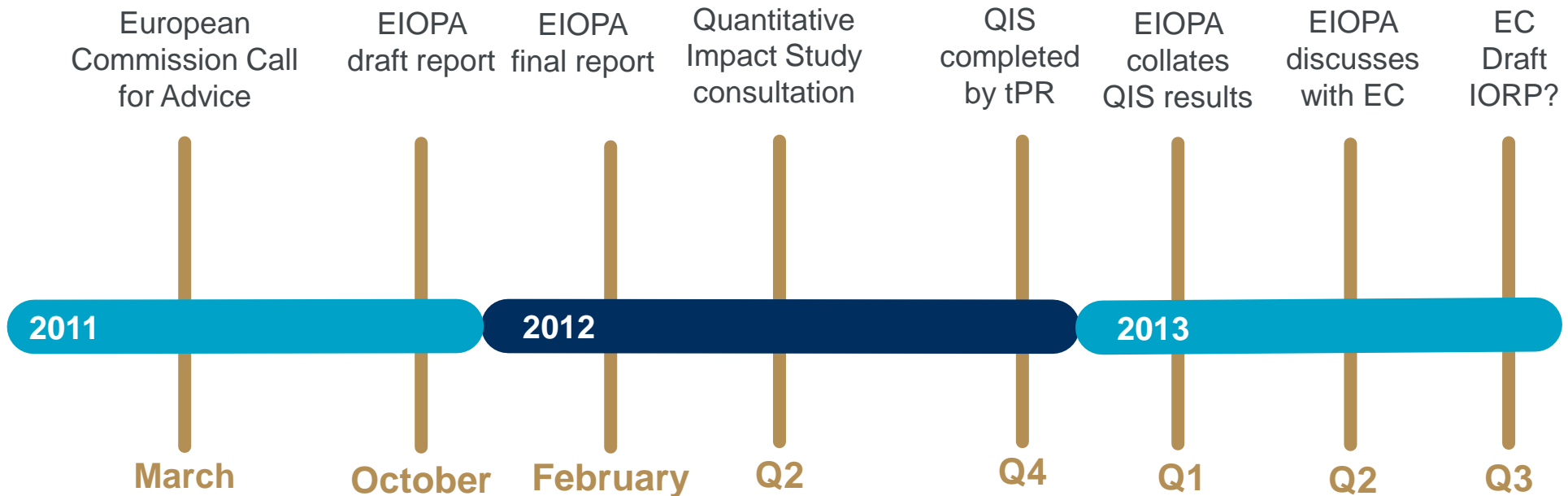
Political background

One possible compromise



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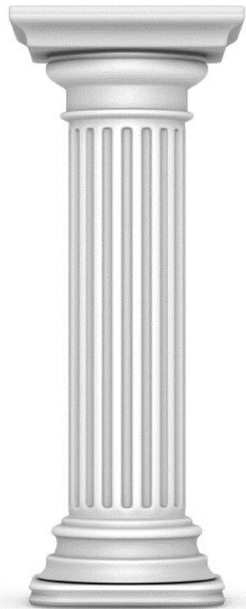
Where are we?



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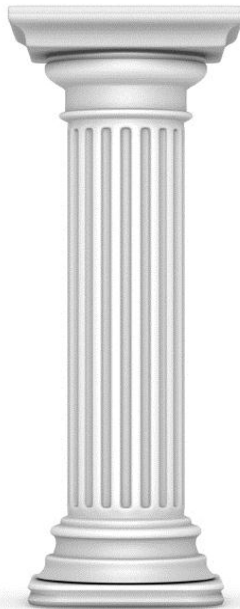
The three Pillars of Solvency II

1



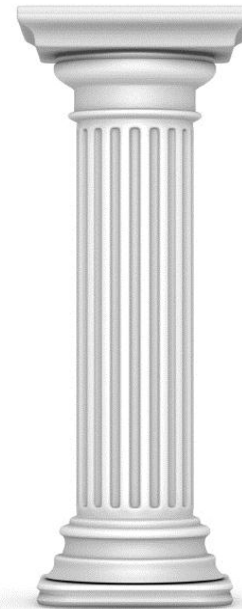
Solvency

2



Governance

3



Disclosure



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Quantitative Impact Study (QIS)

What is it

- An attempt to calculate “Solvency II”-style figures on a common and consistent basis for European defined benefit IORPs.

