

### Hot Topic 3

## Solvency II for Pensions: EIOPA advice and principles for pension fund risk management

Speaker: Celene Lee

Jethro Green

Graham Collins

The solvency II for Pensions working party



## Research Working Party (RWP)

- To understand the impact the proposed IORP II (widely known as “Solvency II for pensions”) will have on occupational pension schemes in the UK
- Celene Lee (Chair), Eimear Kelly, Graham Collins, Jethro Green, Jon Hatchett and Matthew Pearlman
- A separate group prepared Profession’s formal response (NAPF, ACA, SPC also responded\*) – although some members of RWP contributed

### Disclaimer

- Any views expressed in this presentation are those of the presenters (not our employers or the Actuarial Profession)

## Agenda

The potential application of Solvency II to pensions is set to change the pensions landscape over the next few years.

This session will explore the key principles set out in EIOPA's advice on the review of the IORP directive, in particular the introduction of a Holistic Balance Sheet.

- Background
- Holistic balance sheet
- Knock-on effects
- Next steps

The Working Party wishes to explore with the audience how a HBS approach could be adopted in a practical and workable manner for the benefit of pension risk management (irrespective of how political decisions influence any final legislation) and consider whether this approach is beneficial to key stakeholders.

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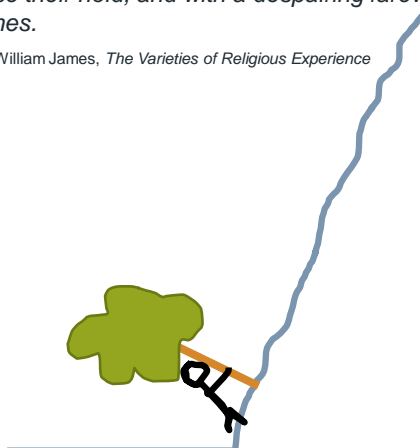
\* all available at [www.eiopa.europa.eu](http://www.eiopa.europa.eu)

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*A story which revivalist preachers often tell is that of a man who found himself at night slipping down the side of a precipice.*

*At last he caught a branch which stopped his fall, and remained clinging to it in misery for hours. But finally his fingers had to loose their hold, and with a despairing farewell to life, he let himself drop. He fell just six inches.*

William James, *The Varieties of Religious Experience*



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# Key elements

## Current regime

- 2003 IORP Directive → Pensions Act 2004 (SSF, TP etc)

## EIOPA

- Technical (not political?) independent advisor to the European Commission
- Supervisor for insurance and occupational pensions schemes (tPR work with)
- Responds to Commission's "call for advice" after stakeholder consultation

## Solvency II

- Insurers regime from January 2013, 2014 ?!
  - Pillar 1: Funding, Capital
  - Pillar 2: Risks, Controls
  - Pillar 3: Reporting, Disclosure
- What elements are transferable/amendable to IORPs

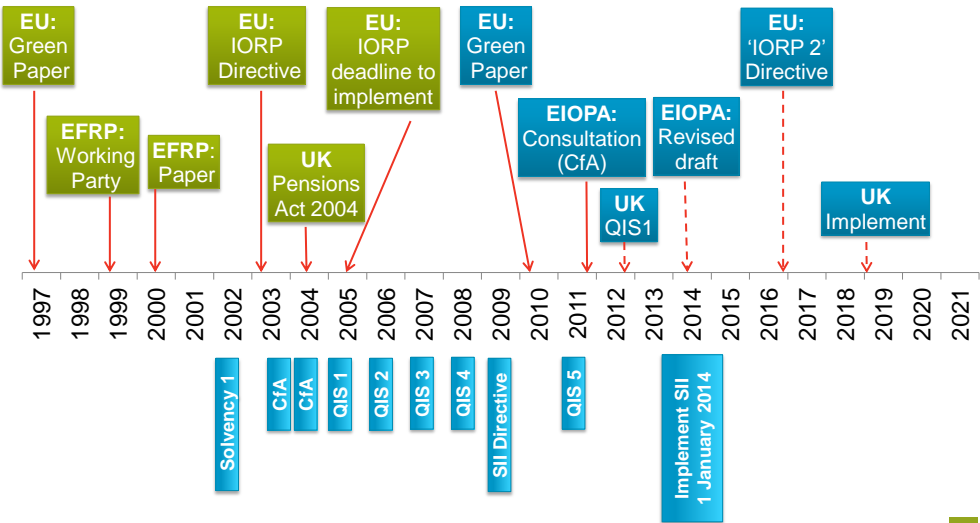
### Jargon Buster:

IORP:	Institutions for Occupational Retirement Provision
TP:	Technical provisions
tPR:	The Pensions Regulator
SSF:	Scheme specific funding
EIOPA:	European Insurance and Occupational Pensions Authority

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# History

EFRP:	European Federation for Retirement Provision (ie EU NAPF)
CfA:	Call for Advice
QIS	Quantitative Impact Study



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## European thinking

- Commission's reasons for review of IORP directive (plus harmonisation):
  - Simplify the setting up of cross border pension schemes (ie >84!)
  - Allow IORPs to benefit from risk-mitigation techniques
  - Modernisation of regulation for DC schemes

2012 EU snippets	
23 January	"As the European authority for both occupational pensions and insurance, we will take a consistent approach to both sectors. But consistent does not mean identical." - Speech to Dutch pension funds, EIOPA
15 February	Final EIOPA advice to Commission published
1 March	"Although we will draw on the approach of Solvency II, there is no question of 'copying and pasting' this approach onto the pension funds sector." Public Hearing in Brussels, Commission
25 April	"I think the commission will push the issue away in a soft kind of way. They will say: 'We will still do this but it will be some time in the future and for now we will concentrate on pillars two and three.' - Personal view of Commission employee

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## Consultation document

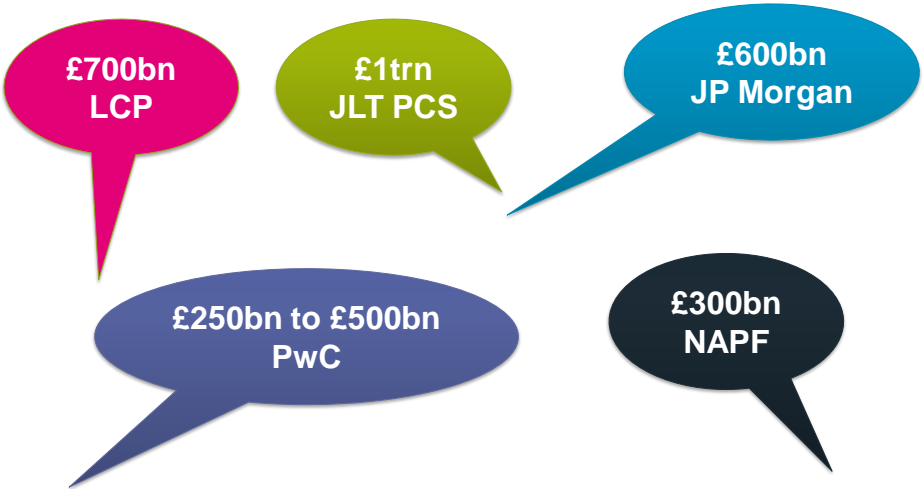
EIOPA's Call for Advice report: 515 riveting pages.....

Scope and definitions	CfA 1: Scope of the IORP Directive CfA 2: Definition of cross-border activity CfA 3: Ring fencing CfA 4: Prudential regulation and social and labour law
Quantitative requirements	CfA 5: Valuation of assets, liabilities and technical provisions CfA 6: Security mechanisms CfA 7: Investment rules CfA 8: Objectives and pro-cyclicality
Governance and other qualitative requirements	CfA 9: General principles of supervision, scope and transparency and accountability CfA 10: General supervisory powers CfA 11: Supervisory review process and capital add-ons CfA 12: Supervision of outsourced functions and activities CfA 13: General governance requirements CfA 14: Fit and proper CfA 15: Risk management CfA 16: Own risk and solvency assessment CfA 17: Internal control system CfA 18: Internal audit CfA 19: Actuarial function CfA 20: Outsourcing CfA 21: Custodian / depository <div>Not unimportant, just beyond today's scope</div>
Disclosure requirements	CfA 22: Information to supervisors CfA 23: Information to members / beneficiaries

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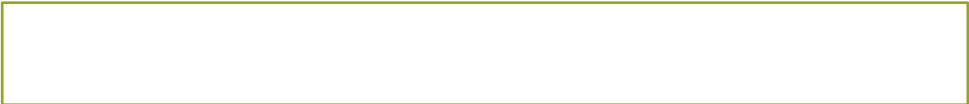
# Some big numbers



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# Holistic Balance Sheet

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## Liabilities 1: Best estimate of liabilities

### EIOPA advice:

Technical provisions should be:

- Market consistent
- No allowance for own credit standing

Start with best estimate of liabilities

### Key issue:

- Discount rate
  - Risk free ("Level A")
  - Expected return on assets ("Level B")



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## Liabilities 1: Best estimate of liabilities (cont)

### EIOPA advice:

Technical provisions should include:

- All expected payments
- eg future expenses, salary increases

### Key issue:

- Treatment of discretionary / conditional increases
- Include in Technical Provisions and then allow as an adjustment to the capital required?



