

Current Issues in Pensions - March 2012

UK Pensions and Europe



EC's review of the EU-wide framework for IORPs

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What is it all about?

- First IORP (Institutions for Occupational Retirement Provision) Directive was adopted by the EU in 2003. It governs the activities and supervision of all occupational pension schemes except State underwritten schemes and unfunded schemes
 - Prudent person rule
 - Requirement to investment mostly in regulated markets
 - Full funding of technical provisions with temporary deficits allowed for non-cross border schemes
 - Member States required to implement by 23 September 2005
- As a result the Pensions Act 2004 introduced the statutory funding objective, and the scheme specific funding regime.
- In 2010 the Internal Markets DG of the European Commission announced that it was intending to review the IORP Directive and that **Solvency II would be the starting point**
- In April 2011, the EC asked EIOPA (European Insurance and Occupational Pensions Authority) for advice on an EU-wide legislative framework for IORPs.

What is it all about?

- EIOPA published a consultation document on 25th October 2011, the consultation closed on 2 January 2012
- UK Actuarial Profession submitted a comprehensive response
- In a speech on 23rd Jan the EIOPA chairman stated:
“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.”
- February 15th EIOPA published final advice to the EC on the IORP Directive
“The Commission will, in 2012, present a legislative proposal to review the IORP directive. The aim of the review is to maintain a level playing field with Solvency II and promote more cross-border activity in this field and to help improve overall pension provision in the EU. This will help address the challenges of demographic ageing and public debt.”
- On 1 March 2012 a public hearing was held in Brussels on the revision of the IORP Directive.

What is the aim of the new IORP?

EC gave three reasons for reviewing the IORP directive

- To simplify the setting up of cross-border pension schemes
- Propose measures that would allow IORPs to benefit from risk-mitigation techniques
- Modernisation of regulation for DC schemes

The Commission also aimed “to attain a level of harmonisation where EU legislation does not need additional requirements at national level”

The Commission’s view is that EIOPA’s advice “should endeavour to maintain consistency across financial sectors ... the general layout of the system should, to the extent necessary and possible be compatible with life assurance [Solvency II]”.

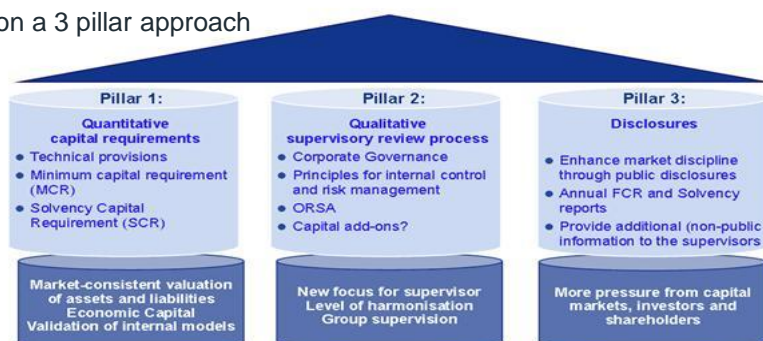
What is the aim of the new IORP?

Recognises that there are differences between pensions and insurance

1. IORPS have a social and employment context
2. Suppliers have more extensive commitments than providers of equity to insurers
3. Greater number of IORPS
4. Different treatment of IORPs compared to insurers not necessarily a departure from SII as SII recognises different treatment in various circumstances.

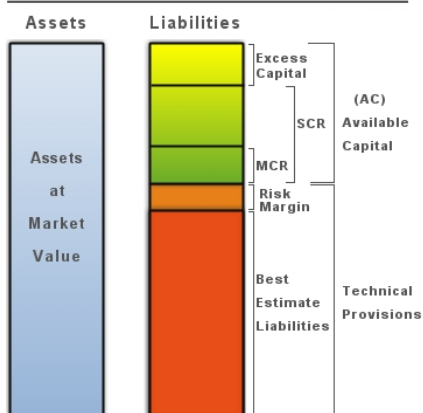
What is Solvency II?

- Is new European wide capital regulatory regime for insurance which aims to protect policyholder interests and make business easier across the EU.
- Due to be fully implemented in January 2014
- S2 based on a 3 pillar approach



Solvency II

Solvency II Balance Sheet



- Best estimate liabilities use "risk free" discount rates. Swap rates adjusted for credit risk.
- Risk margin is the cost of holding required capital
- MCR – Minimum Solvency Requirement - is minimum allowable capital between 25% and 45% of SCR
- SCR – Solvency Capital requirement – is the capital required to cover a 1 in 200 event (99.5%ile confidence level)
 - Can be calculated by standard formula, or
 - Internal model
- Annuity business expects to be able to benefit from an matching premium where the discount rate is higher to allow for illiquidity

What did the IORP consultation from EIOPA cover?