Timetable

- Launch in ~~May 2012~~ October 2012
- Finalise by ~~September 2012~~ January 2013
- Preliminary results (April 2013) followed by more detail later (“mid-2013”) and further consolation on sponsor support (report at “end June 2013”)
- Sponsor support etc “would have to be tested in follow up QIS exercises” (Insurers had 5 QISs)



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QIS – who took part

Table 3.1: Approaches to completing the QIS in participating countries			
		IORPs	Supervisor
Belgium		14	-
Germany	: Pensionsfonds	11	-
	: Pensionskassen	27	
Ireland		-	representative data
Netherlands		9	-
Norway		7	-
Sweden	: Pension funds	9 provided input	completed spreadsheet
	: Pension foundations	-	representative data
	: Art 4 insurer	1	-
United Kingdom			

The Holistic Balance Sheet

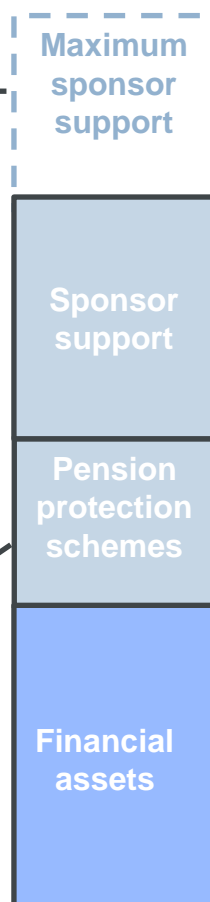
Options/Method:

- Calculate “market value” and “maximum” of sponsor support
 - Benchmark = Market value via two options (both based on 50% recovery on default):
 - (1) Probability distributions of future deficits (via various σ , ρ etc) and sponsor default probabilities
 - (2) Probability tree in which each year the sponsor may default or not default
 - Upper Bound or Maximum = 50% shareholder funds + deficit contributions + 33% of future company “cashflows”
- Shown as ancillary own funds

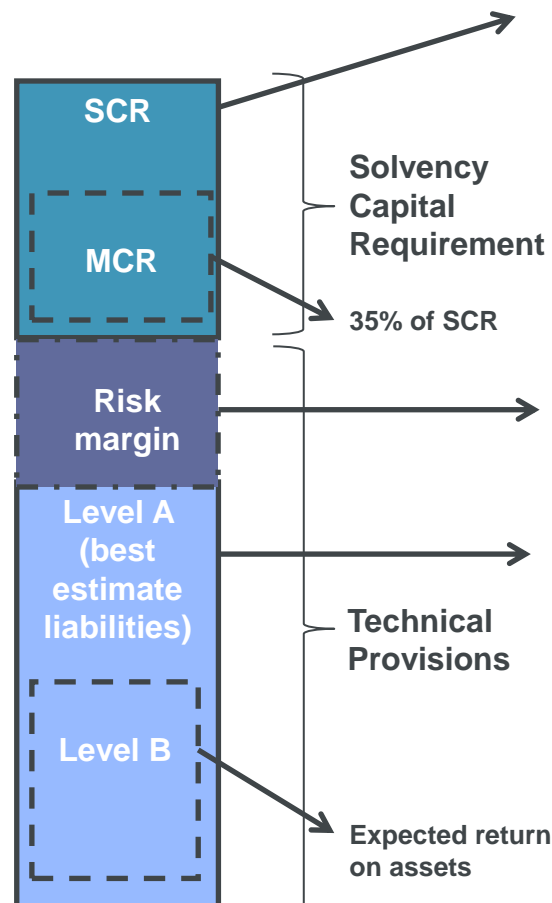
Options/Method:

- Expected PPS benefits allowing for company default probabilities
- Simplification option as per (2) above
- Include/exclude as asset
- Include/exclude in SCR calculation
- Interaction with sponsor covenant

Assets



Liabilities



Sum of range of shocks:

- Confidence level 99.5%, 97.5% or 95%
- Inflation/real risk treatment
- Equity dampener, duration adjustment
- Loss-absorbing benefits/security mechanisms (PPS, sponsor support)

Options:

- 8%
- None (but prudent TPs)
- Individual calculations

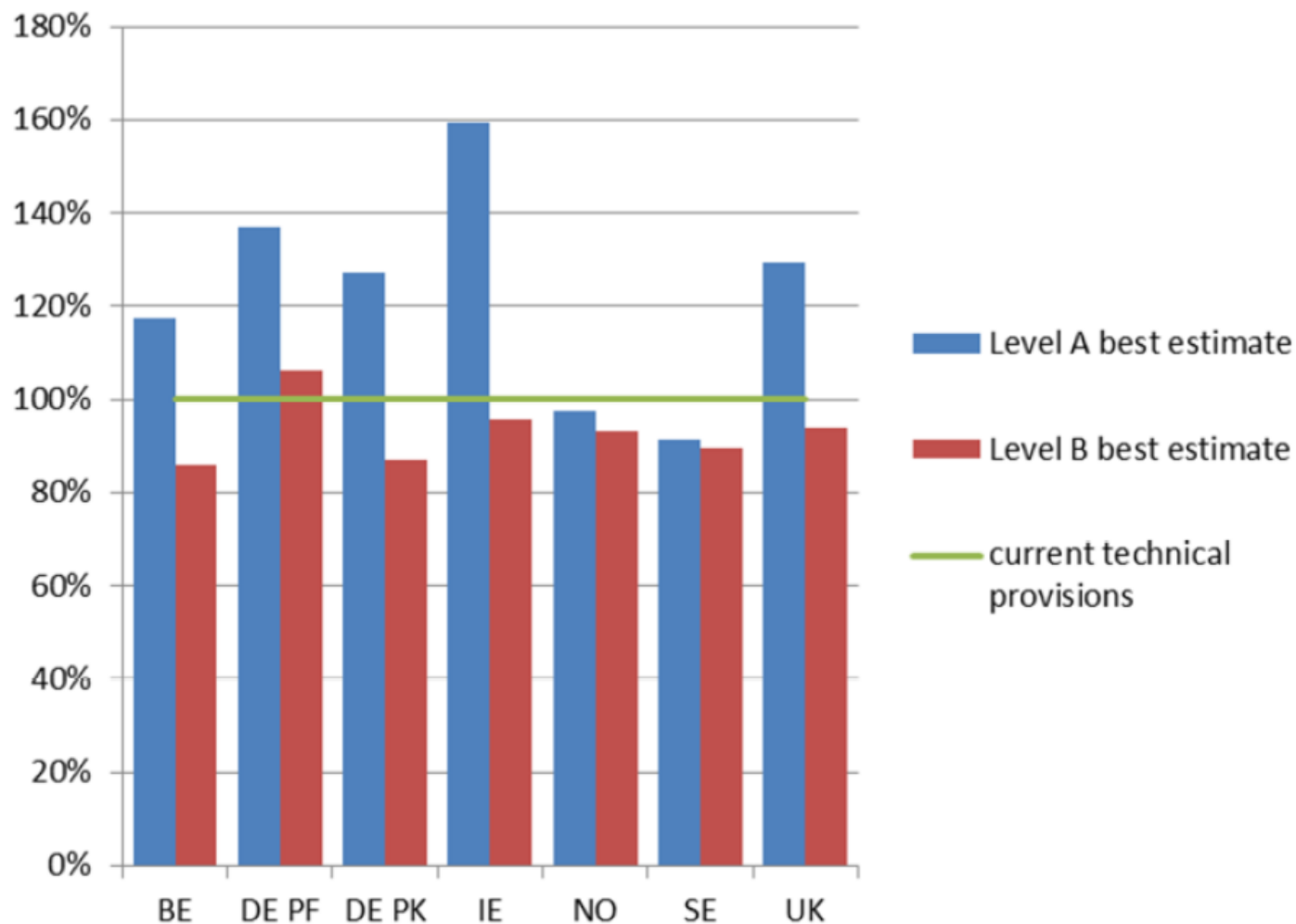
Swap curve less 35bps:

- Options on convergence methodology, counter-cyclical premium and matching adjustment)



