Review of IORP Directive – ACA

Including solvency – capital adequacy for pensions

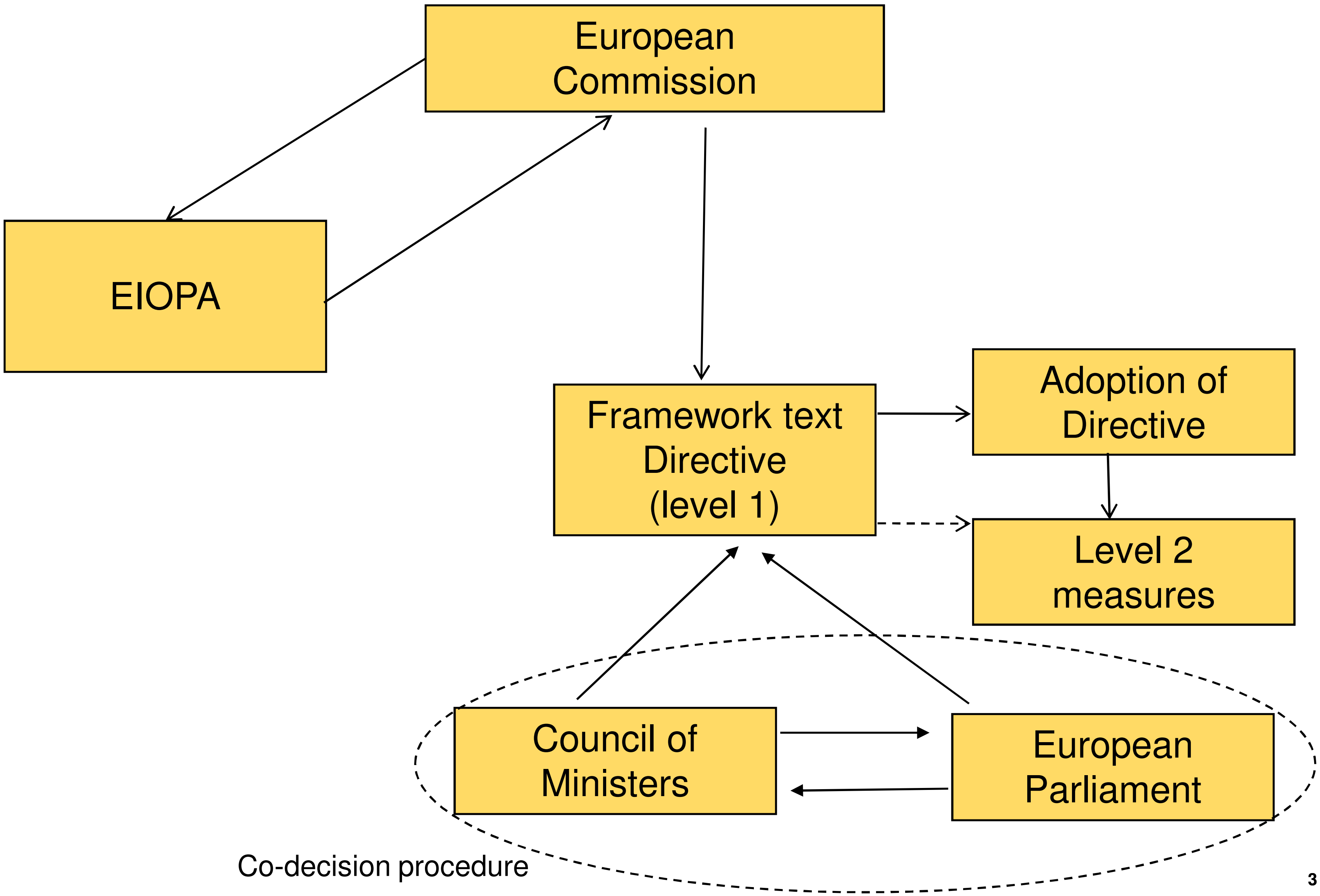
A presentation to ACA Meeting

January 2012

Topics

- Political backdrop
- Capital adequacy requirements
- Other potential changes
- ACA view

Review of IORP Directive: Level 1



Qualified Majority Voting

France	29
Germany	29
Italy	29
United Kingdom	29
Poland	27
Spain	27
Romania	14
Netherlands	13
Belgium	12
Czech Republic	12
Greece	12
Hungary	12
Portugal	12
Austria	10

Bulgaria	10
Sweden	10
Denmark	7
Finland	7
Ireland	7
Lithuania	7
Slovakia	7
Cyprus	4
Estonia	4
Latvia	4
Luxembourg	4
Slovenia	4
Malta	3

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

Review of IORP Directive

Commission issued a “Call for Advice” (CfA) to the European body of supervisors (EIOPA) in April 2011.