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## Liabilities 2: The risk margin

### Solvency II for insurance:

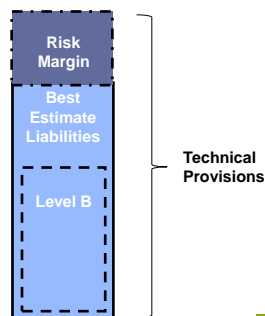
The risk margin reflects the cost of holding capital. For liabilities which cannot be matched perfectly, the addition of the risk margin to the best estimate should equal the price required for transfer to willing buyer.

### EIOPA options:

- Explicit ‘adverse deviation’ margin  
(similar to current IORP, but explicit value placed on difference from best estimate)
- Explicit ‘solvency II’ margin  
(transfer of liabilities/cost of capital)
- No risk margin

### Key issue:

- Should there be a risk margin? If so, is it just a margin for prudence, or follow cost of capital approach?



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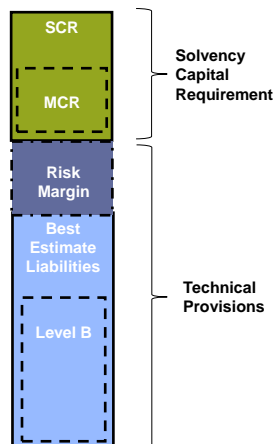
## Liabilities 3: Capital requirement

### EIOPA advice:

Additional capital to provide additional security. Solvency II for insurers worked out using a “stressed” balance sheet.

### Key issues:

- Confidence level / time horizon
- MCR as well as SCR
- Benefit reduction mechanisms
- Risk mitigation / management actions
- Pro-cyclicality / asset smoothing (see later)



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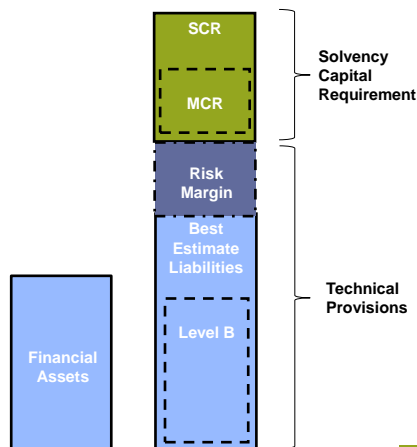
## Assets 1: Financial assets

### EIOPA advice:

Pretty self-explanatory

### Keys issues:

- Valuation of assets
  - No issues
- Other considerations
  - Rules on investment choices for IORPs (eg employer related investment)
  - Governance issues (eg prudent person principle and competence for trustees or equivalent)
  - Outside the scope for today



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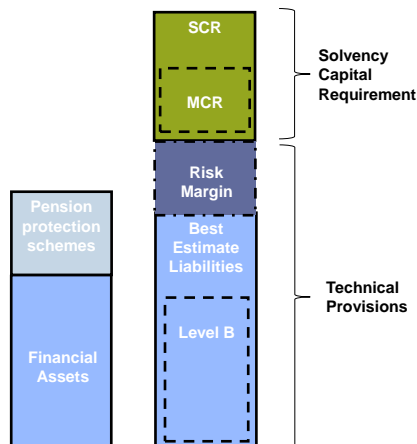
## Assets 2: Pension protection schemes

### EIOPA advice

- A contingent asset – or an adjustment to employer covenant?
- EIOPA ruled out adjustment to confidence level for reasons of harmonisation.

### Key issue:

How can the PPF reduce capital requirements, when by definition benefits will not be paid in full?



