Preliminary QIS results on IORPs

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This paper summarises the first aggregated QIS IORP results with a specific focus on differences among EU countries and describes the next steps of the IORP directive review.

INTRODUCTION

The European Insurance and Occupational Pension Authority (EIOPA) is in the process of reviewing the directive on the Institutions for Occupational Retirement Provision (IORP directive). The aim of the directive is to ensure European regulatory consistency across sectors and enhance members' and beneficiaries' protection.

In this context, a first Quantitative Impact Study (QIS) took place in the fourth quarter of 2012.[i] EIOPA published a preliminary set of results on 9 April 2013[ii] and is expected to publish the final report by June 2013.

Eight countries participated in the QIS (Belgium, Germany, Ireland, Netherlands, Norway, Portugal,[iii] Sweden and the United Kingdom), accounting for approximately 95% of defined benefit liabilities in the European Economic Area. The IORPs completing the QIS exercise represented a substantial part in terms of assets in most respective countries[iv] providing defined benefit plans.

These draft results give a first insight into the workings of the holistic balance sheet (HBS) approach and Solvency Capital Requirement (SCR). However, due to insufficient representativeness, comparability and completeness of the preliminary work, those results do not allow to draw any final conclusion at this stage on the relative security level of IORPs across the EU.

CONTEXT OF RESULTS

IORPs are currently subject to different national prudential rules[v] such that not all member states apply a market-consistent approach and liability values can differ significantly for similar pension obligations.

There is also a wide spectrum of IORPs covered in this QIS, depending on who bears the risk: IORP itself, the sponsoring undertaking or to some extent the members.

These IORPs apply in turn a wide range of security mechanisms (regulatory own funds, sponsor support, pension protection schemes) and benefit adjustment mechanisms (conditional, mixed and discretionary benefits, benefits reductions) provided for in pension schemes and/or national regulation.

The purpose of the HBS is to capture on a quantitative basis all those country-specific security and adjustment mechanisms and include them on a single holistic balance sheet. To properly interpret the results, it is therefore vital to clearly understand the features of each national system and their implications.

VARIATION IN OUTCOMES

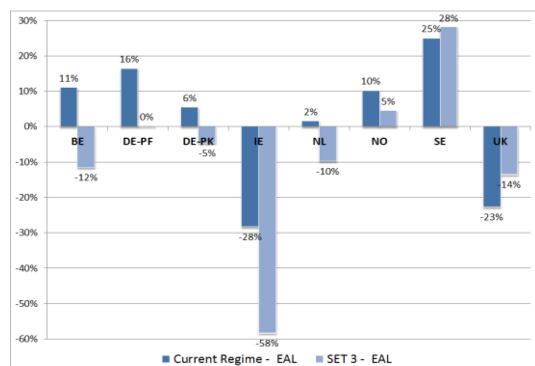
Several factors explain the unduly high variation in the first outcomes from this QIS:

- Calculations are based on ***existing policies and national supervisory frameworks***, whereas practical use of the HBS and underlying supervisory responses under the future regulatory framework are expected to lead to more convergence.
- ***Valuation of key elements was insufficiently specified*** (including sponsor support methodology, allowed simplifications and their related impact, absence of guidance with respect to modelling discretionary adjustment and security mechanisms).
- ***Different interpretation*** of adjustment and security mechanisms across countries ***and inconsistent application*** of the technical specifications within a same country added extra variability to the results.

The results should therefore be analysed with care, mainly focusing on future areas for enhancement.

GENERAL RESULTS[vi]

The graph below compares for the participating countries the excess value over liabilities (EAL[vii]) as a percentage of the total liabilities both under current regime and benchmark scenario (Set 3)[viii] tested under QIS IORP:

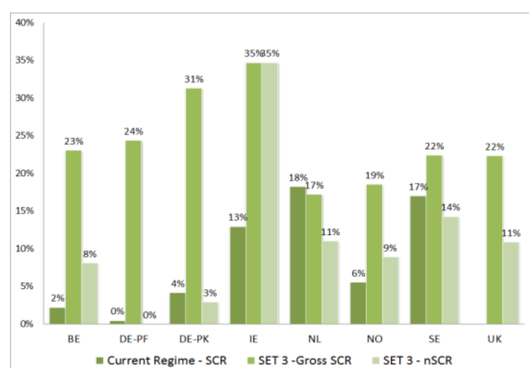


Under the current supervisory regime, only Ireland and the United Kingdom have on average a negative excess of assets over liabilities. Under the tested scenario, only Germany (Pensionfunds), Norway and Sweden would keep a positive excess.

The countries that are most adversely affected are the ones where expected return on assets is currently used to discount technical provisions[ix] with unconditional benefits and a limited value for security mechanisms.[x]

Two countries would even increase the EAL under the future regime: Sweden could use a discount rate that is higher than the current guaranteed rate and the United Kingdom would be able to recognize sponsor support and pension protection scheme that would be higher than the increase in liabilities.