Commission seeking opinions on multiple issues relating to review of the IORP Directive, with most questions starting:

how should article xxx of the Solvency II Directive be amended to deal with the specificities of pension schemes …

EIOPA consulted on its draft advice to the EC in two tranches:

1. Scope, Governance, Cross-border issues (July/August 2011)
2. Investment, Disclosure and Solvency (25 October/02 January 2012).

EIOPA’s draft advice ran to 517 pages

Next step – EIOPA publish response and Public Hearing on 1 March 2012

Capital adequacy for pension schemes

- European Commission (EC) considered Solvency II for *certain* pension funds in 2008.
- Prospect of SII for (all funded) pensions returned in EC consultation paper July 2010.
- EC's desire for harmonised solvency principles remains as strong as ever:
  - Pre-requisite for effective operation of a single market.
  - All European countries have already agreed that "*the Commission, assisted by [EIOPA], should develop a proper system of solvency rules*" for pension funds.
- SII remains the likely starting point (despite objections):
  - Market consistent basis
  - 'Risk-free' discount rates
  - Explicit risk margin.

Background – Solvency II for insurers

- The Solvency II Directive harmonises the solvency regime across insurers in the European Economic Area (EEA).
- The Directive was adopted in 2009, but doesn’t come fully into force until 2014.
- It is a (155-page) “framework” Directive, with the detail being contained in separate implementing measures.
- There have been 83 consultations and 5 detailed quantitative impact studies.
- Solvency II comprises three pillars.

The 3 pillars of Solvency II

Solvency II

Pillar 1 Quantitative Requirements

- Assets and liabilities measured market-consistently.
- Eligibility and classification of own funds.
- Solvency Capital Requirement (SCR) calibrated to a 99.5% VaR over a 1-year period.
- Minimum Capital Requirement (MCR).

Pillar 2 Qualitative Requirements

- Supervisors shall review system of governance, capital structure and capital needs, and take any actions required.
- Corporate governance and effective risk management.
- Own risk and solvency assessment (ORSA).

Pillar 3 Disclosure Requirements

- Public disclosure in form of Solvency and Financial Condition Report.
- Disclosure to supervisors in Report to Supervisors.
- Information includes details of business and performance, system of governance, risk exposures, concentrations, mitigation and sensitivities.
- Quantitative reporting templates.

How do insurers determine liabilities under Solvency II?

Overview methodology for an insurer setting ‘technical provisions’:

- **Best estimate** valuation of future liability cash flows

PLUS

- A **risk margin**

PLUS

- A **Solvency Capital Requirement.**

How do insurers determine liabilities under Solvency II?