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# Assets 3: Employer support

Three main forms in the UK:

- Increase in contributions / recovery plan
- Contingent assets
- Claims on the sponsor on discontinuance

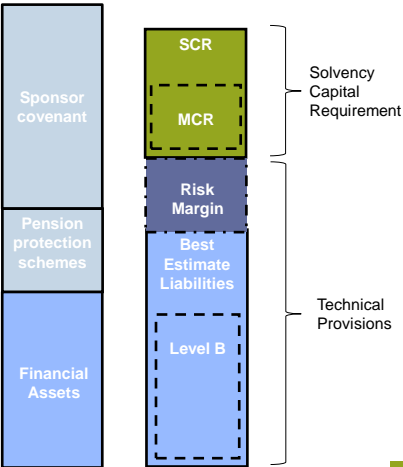
**Covenant:**

Ability *and* willingness to pay

**Key issues:**

- How to measure it\*
- What happens if not enough?
- Is single value useful?

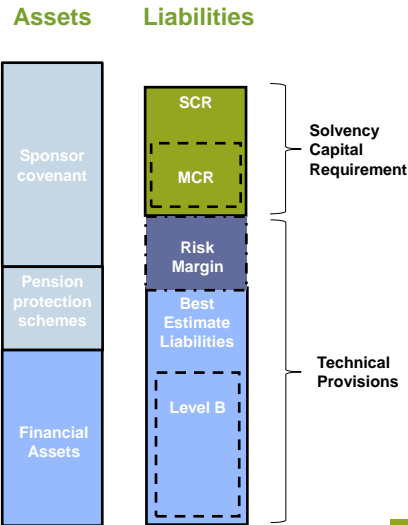
\* Profession commissioning up to £40k research project to present in January 2013



# The Holistic Balance Sheet

**EIOPA's invention:**

- Provide for common level of security for IORP benefits
- Deal with diverse security mechanisms employed by IORPs across Europe
- Act as supervisory tool



## Remedial actions

### Solvency II for insurers

#### Measures:

- SCR fail - 6\* month plan
- MCR fail - 3 month plan

#### Supervisor:

- Approve recovery plan
- Prevent free asset disposal
- Withdraw authorisation
- "Ladder of intervention"

#### Recovery plan:

- Increase eligible funds
  - Raise capital - Rights issue
  - Convert loan to shares
- Reduce risk profile
  - Cease (perhaps temporarily) new business
  - Sell part of business
  - Change reinsurance arrangements
  - Change investment strategy

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\* longer in exceptional circumstances

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## Remedial actions

### "IORP II"

#### EIOPA's options:

- Current IORP Directive (even if go to HBS)
- Solvency II – HBS corrected in "short-term"
- "Short-term" up to TP (longer for full HBS)

#### EIOPA's views (very abridged):

- "set or allow longer periods\*\* ...for IORPs. ... 15 years to be possible... short as is reasonably affordable." 10.3.192
- "very significant transitional period [3<sup>rd</sup> option above] if ...significantly different to the current practice ... higher funding targets were required." 10.3.217

#### Recovery plan:

- Increase eligible funds
  - No shareholders to raise funds (sponsor rights issue?)
  - Contingent assets or more sponsor capital = 'zero sum' game with HBS
- Reduce risk profile
  - Change reinsurance arrangements (buy-in/buy-out, TVs)
  - Change investment strategy
  - Underfunded on TP lead to "withdrawal of authorisation" and wind-up?

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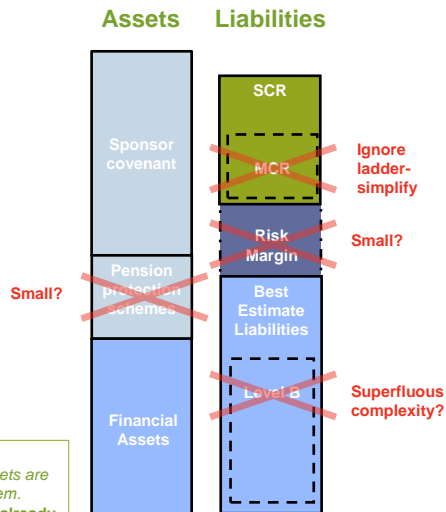
\*\* exceptional circumstances?