- Different work-strands
 1. Scope and definitions
 2. Quantitative requirements: Capital requirements and investment
 3. Governance
 4. Disclosure

Work-stream 1: Scope and definitions

Scope of the directive

- Mostly about application to arrangements in Member States that joined the EU after IORP 1
- Not about unfunded arrangements
 - EC do understand the illogicality of improving security for funded schemes without addressing unfunded schemes
 - Unfunded schemes are covered by other directives
 - Any change unacceptable to Germany in particular

Definition of cross-border activity

- At present different definitions apply in different Member States
- UK does not currently use the definition recommended – Profession has argued for the choice to take account of an assessment of the impact of the change
- Requirement for full funding expected to be removed

Work-stream 1: Scope and definitions

Ring-fencing

- EC realise that most of the benefits of running a cross-border scheme are undermined by ring-fencing
- But ring-fencing is necessary to satisfy Member State social and labour law (where subsidiarity applies)

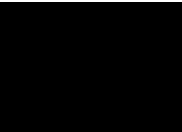
Prudential regulation and social and labour law

- This is about the division of responsibility between Home Member State (where the IORP is based) and Host Member State (whose social and labour laws apply)

Work-stream 2: capital requirements and investment

- 1. Quantitative requirements
- 2. Valuation of assets, liabilities and technical provisions
- 3. Security mechanisms
- 4. Investment rules
- 5. Objectives and pro-cyclicality

Covers 237 pages and 41 questions.



- Want one common set of rules through out EU without national calibrations
- No discretion will be allowed by companies on discount rates
- **Countercyclical premium**, currently being calibrated, will be designed to be major shock absorber. EIOPA will act as trigger for its use depending on market stress levels, with this likely to be formulaic when introduced
- **Matching premium** will be all or nothing, with no partial application. Will only be applicable when no lapse is allowable on liabilities (i.e. annuities)

Quantitative requirements – the holistic balance sheet

- Current IORP Directive distinguishes between
 - IORPs that provides guarantees and cover risks (as opposed to sponsor): similar to an insurer and required to hold assets above TP as a buffer
 - Sponsor backed IORPs where sponsor takes the risks; no requirement for IORP to hold buffer
- Objective: ensure level of security offered by all IORPS is similar and ideally the same but differing ways to achieve security



Possible structure for Technical Provisions

- Option for a two-tier TP
- Level A: Solvency TP, to reflect value of liability on buy-out (or a practical low cost run-off strategy)
 - Determined on market-consistent principles
 - To reflect nature of pension promise (accrued benefits only, no discretionary benefits)
 - Independent of investment strategy pursued
 - Harmonised basis
- Level B: Funding TP, to reflect decisions at the IORP level on how the liability is expected to be financed over a suitable time period
 - Assessed on going concern principles
 - May take advance credit for expected future investment returns
 - Could be Member State specific
- Level B might be required to harmonise towards Level A over time.

Issues raised in Call for Advice 5,6,7 and 8

Valuation of assets liabilities and TPs

- Value assets at MV?
- Value liabilities starting from principle of transfer?
- Take account of own-credit standing of IORP?
- Valuation standards consistent with accounting standards?
- What discount rate to use to calculate Best Estimate Liabilities?
- How should the risk margin be calculated?
- Inclusion of all future expenses?
- What benefits to include, unconditional, conditional, discretionary?
- Powers of the supervisor to raise TPs?
- How to take account of the sponsor support?

Security Mechanisms

- Uniform security level? At what level? Over how long?
- Harmonised prudential C.I. for solv capital? Or differ to reflect benefit adjustment mechanisms?
- Assess solvency capital over what time frame?
- Should SII capital requirements be applied?
- Apply Minimum Capital requirements?
- Include Pension protection schemes in the holistic balance sheet?
- What Supervisory powers in deteriorating financial conditions?
- Recovery periods.

Investment Rules

- Prudent person principle sufficient?
 - Additional limitations on investments by member states?
 - Limits for self-investment in sponsor
 - Should different investment provisions apply for DC and DB?
 - Requirements for DC funds with default options or lifestyleing.
 - Set a Value-at-Risk upper limit for the assets?
 - View on prohibition on borrowing.
- Objectives and Pro-cyclicality
- Include main objective "to protect policyholders and beneficiaries"
 - Consider pro-cyclicality and whether equity stresses should include a "dampener"

Work-stream 3: Governance

Nearly 50% of the EIOPA document!

- Supervisory powers
- Capital add ons = supervisor power to impose higher capital requirements
- Outsourcing
- Fitness & propriety – Profession has argued that fitness should apply to the trustee body collectively
- Risk management
- Own risk and solvency assessment – Profession has argued that DC schemes should disclose risk to members rather than hold capital against operational risk
- Internal controls
- Internal audit
- Actuarial function – likely to mean no reserved positions for actuaries
- Custodian

Proportionality is key!

