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New European Parliament, new European Commission, new solvency requirements for pension schemes?

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Agenda

- Overview of EIOPA consultation on solvency for IORPs
- Summary of six supervisory frameworks – with commentary
- Key points to note
- What are the next steps
- A few other things to bear in mind

EIOPA consultation - overview

- IORP II Directive excludes any new solvency capital requirements - much more work required
- 13th October 2014 EIOPA (the European pensions regulator) consulted on use of Holistic Balance Sheet (HBS)
- One of the main criticisms of 2013 ‘QIS’ was lack of information about regulatory responses
- Latest consultation contained six example supervisory frameworks – ranging from little change to SSFR to near full-consistency with Solvency II

Commission's stated objectives

- Market-consistent and risk-based supervisory framework
- Consistency with Solvency II
- Protection of members and beneficiaries
- Mobilise the financial sector to channel funds to long-term investments for sustainable growth
- Stimulate cross-border pension provision
- Similar level of overall protection for members in schemes of all countries irrespective of national security/benefit adjustment mechanisms (e.g. sponsor support (SS) and pension protection schemes (PPS))

Note re final bullet - variation in Member States' replacement ratios from first pillar (State) pension provision makes harmonising protection levels for second (and/or third) pillar provision a nonsensical objective

Scenario 1 – Solvency II for pensions

Funding target for financial assets

Solvency liabilities (best estimate cashflows discounted on a risk free rate plus an additional risk margin)

Additional funding requirement

Assets including SS can cover an additional funding 'buffer' in relation to risk of specified adverse experience/stress over the next year with a given probability

Recovery period

One year (or less) (broadly in line with current cross-border requirements in the UK)

tPR action in case of failure

Transfer of solvency liabilities to another entity

Summary of framework

Largely consistent Solvency II (except for discretionary benefits, which are not included under this framework)

Aims to minimise reliance on benefit reduction mechanisms and SS and therefore provide a very high level of security for member benefits

Desirable to the EC?

Fulfils the EC's objective of a market-consistent, risk-based solution that is consistent with the insurance framework and provides a high level of security for members (providing that the funding requirements can be met without causing sponsor insolvency)

Scenario 1 – Key Issues

Impact on sponsors and PPSs	These funding requirements are substantially higher than the current requirements for many MSs. This would increase the cost of funding, which would discourage further provision and potentially lead some sponsors to become insolvent if they cannot meet these higher requirements. This would subsequently impact on any PPSs and member benefits
Long-term investments	Schemes would be highly incentivised to invest almost entirely in low-risk, liquid, closely matched assets. This could impact the market-price for such assets (further increasing the cost of funding) and discourage schemes from investing in longer-term growth assets such as infrastructure
Cross-border activity	While this framework may be consistent across the EU, it is difficult to believe employers would be more willing to set up cross-border plans in an environment where funding costs are so high

Scenario 2 –SSFR + additional risk-based reporting

Funding target for financial assets

Best estimate liabilities (best estimate cashflows discounted on using expected return on assets)

Additional funding requirement

Assets including SS can cover an additional funding 'buffer' (relative to best estimate liabilities) in relation to risk of specified adverse experience/stress over the next year with a given probability

Recovery period

Pension scheme sets up a recovery plan in agreement with the sponsor (in line with current requirements)

tPR action in case of failure

Not specified, but likely to be in line with current tPR powers in the UK

Summary of framework

Financial assets must cover best estimate liabilities and assets including the value of SS must cover an additional "buffer". While the base coverage is "best estimate", the example allows MSs to impose additional prudential requirements

Schemes would also have to report the results of the HBS using risk-free discount rates to tPR and members to improve transparency

Desirable to the EC?