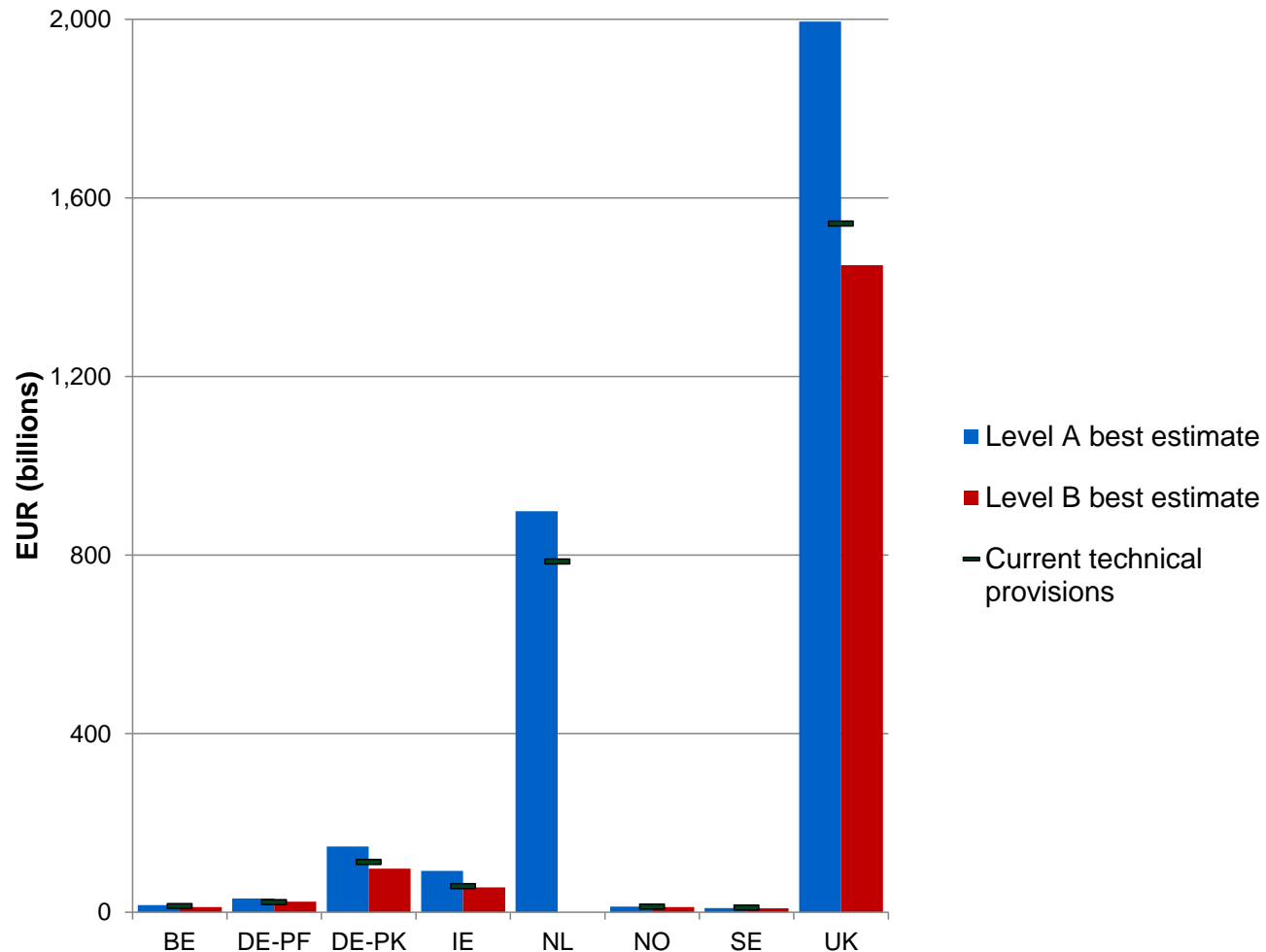
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TPs – Old World and New World