Work-stream 4: Disclosure

Disclosure to supervisors

- UK regulator has more information than most European supervisors about the schemes it regulates
 - but still didn't know how exposed UK IORPs were to toxic debt
- European authorities worry about systemic risk that IORPs may represent
 - but generating risk information can be expensive

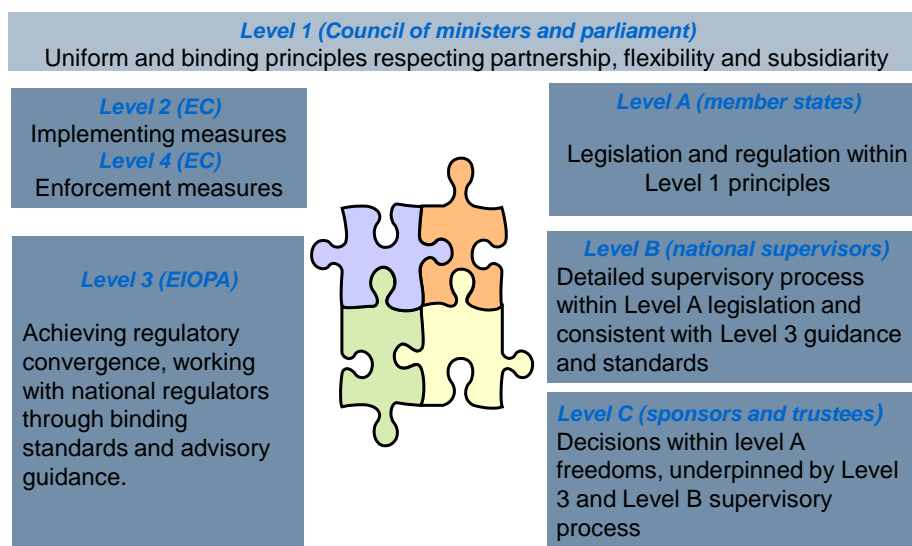
Disclosure to members

- EIOPA advocates standardising information to members
- Profession argued for principles-based disclosure timed to support member decisions with trustee bodies taking responsibility for form and nature of the information

What are the key differences between SII and IORP?

- Risk free rate
 - SII uses a proscribed swap curve adjusted for credit risk
 - Annuity books may be able to allow for a matching premium that provides some level of illiquidity credit. Final details still awaited.
- Margin for risk – additional capital in case assumptions do not turn out as expected.
 - MCR is the minimum level level of protection. Regulatory intervention at (or more likely) before this level is reached.
 - SCR is the capital requirement for adverse events (1 in 200), diversification between risks allowed for
- Governance
- Disclosure

Who decides the right balance?



Qualified Majority Voting

France	29	Bulgaria	10
Germany	29	Sweden	10
Italy	29	Denmark	7
United Kingdom	29	Finland	7
Poland	27	Ireland	7
Spain	27	Lithuania	7
Romania	14	Slovakia	7
Netherlands	13	Cyprus	4
Belgium	12	Estonia	4
Czech Republic	12	Latvia	4
Greece	12	Luxembourg	4
Hungary	12	Slovenia	4
Portugal	12	Malta	3
Austria	10		

A qualified majority is at 258 out of 345 (74.8%) – 88 to 'block'

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1 March 2012 Public Hearing

- Commissioner Barnier (FR)
 - demographic changes oblige the EU to take action
 - succession of crises had highlighted the need to ensure greater safety for pension fund members
 - changes to the directive would contribute positively towards labour mobility and hence growth and employment in the single market
 - want to facilitate economies of scale, risk diversification and innovation in order to enable businesses to reduce their costs and to simplify governance of their pension funds
 - recognised that there has been strong pushback on changing solvency rules and that didn't want to put change through that hampers growth
- Strong representation from UK, Germany, Holland, Belgium, Ireland almost all delegates and panel members pushed back strongly on changing the solvency rules
- Sharon Bowles (UK), representing the European Parliament, said that the detail needs to be in the primary legislation (and hence subject to full scrutiny) and that we should learn from experience of Solvency II

1 March 2012 Public Hearing

- Sue Owen of DWP urged the Commission to focus on outcomes not methodology
- Falco Valkenburg (Groupe Consultatif) pointed out how the Holistic Balance Sheet could be used as a framework but didn't have to drive capital allocation
- Director-Generale Jonathan Faull Commission representative summed up with:
 - “we know whatever we do must be calibrated to support economic growth, job creation, fiscal sustainability.”
 - “...the revision of the Directive is technically complicated, politically sensitive [and] has considerable social and economic consequences. This is therefore a matter that we will treat with great care.”
 - “On the difficult, controversial solvency rules for IORPs, I think that it is clear that a distinction between the past and the future is necessary.”
 - “If we are to apply more rigorous rules to the back book of pension funds, that is most likely to be financially unsustainable”.

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What happens next?

- EIOPA and the Commission are preparing QISs (Quantitative Impact Assessments) and aim to publish results in September 2012.
- Commission “may” consult on QISs
- Draft legislation by the end of the year? (seems unlikely now)

