IORP II - Update

ACA Meeting 21 March 2013 – Paul Kelly

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Agenda

- Background
- QIS Specifications
- QIS issues and areas not dealt with
- Timelines

Background

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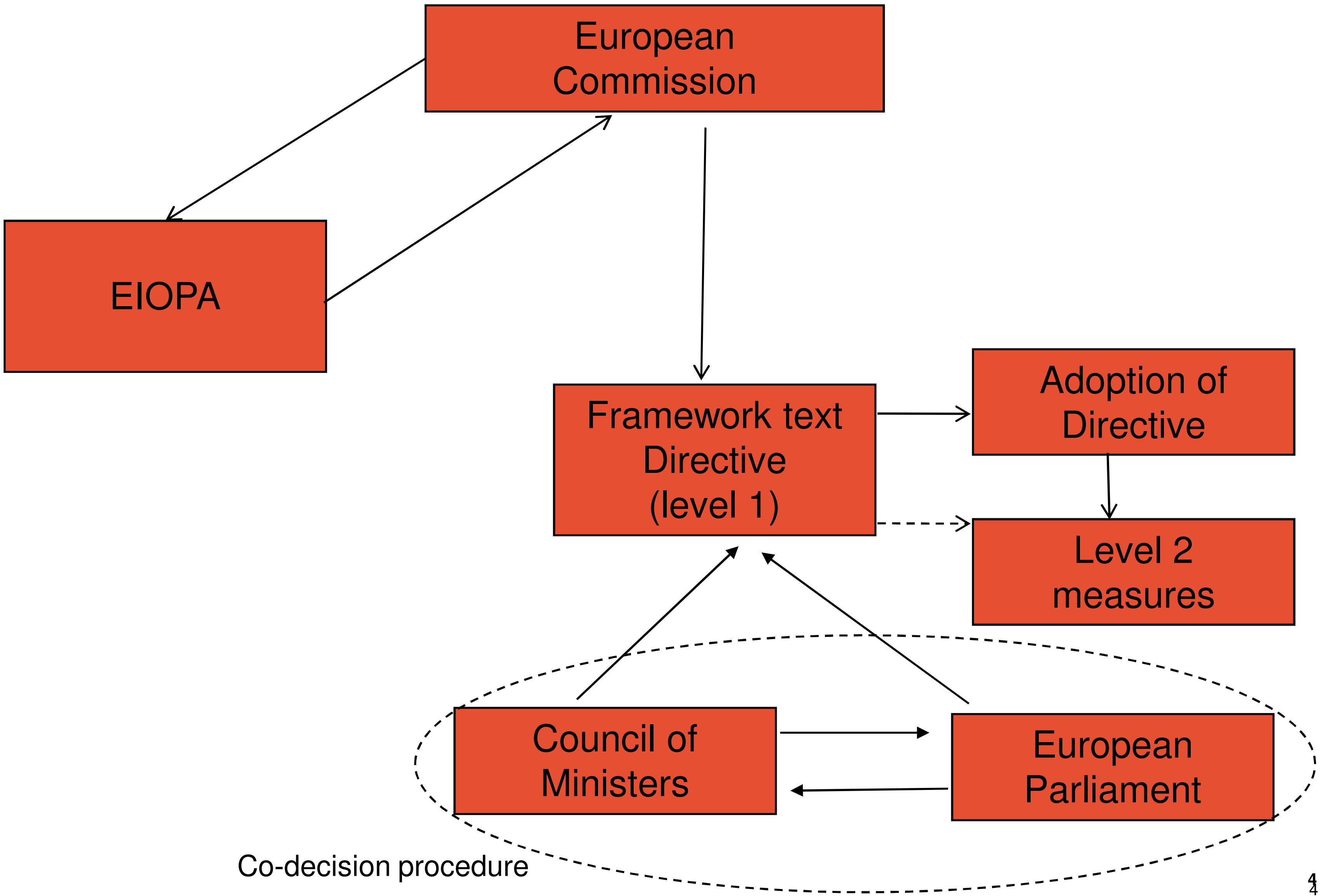
Background - Review of IORP Directive: Level 1



Background - 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 roughly 75% and population requirement – also changing in 2014

Background - 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.