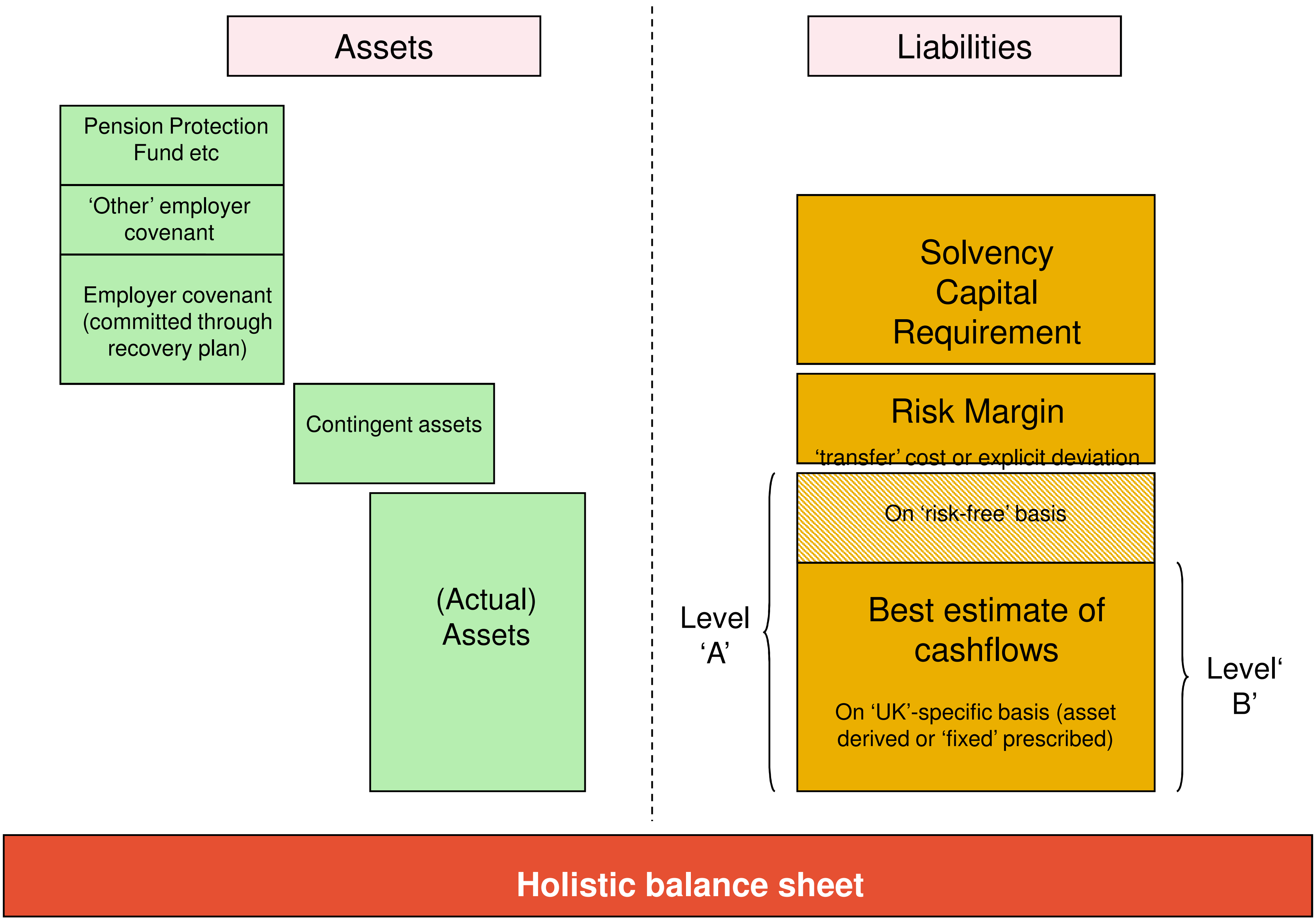
- **Best estimate** valuation of liability cash flows:
  - Discounted using a near risk-free rate.
  - Risk-free based on a swap curve with a deduction of 10 basis points for credit risk.
  - Adjustment for ‘illiquidity’ premium/’matching’ premium.

- **Risk margin:**
  - ‘Quasi’ market value of cost of transferring liabilities to a third party.
  - Cost of the capital that a third party would need to hold to back risks that cannot be hedged.
  - Formulaic, so does not necessarily reflect true cost of such a transfer.

Solvency Capital Requirement (SCR)

- Additional assets required to ensure that insurer can meet its liabilities with a high degree of confidence through the next 12 months - 99.5% probability.
- Standard formula - parameters and methodology specified by European body of national regulators (EIOPA).
- Internal model - own parameters and methodology; proportionate to the nature, scale and complexity of the risks.
- Calculated by first determining, and then stressing (99.5% probability), the required capital for each individual risk:
  - Net assets from the balance sheet assessed under **normal conditions**

    less
  - Net assets under **stressed conditions.**


Assets
Liabilities
Pension Protection Fund etc
'Other' employer covenant
Employer covenant (committed through recovery plan)
Contingent assets
(Actual) Assets
Solvency Capital Requirement
Risk Margin
'transfer' cost or explicit deviation
On 'risk-free' basis
Best estimate of cashflows
On 'UK'-specific basis (asset derived or 'fixed' prescribed)
Level 'A'
Level' B'
Holistic balance sheet

Governance - Key elements

- General governance requirements
- Fit and proper, for trustees and those fulfilling key functions
- Risk management ‘system’
- Own Risk and Solvency Assessment (ORSA)
- Internal controls
- Internal audit function
- Outsourcing