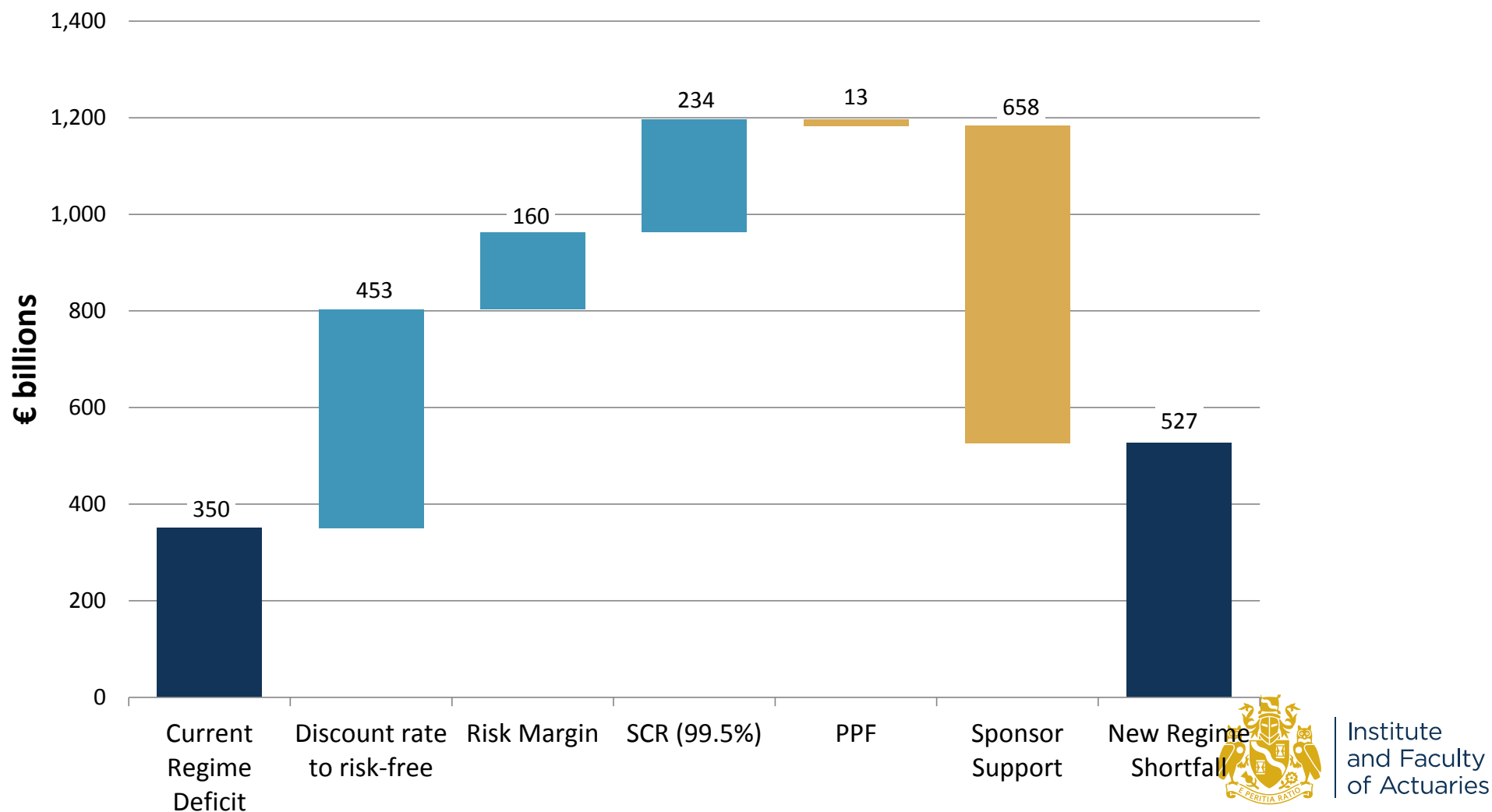
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TPs – unscaled