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Background - QIS

- Responsibility of European Commission
- European Commission to assess macro-economic impact
- EIOPA to assess IORP impact in 5 subgroups for selected countries:
    1. Data
    2. Report
    3. Valuation
    4. Security Mechanisms
    5. Solvency Capital Required
- Countries included: Belgium, Germany, Ireland, Netherlands, Norway, Portugal, Sweden, UK
- QIS Process started in October 2012

QIS Specifications

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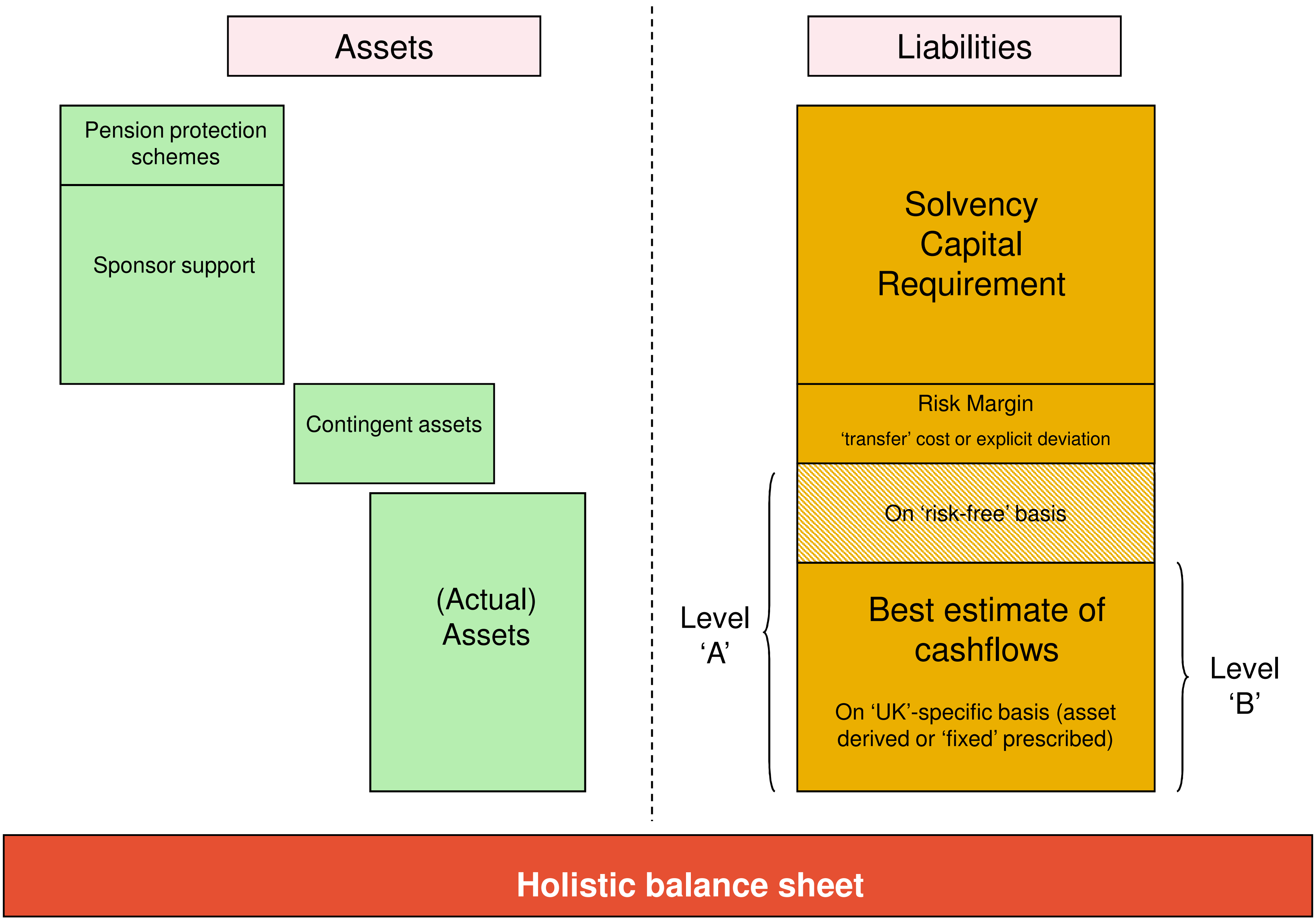
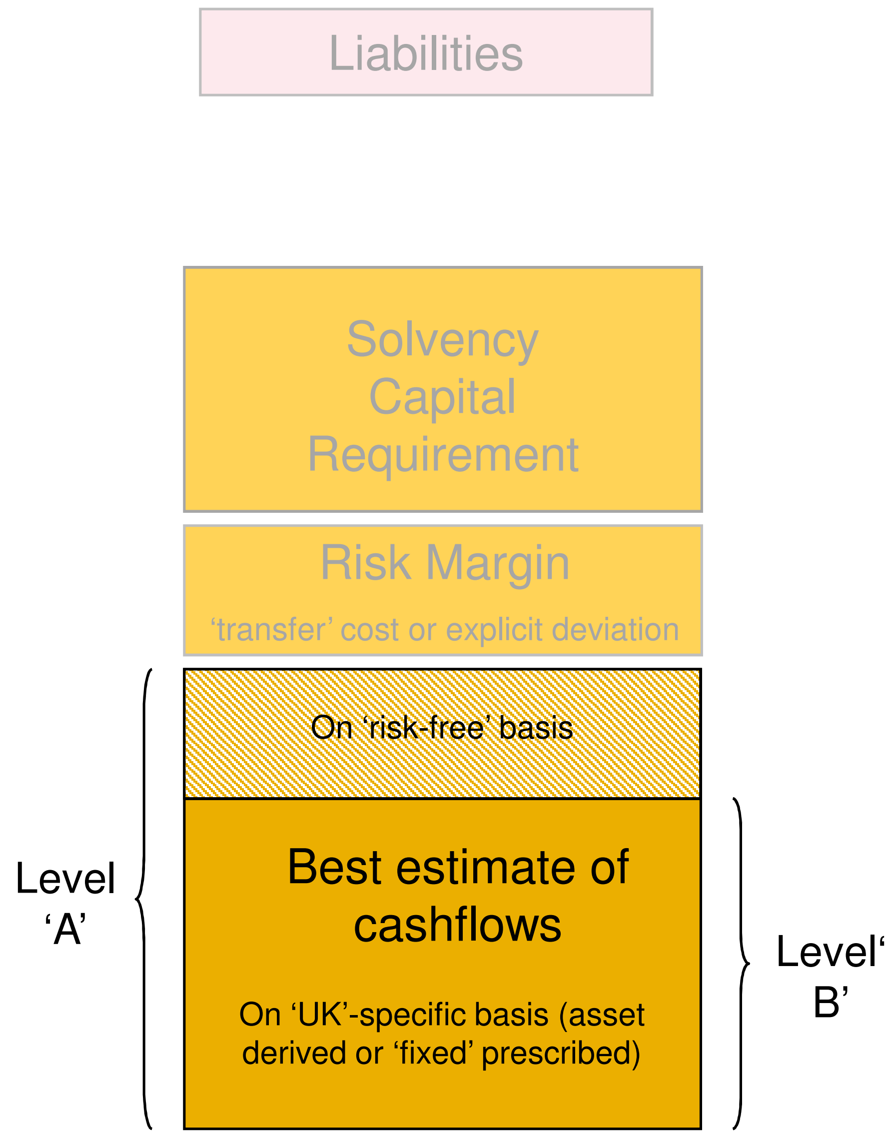
QIS Main Specifications