If we now compare the capital requirements (in % of total liabilities) under the current regime and under Set 3 (99.5% confidence level before and after loss absorbing capacity), we see very interesting patterns.



Except for the Netherlands where the current regime is quite similar in terms of gross capital charge, the SCR under IORP2 would result in a sharp increase in most countries, representing on average about 25% of the total liabilities with a high proportion of market risk[xi] followed by longevity risk and counterparty risk where security mechanisms can be activated.

The loss-absorbing capacity by benefits and security mechanisms plays an important role to reduce gross SCR to nSCR and varies significantly over countries: from 100% for the German pension funds to 0% under current calculations in Ireland, where benefits reduction could actually have been considered.

It should be noted that the minimum funding requirement is not based on the nSCR coverage but on the best estimate of technical provisions calculated with the expected return on assets (Level B – Best Estimate). Only Ireland and the United Kingdom would fail to reach this minimum threshold at the end of 2011.

FIRST ANALYSES ON THE DUTCH MARKET

Nine IORPs were invited by the Dutch Central Bank (DNB) to participate in this QIS, being an adequate representation of the Dutch pensions market. DNB then grossed its results up by weighting and scaling to a national level.

According to the specifications, the benchmark scenario had to include ex-post benefit reductions. However, only IORPs from the Netherlands included these reductions in the benchmark scenario. For comparability, the benchmark scenario for the Netherlands was replaced with the results of Set 14, which excludes ex-post benefit reductions.

Because of this change, also the results of Sets 4 to 18 (which are based on Set 3) could not be included for the Netherlands in the EIOPA report. However, DNB published a national report containing the full QIS results from the Netherlands.[xii]

Under the current regime, assets in the Netherlands exceed the level of liabilities by 2%, but are insufficient to meet the funding requirement.

In Set 14, the current positive excess of assets over liabilities decreases to a negative excess of assets over liabilities of about 10%. This decrease is mainly caused by the lower discount curve for the liabilities, the inclusion of mixed benefits and finally

by the inclusion of a risk margin (which does not exist in the current regime).

The current shortfall with regard to the funding requirement of 17% of liabilities decreases to a shortfall (negative surplus) of 21% under the nSCR with a 99.5% confidence level.

The difference caused by including the security and benefit adjustment mechanisms is rather large (Set 3). Only the inclusion of ex-post benefit reductions turns a shortfall of 200 billion in to a surplus of 19 billion. However, within the IORPs there is a large difference in the use and value of the security mechanisms.

In the original benchmark (Set 3), the current positive excess of assets over liabilities would increase from 2% to 8%. The current shortfall with regard to the funding requirement of 17% would change into a small surplus of 2%.

However, it can be argued that the value of the security and benefit-adjustment mechanisms in this calculation are unrealistically high. Especially the ex-post benefit reductions and the sponsor support, which now reach up to 30% of accrued benefits (for ex-post benefit reductions) and 50% of current unconditional liabilities (for sponsor support), will be unacceptably high from a politic, policy and participant perspective. Also, the fact that benefit reductions would be a last resort (after all other options are exhausted) is not taken into account in the current specifications.

FIRST ANALYSES ON THE BELGIAN MARKET

The national Financial Services and Markets Authority (FSMA) also published a country report on Belgium.[xiii]

Fourteen IORPs conducted the QIS themselves on a voluntary basis, representing only about 23% of assets. The considered sample is, however, quite heterogeneous: two large IORPs with no sponsor support are included, whereas most IORPs can rely on sponsor support. One of those IORPs manages a specific type of pension promise for independents with a benefit reduction mechanism, whereas all other IORPs manage unconditional benefits.

Aggregated results are therefore not representative for the whole defined benefit Belgian pensions market, and results should be analyzed with care without any conclusion on the impact on individual IORPs.

In Set 3, the current positive excess of assets over liabilities of 11% decreases to a deficit of assets over liabilities of about 12%. This decrease is mainly caused by the lower discount curve for the liabilities (+18%), the inclusion of a risk margin (+9%) and the recognition of the sponsor support at a rate of only 1% on average.

It should be noted that there is a lot of variation behind the average value of sponsor support: two large IORPs have a zero value for sponsor support while some others have recognized a substantial negative value in case of surpluses over liabilities (calculated on ABO basis[xiv]) that more or less cancel out the positive values included by many other IORPs. This average sponsor support value would reach 18% if only IORPs with positive sponsor support had been considered.

The results show a strong increase in capital requirement by a factor of more than three. A surplus of 9% of liabilities under the present funding requirements turns into a shortfall of 20% under the nSCR with a 99.5% confidence level. Excluding those two specific IORPs with no loss-absorbing capacity of sponsor support would reduce the shortfall to 1.3%.

