

Solvency II & Occupational Pension Schemes

Introduction

Solvency II is the European Commission's review of the regulatory capital regime of the insurance industry which is intended to replace the current requirements set out under Solvency I. Implementation is not expected before 2010, however, advanced discussions have taken place and it is expected that a formal framework directive will be published in the summer of 2007.

It was previously agreed that occupational pension arrangements would remain outside the scope of Solvency II. However, comments made by the Chairman of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) at the 25th anniversary conference of the European Federation for Retirement in June 2006 have created wide-spread concern about how different European countries would be impacted if occupational pension schemes were to be brought within the scope of Solvency II (whether in its existing format or in an amended capacity).

This briefing note sets out the proposed requirements of Solvency II and the potential impact for the UK pensions industry.

What is Solvency II?

The underlying aim of the EU's new solvency requirements is to make the failure of an insurance company less likely thereby reducing the probability of consumer losses or market disruption. It is hoped that this will be achieved through a more risk sensitive approach with incentives for proper risk management whilst creating consistency between financial sectors and across the EU.

Three pillars have been proposed within the framework, similar to the Basel Agreement for banks, covering minimum capital requirements, a supervisory review process (which aims to identify additional risks and capital requirements) and disclosure requirements to promote market discipline.

To calculate an insurance company's technical provisions under Solvency II an appropriate term structure of risk free rates should be used to discount a best estimate of future cashflows. An explicit risk margin for non financial risks should also be included. In addition, a solvency requirement will ensure that extra capital is provided so that the technical provisions and other liabilities will be covered at the following year end with 99.5% confidence. A minimum capital requirement also exists which acts a trigger for supervisory action.

Relevance for Occupational Pension Schemes

The debate surrounding the use of Solvency II for funding of occupational pension arrangements focuses on whether the level of security of a pension promised under an occupational pension scheme (provided through advanced funding) should be as high as that applying to benefits secured with insurance contracts. The following section highlights the main differences between these two types of benefit promise.

The Benefit Promise

Insurance contracts are legally binding agreements between the insurer and the insured. Pension scheme benefits are essentially labour agreements negotiated between social partners and consequently have a number of features that insurance products do not e.g. the benefits are delivered through third parties (i.e. schemes) which may be Trusts, the pension scheme trustees may change the contribution level or benefit range, benefits are not always funded and they are generally not tradable, assignable or commutable.

Time Horizon

Pension schemes generally have a longer time horizon which may allow them to invest in more illiquid assets (e.g. private equity) than insurance companies. If one accepts a time diversification case this applies to equity assets as well.

Participation

Pension schemes often have compulsory participation covering all employees resulting in a broader base of member than insurance contracts which are selected by the individual depending on needs and affordability.

Discretionary Benefits

Pension schemes can often provide discretionary benefits whereas insurance products do not.

Hence, it may be difficult to argue that occupational pension schemes and insurance companies should be subject to the same capital requirements.

Impact for Different Member States

Local solvency rules differ between different member states and therefore the impact of including occupational pension schemes within the scope of Solvency II differs for each state.

In the UK, occupational pension arrangements were not originally designed to be identical to insurance company products; freer investment strategies were permitted and the backing of the employer provided a degree of certainty to the benefit promise. Furthermore, the impact of increased legislation has already increased most pension scheme's costs beyond the affordable. However, in other countries, such as Denmark more onerous occupational pension scheme funding regimes have been implemented and in countries like Germany a mandatory state backed insurance scheme applies.

It should be noted that the controversial new Financial Assessment Framework (FTK) introduced recently in the Netherlands provoked much debate. The requirements finally put in place were a 105% funding level with a 97.5% probability of remaining above the minimum funded status over a one year period.

Consequently, the attitudes of the member states towards the inclusion of occupational pension schemes within the scope of Solvency II vary greatly. Only the UK and Ireland (and to a lesser extent the Netherlands) would be impacted adversely and many member states have little interest in this area since they do not have significant occupational pension scheme liabilities.

It is therefore likely that any voting powers held by the UK and Ireland would be insufficient to prevent a qualified majority voting these restrictive funding requirements into EU law.

Financial Impact for the UK

The chairman of the Pensions Committee of the Group Consultatif Actuarial European presented the following assessment of the impact of Solvency II on the UK pensions market in June 2006.

EUR Billion	FTSE 100 Companies
Number of Defined Benefit Pension Schemes	87
Assets	491
Technical Liabilities (IAS 19)	587
Solvency II Technical Provisions	672
Solvency Capital Requirement	140 – 190

<http://www.actuaries.org/IACA/Colloquia/Paris/IACAParis2006session104.ppt>

These figures show that the FTSE 100 companies would have to provide additional pension funding of the order of EUR 370 billion in order to comply with the current version of Solvency II. This compares with an overall FTSE 100 market capitalisation of EUR 2,300 billion.

Worse Case Scenario?

The table above illustrates the financial impact that the introduction of Solvency II would have on occupational pension schemes. As a minimum we would expect all remaining open defined benefit plans to close in the UK since this type of arrangement would become prohibitively expensive.

Further, since company finances would be adversely affected, the shares held by the occupational pension schemes are likely fall in value thereby increasing the existing pension scheme deficits. In order to comply with the 99.5% confidence requirement under Solvency II we would expect a large movement away from equities and into bonds. Since UK pension schemes own approximately 15% - 20% of the UK equity market this would exacerbate the fall in share prices. Many companies may then be forced to abandon their pension schemes as a result of the downward pressure on the market resulting in an increased number of claims on the Pensions Protection Fund, further weakening the security of members' benefits.

In order to avoid the damaging impact on UK companies and the UK stock market would it be necessary for the UK to leave the EU in order to avoid these potential adverse consequences?

In order to withdraw from the EU a member state must inform the EU of its intentions and then negotiate a withdrawal agreement. This is a largely untested area of the constitution and it is not clear what these negotiations may involve.

What action should be taken now?

The UK Treasury represents the UK on the European Insurance and Occupational Pensions Committee (EIOPC) who will develop the Framework Directive. The FSA and the Pensions Regulator are currently working together to analyse the possible implications for the UK if occupational pension schemes were brought within the scope of Solvency II. In the meantime this issue needs to be highlighted so that relevant lobby groups can begin to appeal to the European Commission either demanding confirmation that UK occupational pension schemes will not be required to comply with Solvency II or that significant concessions will be made to ease the burden of financial compliance.

We believe it is vitally important that the impact of this potential change is well understood by those tasked with negotiating legislative change on behalf of the UK in Europe. We do not consider that the unique position of the UK's well developed occupational pension schemes should be further attacked by Europe wide legislation. Other member states hide their own pension problems behind state arrangements which are not subject to Solvency II requirements thus creating an unlevel playing field and a barrier to efficient trade – the prime purpose of the EU.

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