		Set 1	Set 2	Set 3
		Upper bound	Lower bound	Benchmark
HBS	Discount rate	Basic risk-free interest rate (convergence QIS5)	Basic risk-free interest rate (convergence of 10 years after LLP)	Basic risk-free interest rate (convergence of 10 years after LLP)
		Exclude long-term nature adjustment	Include long-term nature adjustment	Include long-term nature adjustment
	Risk margin	Cost-of-capital	Exclude	Cost-of-capital
	Pure discretionary benefits	Include	Exclude	Exclude
	Mixed benefits	Include	Exclude	Include
	Pension protection scheme	Exclude	Asset	Asset
	Ex post benefit reductions	Exclude	Include	Include
	Sponsor support	Ancillary own funds	Asset	Asset
Level B	Discount rate	Asset-based	Asset-based	Asset-based
SCR	Equity risk module	Symmetric adjustment	Duration-based	Duration-based
	Inflation risk module	Exclude	Include	Include
MCR		Include	Include	Include


Assets
Liabilities
Pension protection schemes
Sponsor support
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

Technical Provisions

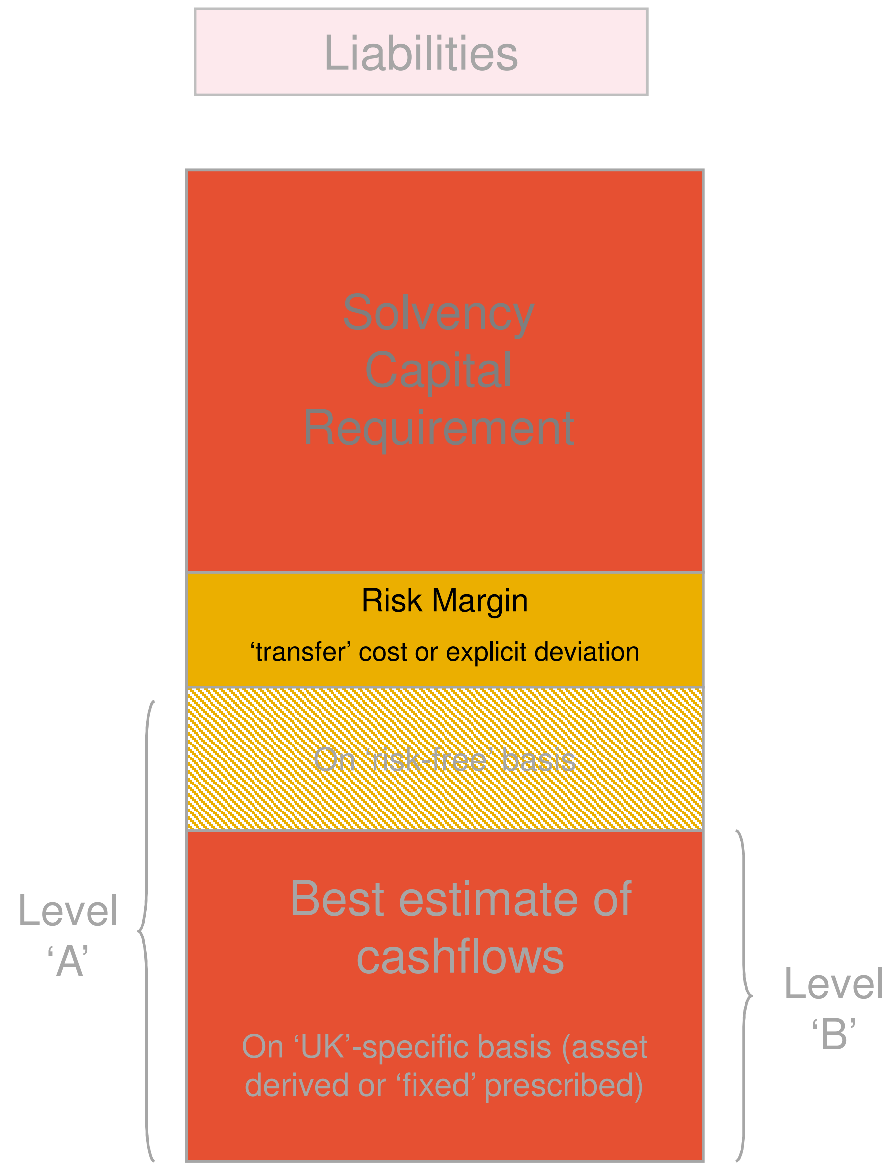
- Level A
  - -Risk-free interest rate curve supplied by EIOPA
  - -Swap bid rates less 35bp (credit risk adjustment)
  - -Other options
  - -Also “Matching premium” (relating to ring-fenced matching assets)
- Level B
  - -Interest Rate based on expected return
- Other Assumptions
  - -Best Estimate