FURTHER WORK

This first exercise points out several issues that need to be addressed properly:

- In the methodology for ***quantifying the Sponsor Support***,[xv] the maximum amount (especially in case of multi-employer schemes) should be further investigated. More guidance should also be provided to establish the default probability of unrated sponsors and the legal enforceability of their support.
- The role of ***Level B estimate*** threshold should be further specified in terms of tiering of assets, recovery plans and supervisory responses. More work should also be carried out on the actual derivation of the level B rate.[xvi]
- ***Long-term guarantees*** have been introduced in this first QIS, but the adjustments to the risk-free curve, given the long-term nature of pension liabilities, should be refined after the assessment that took place within insurers in the first quarter of 2013. The results of the LTGA executed by the insurance industry are not very consistent throughout Europe, so this might become a long and difficult process.
- The ***valuation of discretionary adjustments and security mechanisms*** should be subject to further guidance to avoid too much room for interpretation when modelling those key elements.

- The ***calibration of the SCR parameters*** (including equity risk sub-module) should be another area for development.
- The **supervisory framework** (such as supervisory actions, for example) can significantly influence the numbers but also enhance comparability, and therefore should be clarified.

NEXT STEPS

The initial planning called for a legislative proposal by the European Commission on the new IORP directive by June 2013.

This timing is now clearly unrealistic, while the variation in results reinforces the need to take the required time for developing this new regulatory framework.

In the meantime, EIOPA aims to publish a report on sponsor support and a final report on QIS results by June 2013.

The next steps are also to be considered in interaction with other EIOPA works for the future Solvency II framework (including, among others, long-term guarantee assessment, interim measures and calibration for long-term investments) .

SUMMARY

It is hard to interpret and compare the first QIS results.

There are still quite some ambiguities in the specifications with no clear documentation under current EIOPA report on their effective implementation and methodologies used across countries. These also contribute to the results not being easily comparable.

Also, supervisory responses to certain circumstances are not specified yet. These responses will influence the values.

It should finally be noted that the security and benefit-adjustment mechanisms (such as sponsor support and ex-post benefit reductions) seem to be overvalued if they are valued according to the specifications.

This first QIS was a necessary step, but there is still a lot of work to be done on the future IORP regulatory framework.

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[i] See our first market update for more information: http://europe.milliman.com/perspective/published-articles/new-risk-based-prudential-regime.php

[ii] See complete document on: https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/QIS/OPC/qis1/Outcome/EIOPA-BoS-13-021_QIS_on_IORPs_Preliminary_Results_for_EC_-_20130409.pdf

[iii] It should be noted that Portugal participated in the QIS but did not publish the results due to a quality and completeness issue.

[iv] Two exceptions should be mentioned here: the 14 Belgian IORPs represent only about 23% of total assets and the seven pension funds in Norway account for 50% of total assets.

[v] The only requirement of the 2003 IORP directive is that assumptions and methodologies should be chosen prudently.

[vi] It should be noted that the results have been aggregated by the national supervisors based on different approaches (including scaling up to ensure some representativeness).

[vii] Which equals assets – (technical provisions + other liabilities).

[viii] A short description of the most important sets: Set3 - Benchmark scenario, Set 1 - Upper bound scenario, Set 2 - Lower bound scenario, Set 14 - Exclusive ex-post benefit reductions. A total overview can be found in the EIOPA technical specifications: https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/QIS/OPC/qis1/Technical_specifications/Commission_-_Technical_specifications_QIS_on_IORPs_-_8_October_2012.pdf

[ix] The diversity of discount rates between member states is best illustrated as follows: BE, DE, IE, UK use expected return on assets, while NL uses adjusted swap curve, NO the contractual interest rate (2.5%-3.7%) and SE an average between the government bond curve and the covered bond (AAA) curve.
Besides lower discount rates, a risk margin of 8% is added on top of the best estimate. It should, however, be noted that the concept of risk margin for IORPs and the value of 8% are still under question (e.g., Norway assessed this percentage to range between 1.2% and 1.65%).

[x] Non-unconditional benefits are mainly observed in DE pensionskassen, NL and NO. Sponsor support can be recognised in BE, DE, NL, SE and UK. DE pensionskassen and UK also benefit from pension protection scheme.

[xi] Market risk consists mainly of interest and equity risk. The high proportion invested in euro government bonds by IORPs EOY11 is a possible source of explanation for the relatively low capital charge for spread risk.

[xii] See complete document on: http://www.dnb.nl/binaries/National%20note%20-%20Netherlands_tcm46-290649.pdf

[xiii] See also the national supervisor report on: http://www.fsma.be/fr/Supervision/pensions/bpv/Article/Europe%20bpv/~/media/Files/fsmafiles/Europe%20bpv/reportbelgium.ashx

[xiv] See our feedback market update on QIS for more information on ABO-PBO approach: http://europe.milliman.com/perspective/published-articles/feedback-QIS-IORP.php

[xv] In the absence of sufficiently strong adjustment or security mechanisms, HBS may not balance because of default risk from the sponsor support. The only way to close the gap would consist of additional payments or benefits reduction to have liabilities fully covered by investment assets.

[xvi] The derivation of equity risk premium should be refined while reflecting any allowance for further planned changes in IORPs asset allocations.