Risk based solvency for pensions

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Agenda

1. Motives behind demands for risk based solvency
2. Issues for pensions if Solvency II seen as appropriate standard
3. Are there any other risk based alternatives?

The wish list for pensions

- **Remove regulatory arbitrage (EP)**
  - Prevent unequal treatment of market players
  - Avoid distortion of competition
  - Promote cross-border business
- **Same risk same capital (EP)**
  - Promotion of common market in financial products
  - Consumer protection viewpoint
- **Inadequate pricing of pension risks (EC)**
- **Better risk management (SII)**
  - Risk focussed decision making
  - Advanced risk management techniques
  - More efficient capital allocation

Subject to:

- **Taking account of specific features of occupational retirement provision (EP)**
- **Balance between protection for members and cost for sponsors (EC)**

Are these all mutually compatible and achievable within the IORP framework?

Solvency II for pensions: The issues (1)

EU pensions landscape not as homogeneous as insurance landscape

- Differing national slants between
  - State and occupational pensions
  - Types of occupational pension schemes
  - Plan design and risk sharing mechanisms
  - Funding practices, often shaped by national legislation
  - Tax treatment of pensions
- Exemptions from IORP Directive for unfunded and book reserve schemes

Much of this derives from the principle of subsidiarity - EC is supposed to protect this!

Unpalatable consequences of removal?

Free competition vs disproportionate impact on capital requirements between States with:

- generous funded occupational pensions, with highly regulated plan designs - most affected
- unfunded schemes - remain exempted or hit hard?
- little or no occupational DB provision –indifferent

Levelling the pension landscape is difficult, expensive and questionable

Solvency II for pensions: The issues (2)

Pensions are different

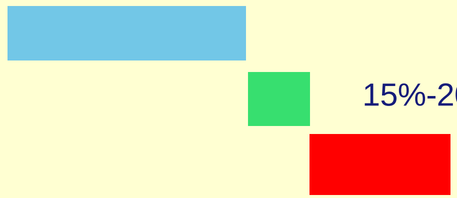
- A pension promise is a ‘best endeavour’ social contract; an insurance policy provides a contractual guarantee
- Inter-generational risk sharing is an integral part of the pension proposition – EC
- Pension risks are traditionally backed by sources of solvency capital outside the pension fund: Sponsor covenant; Contingent assets; PPF
- A quantitative standard raises further questions about how to value external solvency capital, its quality and its policing – more complexity to an already heavily-regulated area

Lack of homogeneity in the pensions area has traditionally been addressed through less rigid prescription and more flexibility

Solvency II for pensions: The issues (3)

Compliance cost of copying across Solvency II rules unamended:

- TP, say 100% IAS 19
- → Risk free rate
- \+ Solvency capital



15%-20%

40% - 50%

Well in excess of buy-out levels

But not necessarily new capital!

Source: Risklab (on behalf of OECD)

Principal risk factors:

- Plan design
- Asset strategy
- Funding strategy
- Demographic profile

Risk mitigants:

- Risk sharing rules
- Management actions
- Capital easements

Purely for illustration: clarified objective and adaptations for pension specific features would lead to very different figures

Solvency II for pensions: The issues (4)

Behavioural and other impact on employers

- Good-bye to future DB accruals?
  - Long term impact contrary to government's aims!
  - … and EC's aims as well: 'any requirement that discourages employers from providing private pensions would not be in the interests of workers'
- Additional capital requirements for legacy arrangements
  - serious solvency problems for small employers
  - significant impact on capital markets, unless spaced over long periods
  - UK companies would initially appear less competitive than others
- All DB sponsors become owners of an insurance subsidiary: rational strategy for most may be to hive-off the pension scheme and focus on core business.

Really the last straw for employers?

Solvency II for pensions: The issues (5)

Something for the politicians

- Potential magnification of anomalies between countries who are hit hard and others who are not. Questions sustainability of pension systems decided by member states.
- Any change having a retrospective impact on legacy pension costs would be viewed as changing the pensions deal and expected to be accompanied by proportionate measures to ease the pain.
- In principle the PPF should also be subject to the same requirement, and therefore levies would increase (probably quite substantially)!
- UK legislation on ownership of pension scheme assets and the balance of power between trustees and employers would require a major re-think
- The new scheme specific funding regime has just been put in place at a great expense, and appears to be working.

All this against a background of wanting to promote good occupational pensions !

Risk based alternatives (1)

Quantitative standard: A modified Solvency II?

- With detailed rules devised specifically for pensions: security level, management actions etc
- Addressing existing forms of solvency capital for pensions: credits for sponsor covenant, contingent assets, insolvency protection etc
- With clarity on ownership and quality of solvency capital: where posted and how initial impact is mitigated
- Possibly with checks and balances to encourage employers to take controlled risks: conditional indexation etc

A more palatable standard?

But not without difficulties which need to be addressed outside the IORP brief.

Risk based alternatives (2)

Qualitative standard: Promoting the right behaviours to deliver the desired objective

- At EU level: Capture high level objectives within a principles-based framework which can cope with essential differences between financial sectors as well different styles and structures for pension provision within EU countries**.**

- At country level: Detailed rules on bespoke basis to comply with principles but tailored to suit particular features of pension provision in the country concerned.

Essentially, a trade-off within reason between different elements of security, if necessary supplemented by

- Specific checks and balances to promote right behaviour
- Stronger governance at regulatory and scheme level
- Greater disclosure

Member security

=

Funded collateral

+

External security

+

Regulatory discipline

+

Disclosure

Builds on regulatory approach already embedded in IORP Directive, and less divisive