Holistic balance sheet

Risk Margin

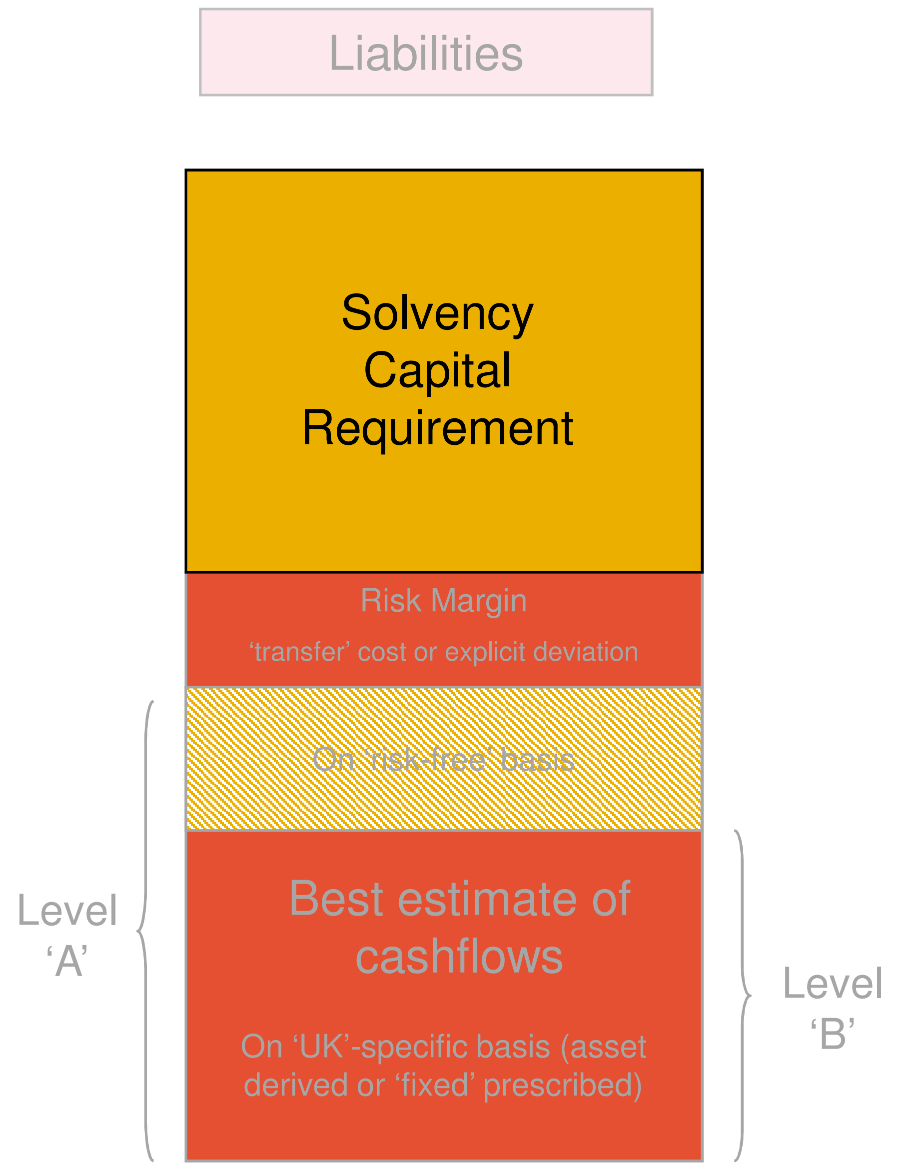
- 8% of Level A Technical Provisions
- Or individual calculation?
- Option of none (but then Level A Technical Provisions would need to be prudent rather than best estimate)