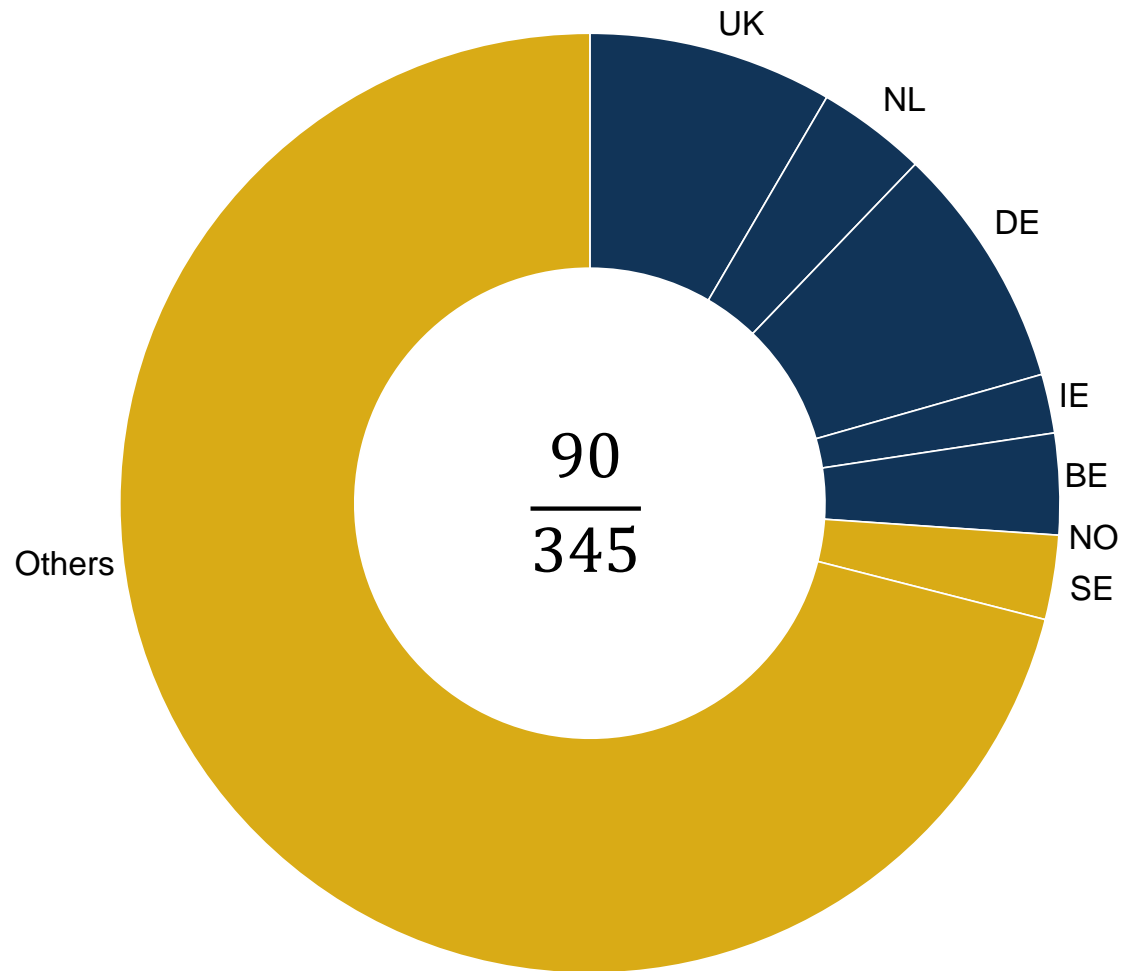


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UK's Holistic Balance Sheet

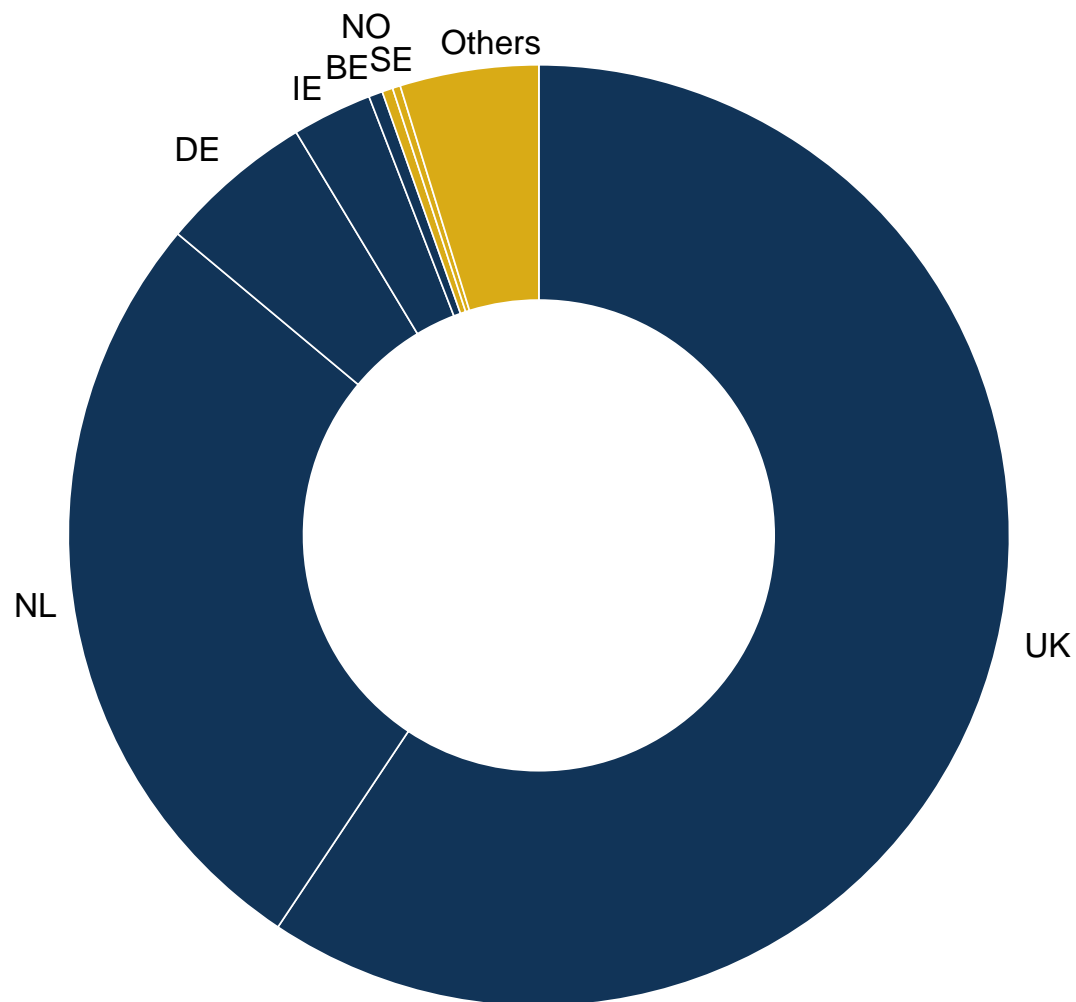


Qualified majority voting



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Or by technical provisions



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Sponsor support

Benchmark	Upper bound
Market valuation	Maximum support
£658 billion	£2,739 billion
As an asset	As ancillary own fund
True and fair view?	Aggregation