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# A possible simple route for the UK

- **Liabilities**
  - No Risk Margin, No MCR, No Level A / Level B
  - 'Risk free' discount rate
- **Assets**
  - No PPF
  - Tier 1: Financial assets
  - Tier 2: Employer support (50% maximum of total assets)
- **Other**
  - Future service only
  - Return to discretionary increases?
  - Recovery plans of up to 15 years

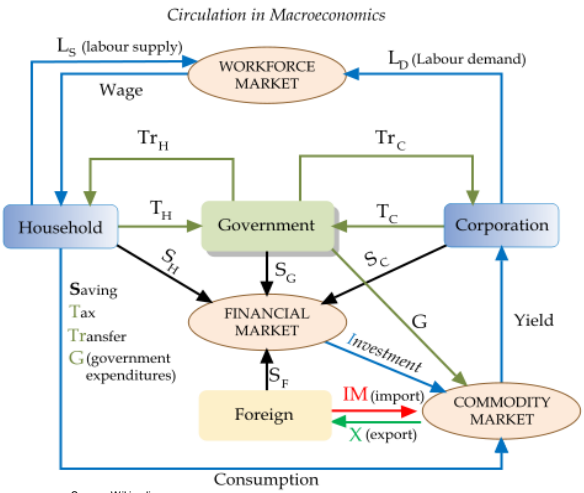
Perhaps describe as....  
A regime where the risks that a trustee runs by investing in mismatched assets are permitted according to the sponsor's ability and willingness to underwrite them.  
...which is maybe relatively close to where we are already



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## Knock-on effects

# Macroeconomics



Source: Wikipedia

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## Financial/Commodity markets:

- Cashflows don't (dis)appear
- Households/companies capital via different entry points

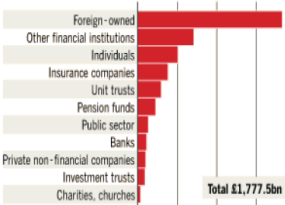
## Workforce market:

- More or less pensions actuaries needed?!
- Labour mobility (tax harmonisation?)

# Markets - Equity

Market value of UK quoted shares

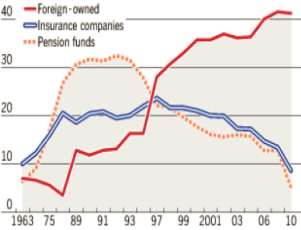
By sector of beneficial owner, Dec 31 2011 (£bn)



Source: Office for National Statistics

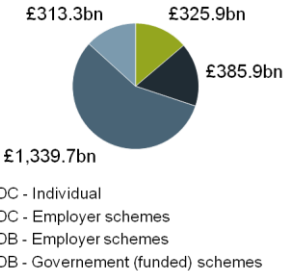
Percentage of total market value

By sector of beneficial owner (at year-end)



Liabilities at 31 December 2010

Source: O/N/S



- Are DB funds still an important market participant?
- Kay Review – who will be active in future lobbying?
- DC members funds are 'new' capital\*, but less engagement? and lower level?

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\* £22.6bn in contributions 2010

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# Markets - Bonds

Table 7.1 | Average asset allocation in total assets<sup>99</sup>

	Extended Purple 2006	Extended Purple 2007	Extended Purple 2008	Purple 2009	Purple 2010	Purple 2011
Equities	61.1%	59.5%	53.6%	46.4%	42.0%	41.1%
Gilts and fixed interest	28.3%	29.6%	32.9%	37.1%	40.4%	40.1%
Insurance policies	0.9%	0.8%	1.1%	1.4%	1.4%	1.6%
Cash and deposits	2.3%	2.3%	3.0%	3.9%	3.9%	4.1%
Property	4.3%	5.2%	5.6%	5.2%	4.6%	4.4%
Other Investments						
- 'Other'	3.1%	2.5%	3.8%	4.5%	5.4%	6.3%
- Hedge funds	N/A	N/A	N/A	1.5%	2.2%	2.4%

Source: PPF / The Pensions Regulator

- Trend to bonds with ageing schemes – IORP II accelerate?
- Index-linked gilts supply compared to £1,436bn buy-out liabilities\*
- Swaps / Forwards / Options market fill gap? % short v long? Inflation-linked limited



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**Interest rate derivatives (OTC) : 31 December 2011**