Holistic balance sheet

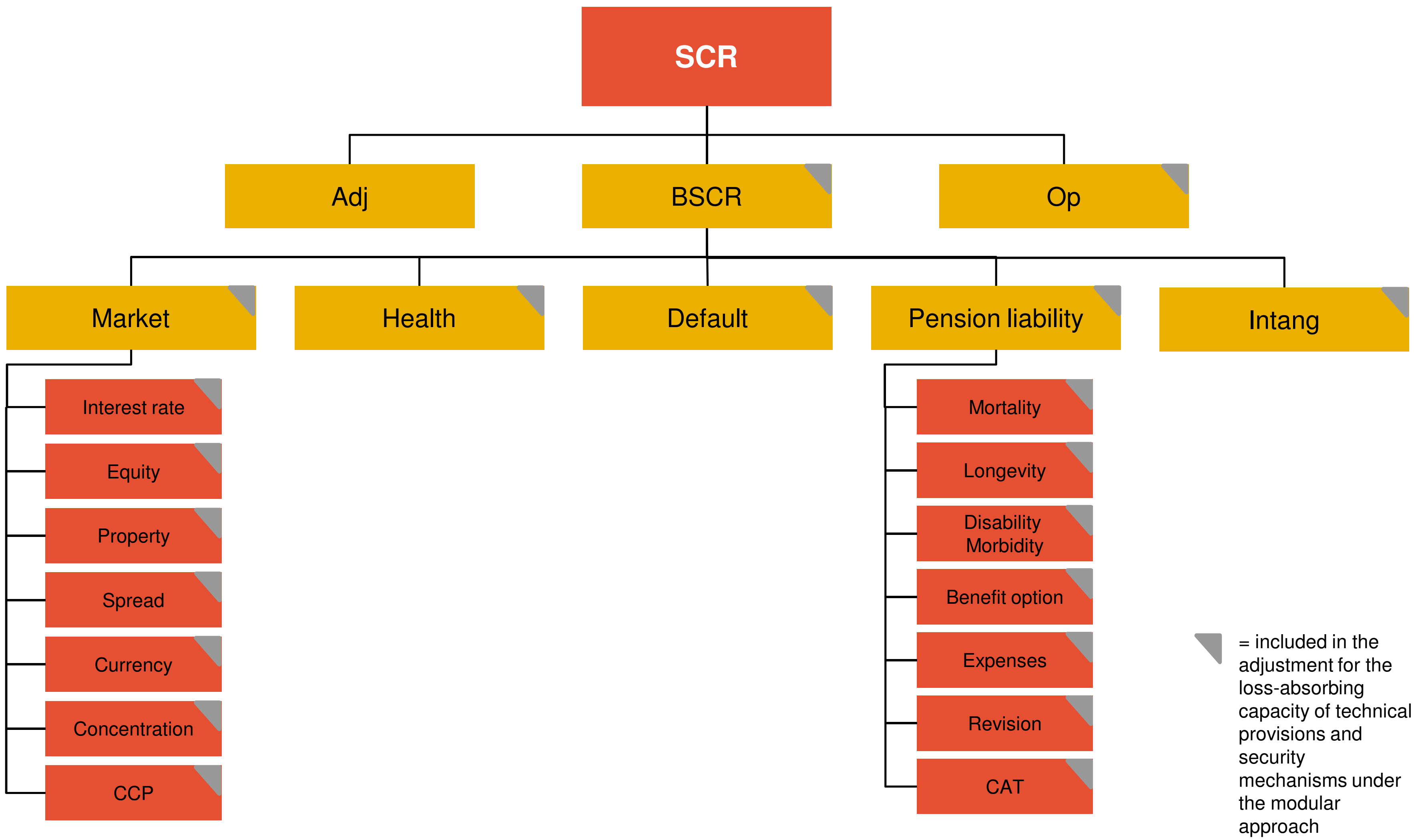
SCR

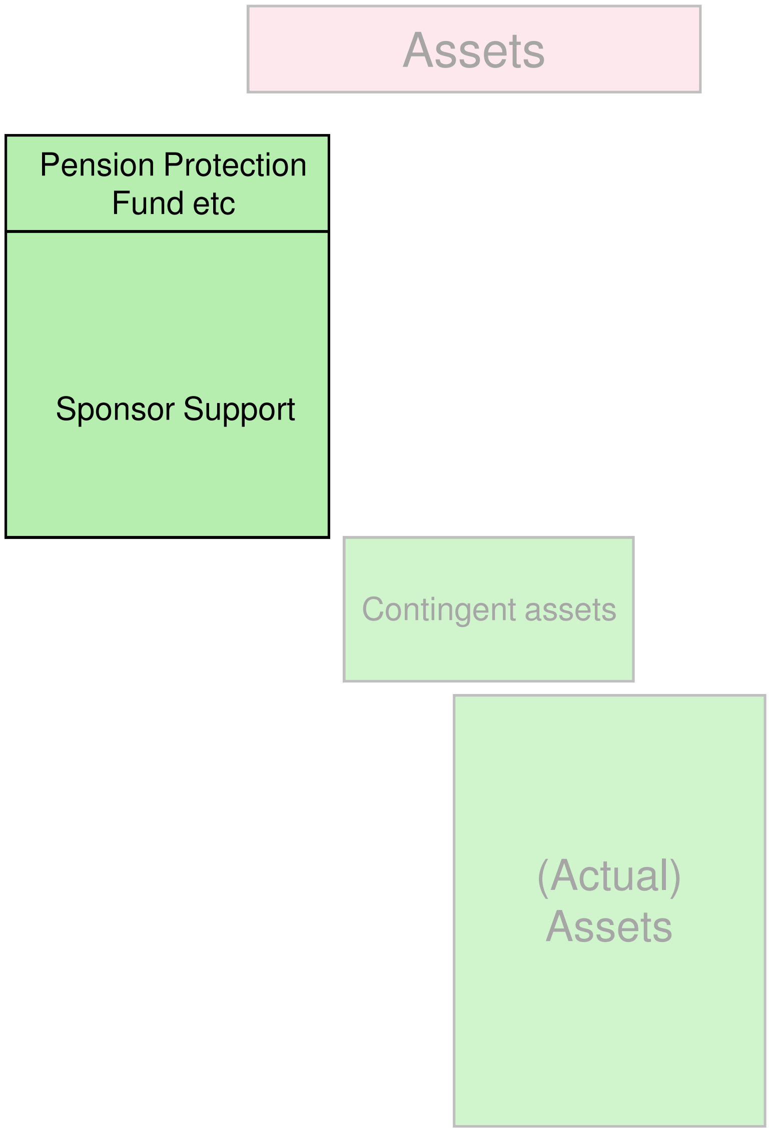
- Calculate change in "net asset value" (ie assets less TPs) under range of different scenarios (shocks)
- SCR calculations based on QIS5 for Solvency II 99.5% confidence level (options 97.5% and 95%)
- Overall SCR equals
  Basic SCR; +
  SCR for operational risk; -
  Adjustments for loss absorbing effect
- Also MCR