- *Proposals for revised specifications by end of June 2013 for future QIS*
- *6.50 “...the use of this method may materially misstate the value of sponsor support in the UK and therefore the figures mentioned above are highly uncertain...Until the further work on sponsor support is completed, the current results should be interpreted with caution as it is possible that the sponsor support figure will change considerably...”*

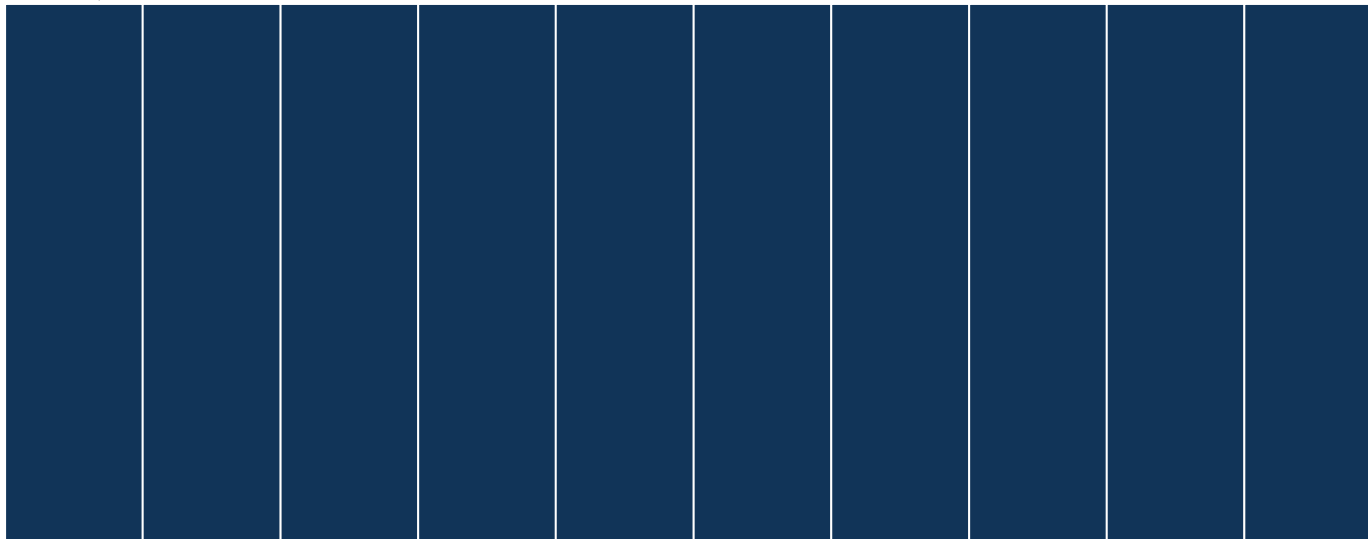


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Recovery plan

Actual (assume level, no discounting etc)