Disclosure

- Generally schemes providing DC benefits likely to face most change
  - Greater emphasis on provision of information at the point of, or before, joining, through a Key Information Document (KID) that covers
    - Identification of scheme
    - Description of the investment objectives and policy
    - Performance information (possibly past performance or 'scenarios' – which we equate to projections on certain assumptions)
    - Detail of costs and charges
    - A risk/reward profile (possibly adjusted dependent on the member's individual time horizon)
    - Employer and employee contribution commitments
    - Country-specific information
- Existing pre/at joining information requirements to be maintained for DB

Investment

- Focus on trustees retaining responsibility for understanding the investments, but providing for some investment functions to be outsourced
  - Retain provision that Member States should not restrict schemes from holding up to 70% in equities – other than in “low risk or default” DC funds or where members have no investment choice
  - Remove provision allowing Member States to restrict scheme investments to 30% in foreign currency - other than for DC
  - Remove explicit provision that schemes are allowed to invest in risk capital markets (as covered under prudent person principle and confusion as to what it means!)
- Retain ability for individual Member States to impose more stringent investment rules for particular schemes but “make it clear that the objective is to allow the supervisor to have appropriate powers of intervention”
- Retain prohibition on borrowing (with exemption for ‘subordinated loans’ – applicable in some other Member States, notably Netherlands)
- New restriction – assets to be properly diversified to avoid “excessive reliance on …geographical concentration”

Investment continued

- Member investment choice, default options and life-styling – four options
  1. No substantive change to the Directive (existing Directive is silent)
  2. Permit (or encourage) Member States to specify requirements
  3. Set minimum supervisory involvement - “subject to further evaluation”
  4. Set standardised ‘minimum’ requirements where a default or lifestyle fund is offered (at least in cross-border activity cases)
- The options consider the degree of permitted or required European/Member State (supervisory) control as to whether, for example, a default is “adequate for members risk appetite and that its risk profile is appropriate”
- Supervisors *may* act to ensure
  - member involvement with fund selection is adequate
  - Default takes account of members’ expectations

ACA View

- Joint effort from all members of the Pensions and International sub-committees
- Agreed with main Committee
- Full response submitted to EIOPA
- Press Release
- Generally in line with “hard-line” view of NAPF, CBI etc
- Actuarial Profession and Groupe Consultative generally softer view as regards holistic balance sheet (“concept has merit”….)

ACA View (extracts)

- **SOLVENCY II TYPE APPROACH TO FUNDED PENSIONS IS 'INAPPROPRIATE, UNAFFORDABLE AND UNNECESSARY'**
- The level of harmonisation proposed is not appropriate or achievable, given the other tax and legislative differences that remain across the European states. If harmonisation was indeed the goal, these measures fail by excluding book reserves.
- Rather than harmonisation for its own sake (an unworkable and unattainable ideal), better for the EU to focus on cross-border provision.
- The EIOPA consultation looks at three objectives - adequacy, security and sustainability. The ACA says importing a complex Solvency II type system onto already complex Member State systems of prudential and social regulation runs counter to and may paradoxically jeopardise the "adequacy" and "sustainability" limbs presently in place.
- The requirements are overly complex for regulating an industry that has social aims as well as financial objectives and which makes provision at a small business level. Comparability and harmonisation between insurers makes sense, because they compete in the market for business. There is no such competition between IORPs.

ACA View (extracts)

- A risk free approach to interest rates is as unworkable as it is unaffordable, says the ACA, most particularly within the EU at present.
- Of the three options discussed in the EIOPA paper as regards the calculation of "best estimate" funding, a two-tier approach, does have merit in principle, says the ACA, provided the implementation is largely left to Member States.
- Sitting alongside this two-tier approach, the "holistic balance sheet" as proposed in the EIOPA paper is, in practice, unworkable says the ACA. The difficulties with placing formal monetary value on the value of the sponsor covenant are massively understated in the consultation.
- As regards DC schemes, the calculation and maintenance of a reserve to cover operational risk will add significantly to frictional costs.
- Overall, there would not be enough actuaries in Europe to begin to deal with the workload, should the complexities described in this consultation ever be visited upon us, regardless of the simple truth that a Solvency II type regime is inappropriate, unaffordable and unnecessary for pensions.