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## Will the 'holistic balance sheet' prove to be Solvency II by the back door?

### In brief

- On 25 October 2011, EIOPA published a consultation paper on its draft advice to the European Commission on the review of the IORP directive.
- This review could have significant implications for the funding of UK defined benefit schemes if it results in a regime similar to that imposed by Solvency II on insurance companies.
- Potentially UK DB schemes may in future need to be funded on a basis similar to full buy-out, with a requirement to hold solvency capital in addition.

### Next steps

- The EIOPA consultation closes on 2 January 2012. Individual UK pension schemes may wish to consider responding to the consultation.
- The next stage is for EIOPA to deliver its final advice to the European Commission (now expected by the end of February).
- After this, the European Commission is expected to start work on the new IORP Directive. A draft directive and a quantitative impact assessment are expected in 2012.

On 25 October 2011, the European Insurance and Occupational Pensions Authority (EIOPA) published a consultation paper on its draft advice to the European Commission (EC) to help the EC's review of the Institutions for Occupational Retirement Provision (IORP) directive. This review could have very significant implications for the funding of UK defined benefit (DB) pension schemes if it results in a funding regime similar to the Solvency II directive regime for insurers.

### Background

The IORP directive is the European legislation which provides a framework for the regulation of funded occupational pensions in Europe. The EC has initiated a review of the directive for several reasons including its wish to promote the use of cross-border schemes (currently very rare in the EU), the desire for a level playing field between pensions and insurance, and the perceived need for EU-level risk-based supervision. To inform its review, in April 2011, the EC asked for advice from EIOPA (the EU supervisor for insurance and pension schemes) in a number of areas in a formal "Call for Advice".

### EIOPA consultation paper

On 25 October 2011, EIOPA published a consultation on all its draft advice to the EC (a preliminary consultation in July 2011 did not cover funding). The mammoth consultation, which sprawls to over 500 pages, covers (amongst other things) how Solvency II style insurance funding could apply to EU occupational pension schemes, including UK DB schemes. The consultation closes on 2 January 2012 after which EIOPA is expected to give its final advice to the EC so that the EC can start work on a new IORP Directive. This briefing note focuses only on the proposals on funding and security mechanisms and on the possible implications for UK DB schemes.

### Different types of IORP: different policy options...?

At present, the IORP directive recognises two main types of IORP:

- *Article 17(1) schemes*: where the IORP itself provides guarantees to cover certain risks. There are currently no such schemes in the UK.
- *Sponsor-backed IORPs*: where the sponsoring employer bears the ultimate risks e.g. UK DB schemes.

The two types of IORPs are currently subject to different solvency requirements, i.e. Article 17(1) schemes, common in the Netherlands, are required to hold additional capital.

The EC has set EIOPA the task of ensuring that the level of security offered by all IORPs is 'similar and ideally the same', although this can be achieved in different ways. EIOPA recognises that there are important differences between pension schemes and insurers. In the consultation paper, EIOPA considers two broad policy options, each of which represents 'one end of the spectrum of possibilities':

- *IORP directive*: keeping the current approach i.e. different solvency requirements for different types of IORP, often allowing for security mechanisms implicitly; and

- **'Holistic balance sheet'**: which aims to create a single regulatory framework sufficiently flexible to cope with both main types of IORP. All security mechanisms would be recognised in an explicit way.

EIOPA suggests that a holistic balance sheet approach is necessary to achieve the EC's goal of a similar level of security between IORPs.

**Holistic balance sheet**

The holistic balance sheet approach differs from simply applying a Solvency II style regime, because it considers elements outside the IORP itself.

For a typical UK DB scheme, the holistic balance sheet might have the following asset components:

- **Financial assets**: valued at market value;
- **Financial contingent assets**: such as escrow accounts and charges over property;
- **Non-financial contingent assets**: comprising the 'value' of the sponsor covenant and possible recourse to a pension protection scheme (e.g. the UK's Pension Protection Fund (PPF)). The sponsor covenant could explicitly include the support provided to a pension scheme through a recovery plan. EIOPA envisages that recovery plans of up to around 15 years might be appropriate.

Similarly, the liabilities taken into account might include:

- **'Best estimate' of liabilities**: note that 'best estimate' here may mean a market-consistent risk-free rate.
- **Risk buffer**: this would be a buffer for covering risks beyond what is determined at the 'best estimate' level.
- **Capital requirements**: additional solvency capital calculated on a risk-based basis.

Together the best estimate of liabilities and the risk buffer would constitute the technical provisions. It is worth emphasising that 'best estimate' may not mean the same thing as is usually the case in a UK DB context. It seems more likely that it will mean discounting at a 'risk-free' rate in line with the Solvency II directive i.e. potentially technical provisions (the 'best estimate' plus a risk buffer) may need to be set at a level similar to full buy-out.

EIOPA notes that this would lead to a 'material rise in technical provisions in many Member States' and higher up-front financing costs leading to employer reluctance to provide DB pensions.

Furthermore, the additional solvency capital requirements could result in a basis even stronger than full buy-out for UK DB schemes.

EIOPA does consider an alternative valuation approach with two levels of technical provisions:

- **'Level A technical provisions'**: which are fully harmonised and based on a risk-free interest rate; and
- **'Level B technical provisions'**: which could be calculated using an interest rate based on expected asset returns.

Harmonisation could start with Level B technical provisions moving over time to a higher level of technical provisions. Financial assets may only be required for Level B technical provisions with the difference between Level A and Level B covered by other items on the asset side.

Sponsor covenant could include paying (increased) contributions on an ongoing basis, the sponsor paying the benefits directly if the IORP cannot, and claims on the sponsor where the IORP is discontinued (e.g. UK statutory debt on the employer). EIOPA note that valuing sponsor covenant might be difficult and suggests that schemes might be allowed to use approximations and qualitative assessments. EIOPA also considers whether pension protection schemes (such as the PPF) should be included as an asset in the holistic balance sheet, although it appears to suggest that it is questionable whether such schemes should be taken into account.

**Possible impact on defined contribution schemes**

EIOPA is considering requiring DC schemes to hold additional assets to cover operational risks so the holistic balance sheet could apply to DC schemes too with possible cost implications.

**Summary**

It had been feared that the review of the IORP directive could result in a Solvency II style regime being imposed on UK pension schemes. It seems that this will not come to pass, at least directly; however, the 'holistic balance sheet' might be almost as bad a prospect: employers might still have to fund on a basis stronger than full buy-out and a complicated (and costly) explicit valuation of the employer's covenant and possible recourse to the PPF might be needed.

Although the consultation is fearsomely long and detailed, there remains in places a lack of clarity on key points of detail and on the preferred policy option, which is frustrating for such a potentially significant consultation. It is hard to see why existing UK DB schemes, which are not competing with insurers, need to be subject to similar solvency requirements. The EC may get their desired 'level playing field' but at the cost of ending the game for UK defined benefit schemes.

**Where can I get further information?**  
 For specific advice, please get in touch with William Fitchew on 020 7839 8600 or by email on [william.fitchew@puntersouthall.com](mailto:william.fitchew@puntersouthall.com). Alternatively, speak to your usual Punter Southall contact.

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