Holistic balance sheet

Components of SCR





Pension Protection Schemes

- Calculate expected benefits payable by PPS upon default in each year Allowance made for expected amounts recoverable from sponsor @ 50% (simplified spreadsheet method possible)

Sponsor Support (Employer Covenant) Value

- Maximum (based on 50% of shareholder funds + recovery plan contributions + 33% of future cash flow)
- Actual (Calculated stochastically or deterministically using standard EIOPA method) – assuming 50% of deficit recoverable on default.

Holistic balance sheet

QIS Issues and Areas not dealt with

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UK QIS

- The pensions regulator (tPR) undertook the QIS on behalf of UK pension schemes, using data it already holds (or that is publicly available).
- It supplemented this with data from the top 100 (by size) pension funds in the UK
- Input was provided by expert group (including strong representation from ACA firms)
- Final UK QIS numbers are believed not to be materially different from the impact assessment that tPR prepared for DWP, published in November 2012:
  - Deficit on Level A + Risk Margin c £800 bn (cf current regime £300 bn)
  - PPF value likely to be very low c £10bn
  - Great variability on value of sponsor support
  - Significant proportion of the deficit on the UK aggregate HBS is attributable to schemes with a non-UK parent
  - Similar levels of “pain” in other countries (somewhat lower in Netherlands)
- Responses to tPR’s large scheme questionnaire (that it used to complete the QIS on behalf of UK pension schemes) were critical of the covenant valuation methodology
- Barrie & Hibbert/PwC papers on sponsor support valuation presented to Faculty and Institute of Actuaries.

EIOPA: More work is needed on …

- Sponsor support
- Pension protection scheme
- Confidence levels other than 99.5%
- Parameters and correlation
- Minimum capital requirement
- Inflation
- Long term guarantees
- Risk margin
- Proportionality
- Level B expected returns
- Discretionary benefits

Timelines

Next Steps

- EIOPA drafts interim QIS findings March 2013
- EIOPA final QIS report in June 2013
- Commission seeking input on Governance and Disclosure (but not through EIOPA) – Pillars II and III
- Draft Directive in 2013
- “Mini-QIS” in parallel on valuation of sponsor support and other areas
- Note acceptance of Transitional measures

Is a draft IORP II Directive possible by Summer 2013?

- Initial QIS results needed.
- Can EIOPA deliver to Commission's timetable?
- Will EIOPA resist the Commission's will?:
  - "this QIS is not a complete assessment of the practicality of the holistic balance sheet, and further modelling will be needed. However, EIOPA is continuing with this QIS under the assumption that further QISs will be undertaken".
- QIS will inform broader macro-economic impact assessment and cost/benefit analysis.
- Do delays to Solvency II impede progress on IORP II?
- Note retirement of Karel Van Hulle

Why the urgency?

- European Parliamentary elections in June 2014.
- European Parliament unlikely to accept new proposals for Directives beyond the end of 2013.
- New Parliament heralds new Commission – New Commissioner responsible for IORP II unlikely to be French, Irish or Italian.
- But would a delay kill-off IORP II?
- And what happens when the political horse-trading starts?