All EU schemes report results on a consistent measure, which will allow them to be compared more readily

This scenario gives flexibility to individual MSs to build in suitable prudential requirements above the minimum where appropriate

Scenario 2 – Key Issues

Benefits of additional reporting requirements?	The requirement to report the HBS on a risk-free basis to tPR and members with no attaching regulatory response seems to add limited value. It is not clear how the highly technical HBS would be useful to members – it is difficult to understand for many professionals and the implications are not obvious. Many schemes will be dubious of the benefits of this additional measure in the context of their wider risk management
Value of change	This revised framework appears to result in similar outcomes to the existing framework (but with risks more explicitly stated). It is not clear what the advantage of this proposal is over the current regime. It would not achieve stated aims of a market-related, risk-based solution that is consistent with the insurance framework
Cross-border activity	Due to the likelihood of different provisions applying in different MSs, the consultation envisaged that the full funding requirement would be still be enforced under this scenario and there would be no real incentive for increased cross-border activity

Scenario 3 – HBS+

Funding target for financial assets

Best estimate liabilities (best estimate cashflows discounted on using expected return on assets)

Additional funding requirement

Assets including SS and PPS can cover an additional funding 'buffer' (relative to solvency liabilities) in relation to risk of specified adverse experience/stress over the next year with a given probability

Recovery period

Pension scheme sets up a recovery plan in agreement with the sponsor (in line with current requirements)

tPR action in case of failure

Flexible approach to restore sustainability

Summary of framework

Very similar to scenario 2 except:

The higher additional funding requirement (to be covered by assets, the value of SS and any PPSs) is based on solvency liabilities plus a risk buffer

tPR can take action on reported results of HBS to demand modification to make the scheme "sustainable"

Desirable to the EC?

Advantages similar to scenario 2; plus greater consistency with SII but still gives MSs flexibility to allow for additional prudential requirements. Whilst solvency is assessed on best estimate, the framework is there to encourage funding on a full solvency basis. Overall, this gives a higher level of harmonisation across the EU

Scenario 3 – Key Issues

Impact on sponsors and PPSs	These funding requirements are potentially substantially higher than the current requirements for many MSs for some schemes, particularly where the level of SS is low compared to solvency liabilities and these is no PPS
Long-term investments	Schemes would be incentivised to invest more heavily in low-risk, liquid, closely matched assets to minimise the additional funding requirement. This could impact the market-price for such assets (further increasing the cost of funding) and discourage schemes from investing in longer-term growth assets such as infrastructure
Cross-border activity	Under this framework, EIOPA note that they are likely to maintain the 100% funding requirement for cross-border schemes. Whether cross border activity increases is likely to depend on the supervisory response of different MSs to correcting any “underfunding of the HBS”

Scenario 4 – HBS + benefit reductions

Funding target for financial assets

Best estimate liabilities (best estimate cashflows discounted on using expected return on assets)

Additional funding requirement

Assets including SS and PPSs can cover an additional funding ‘buffer’ (relative to solvency liabilities but allowing for potential benefit reductions) in relation to risk of specified adverse experience/stress over the next year with a given probability

Recovery period

Pension scheme sets up a recovery plan in agreement with the sponsor (in line with current requirements)

tPR action in case of failure

Not specified, but likely to be in line with current tPR powers in the UK

Summary of framework

Similar to scenario 3 above except:

An allowance in the additional funding requirement for benefits to be reduced on sponsor default

There is no requirement for additional pillar 2 reporting and potential supervisory action

Desirable to the EC?

This scenario gives an EU wide, risk-based approach to funding requirements and is moving closer to SII (but it may not be viewed as fully market-consistent as risk-free rates are not used for the funding target)

Scenario 4 – Key Issues

Impact on sponsors and PPSs	While the additional funding requirements are likely to be mitigated by allowance for potential benefit reductions on default (in some MSs), this scenario could result in increased funding requirements, particularly for schemes with low SS values as compared to solvency liabilities. This, in turn could lead to a short to medium term increase on claims to PPSs
Long-term investments	Schemes could be incentivised to invest more in low-risk, liquid, closely matched assets. This could impact the market-price for such assets (further increasing the cost of funding) and discourage schemes from investing in longer-term growth assets such as infrastructure
Cross-border activity	While this framework may be consistent across the EU, it is difficult to believe employers would be more willing to set up cross-border plans in an environment where funding costs are higher

Scenario 5 – Solvency funding

Funding target for financial assets

Solvency liabilities (best estimate cashflows discounted on a risk free rate plus an additional risk margin)

Additional funding requirement

N/A (but HBS reportable to tPR, allowing for additional "buffer" against risk, SS, PPSs and potential benefit reductions)

Recovery period

Pension scheme sets up a recovery plan in agreement with the sponsor (in line with current requirements)

tPR action in case of failure

Flexible approach to restore sustainability

Summary of framework

Funds solvency liabilities with financial assets (providing a high-level of security if it does not result in sponsor insolvency). It is broadly similar to scenario 1, without the explicit additional funding requirement for risks – these will simply need to be "reported".