Nominal amounts outstanding	£27,936bn
Gross market value	£1,066bn

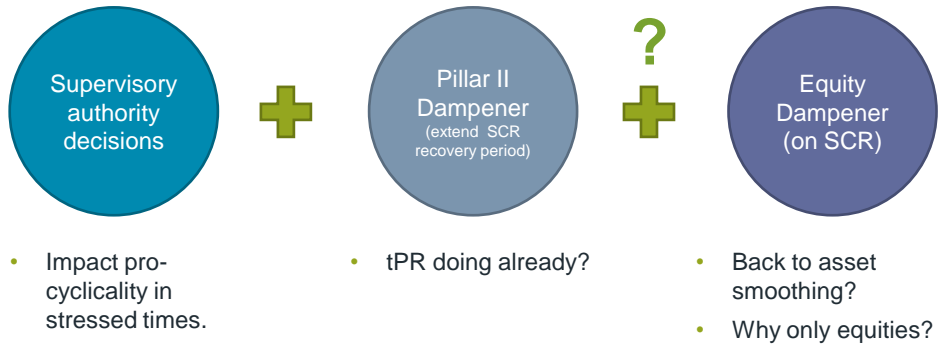
Source: bis.org [\$ converted to £]

\* Purple Book at 31 March 2011

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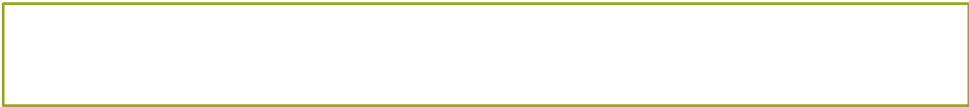
# Pro-cyclicality

- Vicious circles/intersections:
  - Asset volatility, Forced sales, Company support weakened, Short-term versus long-term
- Borrowing from Solvency II EIOPA proposes...



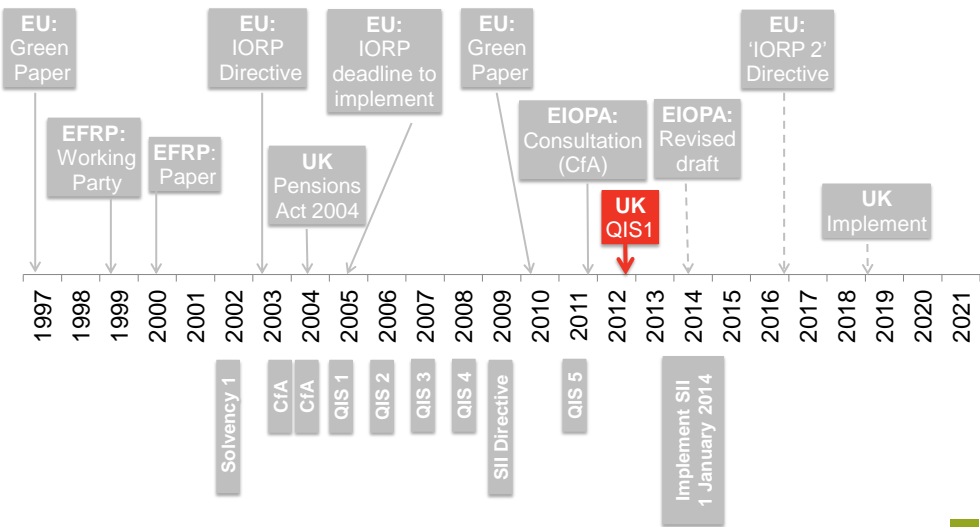
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# Next steps

## Timeline



## Quantitative Impact Study

UK  
QIS1

### Timetable

- Launch in ~~May 2012~~ Winter 2012 ?
- Finalise by ~~September 2012~~ Q1 2013 ?
- Consultation on QIS published expected in June 2012 – another 500 pages...
- Insurers had 4 QISs

### Method / Coverage

- UK, Netherlands, Germany, Ireland, Sweden, Belgium and Portugal
- All UK schemes **OR** largest schemes to get 80% coverage **OR** Pensions regulator/PPF
- Sponsor covenant method

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## Key points

- QIS is next step (including consultation)
- IORP II is likely to arrive in some form in next 5 to 10 years
- Uncertainty exists – more documents/discussion to come
- Could be as substantial a “fall” as some say....
- ... or might just be a mere “six inches”
- Knock-on effects of importance



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## Questions or comments?

Is HBS a good idea?

Will it happen?

Biggest concerns?



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## Talking points

### PPF

- Only value at default (maybe past 99.5%?) and not full benefits

### Employer covenant

- Measuring
- 1 in 200 event might imply many companies bust?

### Time horizon/probability level for analysis

- 1 year appropriate? Frequency of calculation

### Don't forget DC

- Key Information Document (KID)
- Operational risk capital

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