Can afford
in year 1

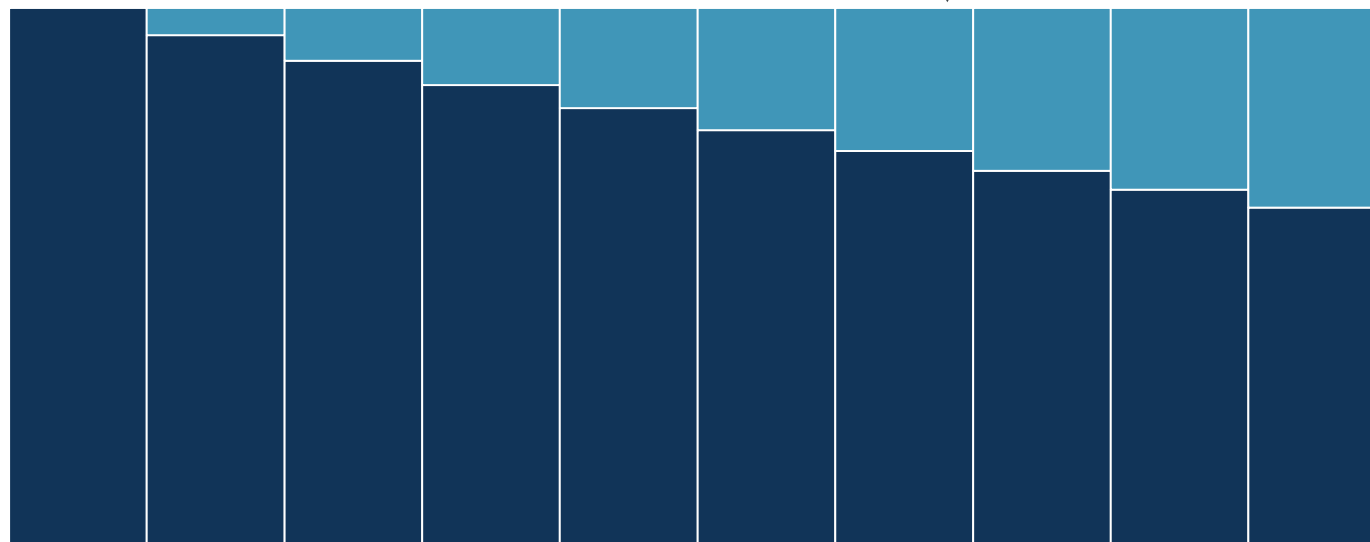


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Recovery plan

Allow for default

Allow for defaults
in later years = deficit



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Measurement of sponsor covenant

Key observations

- Parent company support / goodwill / intangible assets
- Same default probability (4.175%) for companies with credit of B and below
- For UK, unrated assumed to be BBB (0.24%)
- Broad brush recovery rate of 50% cap
- Definition of cashflows – considerable potential for interpretation and judgement



Measurement of sponsor covenant

Business valuator's view

- Market consistency – scheme can never sell its claim on a sponsor
- HBS 6.39 : average of 3 most recent year's cashflows
 - Definition of cashflows
- HBS 6.39 suggests the use of 33% of cashflow as an input
- Use of future business plans – EIOPA suggests if sufficient information from future business plans – these can be used but not for QIS.
- EBITDA less capital expenditure, ungeared tax and working capital movements “free cashflow used to support debt and equity” as recognised by most financial analysts
- Suggestion that detailed analysis only carried out if value is less than 3x HBS deficit



Measurement of sponsor covenant

Modeller's view – borrowing insurance concepts

- Market-consistent valuation methodology means that we do not need to make a direct estimate of the sponsor's probability of default, we only need to observe the market price of bearing that default risk.
- Assume pension fund is an unsecured creditor like other corporate debt-holders
- The sponsor's commitment can be a fairly complex form of cashflows:
 - Credit-risky and long-term
 - May be dynamic and path-dependent
 - Sponsor credit risk may be correlated with deficit size ('wrong-way risk')
 - Market-implied cost of sponsor credit risk may not be directly observable , etc.
- Requires market-based estimate of cost of exposure to default risk across all possible future circumstances that may arise over the period in which deficit contributions are made



Measurement of sponsor covenant

Key questions still unresolved

- HBS meant to be from a member's perspective
- Too optimistic
 - Not giving enough warning about level of insecurity faced by members
 - Not allow them options to seek alternative retirement income
- Too conservative
 - Scare-mongering
 - Leads to wrong decisions being made, e.g. transfer into personal pension market
- Whichever method is adopted, likely to require historic assessment of credit risks
- Systematic underestimate of defaults?



Limitations of QIS

- 18 variants but none on sponsor support
- UK ignores benefit reductions
- Ireland ignores sponsor support
- Netherlands has discretionary benefit reduction powers but ignored them
 - *“This means that the relevant items in the holistic balance sheet do not reflect the accurate value”*
- Distribution of results by scheme could point to significant weaknesses
- Risk margin set at 8%



First impressions

- 6.50 “...the use of this method may materially misstate the value of sponsor support in the UK and therefore the figures mentioned above are highly uncertain... the current results should be interpreted with caution as it is possible that the sponsor support figure will change considerably...”
- 8.14 “...the required calculations were very complex and extensive....certainly too costly for small pension schemes. It was also suspected...that the results are not representative.”
- 8.15 “...QIS outcomes depend on many assumptions. The 97.5% and 95% confidence levels are derived using an overly simplified method. ...If a new European prudential regime is introduced...the holistic balance sheet values [will change]...Many IORPs concluded that the results of this QIS are therefore not reliable and that **more QISs are needed...**”



Possible outcomes

More QISs

IORP 2016, PA 2017

Holistic balance sheet

10+ year transition

Sell equities
Buy bonds



Close future DB accrual

Pillars 2 & 3

EU sustainability agenda

Scope: benefit reductions

Regulator powers



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Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.



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