MSs have option to impose additional buffer requirements in the funding target for financial assets

Desirable to the EC?

Fulfils EC's objective of a market-consistent, risk-based solution and provides a high level of security for members (providing that the funding requirements can be met without causing sponsor insolvency). It also provides increased (but not complete) consistency with the insurance framework

Scenario 5 – Key Issues

Impact on sponsors and PPSs	These funding requirements are substantially higher than the current requirements for many MSs. This would make the cost of funding schemes higher, which would discourage further provision and potentially lead some sponsors to become insolvent if they cannot meet these higher requirements. This would subsequently impact on any PPSs and member benefits
Long-term investments	Pension schemes would be highly incentivised to invest almost entirely in low-risk, liquid, closely matched assets. This could impact the market-price for such assets (further increasing the cost of funding) and discourage schemes from investing in longer-term growth assets such as infrastructure
Cross-border activity	While this framework may be consistent across the EU, it is difficult to believe employers would be more willing to set up cross-border plans in an environment where funding costs are so high

Scenario 6 – no change but additional risk reporting

Funding target for financial assets
Consistent with current SSFR

Additional funding requirement
N/A (but HBS reportable to tPR, allowing for additional “buffer” against risk, SS, PPSs and potential benefit reductions)

Recovery period
Consistent with SSFR

tPR action in case of failure
Flexible approach to restore sustainability

Summary of framework

Identical to that under IORP I, except schemes must disclose HBS to tPR, which can take some form of action if this assessment demonstrates that the scheme’s pension promise is “unsustainable” (although it is unclear what exactly this means)

Desirable to the EC?

Does not make any significant changes to the current requirements. But, the introduction of a consistent HBS assessment across the EU might be seen as a stepping stone to further future changes. The EC may view this as the easiest option to implement in the face of opposition from MSs

Scenario 6 – Key Issues

Ill-defined supervisory responses	This scenario does not make clear what action tPR could take to restore “sustainability”. By definition, the HBS takes into account all potential assets and liability reduction mechanisms available to a scheme, so it is difficult to see what positive action could be taken as a result of this assessment to remedy a deficit
Cross-border activity	Given the current low levels of cross-border activity, maintaining the status quo is unlikely to fulfil the EC’s objective of stimulating more cross-border pension provision

Potential increase in funding for UK?

Least impact

Scenario 6

Scenario 2

Scenario 4

Scenario 3

Scenario 5

Scenario 1

Greatest impact

Key points to note

Several of these scenarios suggest that financial assets would only have to cover a “best-estimate” of liabilities based on expected asset returns. However, all of these scenarios would grant MSs the right to impose further prudential requirements. In the UK, we believe tPR would be almost certain to do so given their stated objective to protect the PPF (although this would need to be balanced against tPR’s other objectives)

Some of the scenarios allow for potential benefit reductions on sponsor default in HBS for some purposes (e.g. scenarios 3, 4, 5 and 6). It is not clear how this would affect results in the UK

The HBS is EIOPA’s preferred solvency capital assessment framework, but it is not the only option

What happens next?

QIS – May/June

150 – 200 (?) pages

Cut-down version from tPR (10 - 15 pages?)

HMG keen for schemes/sponsors to respond

Stress-test

Other things to bear in mind

EIOPA budget has been fettered – but no reason to consider will drop HBS work

Gabriel Bernardino (EIOPA chair) stepping down at end of year?

EIOPA continues work on other things

- Report on costs and charges of IORPs (feed into ‘KIID’ debate)
- Statistical database for pensions
- Report on investment options for occupational DC scheme members
- Consultation on good practices on individual transfers of supplementary pensions

IORP II work continues; in Parliament – to reach trilogue end of 2015 and law by April/May 2016

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