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Solvency 2 - IMPORTANT "Draft Technical Specifications - QIS of EIOPA's Advice on the Review of the IORP Directive"

21st June 2012

The European Commission has asked the European Insurance and Occupational Pensions Authority (EIOPA) to review the 2003 European Directive for the activities and supervision of

Institutions for Occupational Retirement Provision (IORP). The outcome of this process is likely to drive the shape of the UK pensions industry for at least the next ten years and is therefore of vital importance.

EIOPA has been criticised in the media for not providing any form of impact analysis for their recommendations; this is an important part of any European legislation and is highly relevant as the stated aims of the review include the encouraging of cross-border pension provision activity (it is perhaps a moot point as to whether any appetite for this actually exists).

EIOPA has therefore announced a consultation on the technical framework for the first Quantitative Impact Study (QIS) for pension provision. By way of comparison, the insurance industry has already gone through 5 QIS exercises in establishing and moving to implement Solvency 2. The scope of this consultation, which expires on 31 July, is to seek views on the form of the QIS; the actual study itself is not expected to take place until Q4 2012.

The Pensions Regulator has already indicated that it will be responding to EIOPA's QIS so there will not be any additional informational burden on UK pension schemes at this stage. However, the Regulator comments that it would take into account any submissions from pension schemes able to run the methodology voluntarily.

We are of the view that regulators often value direct engagement with direct users as well as advisers and trade bodies and would therefore recommend larger schemes consider some engagement. However it should be noted that the consultation document is highly technical, covering both

- the valuation of the 'holistic balance sheet': comprising technical provisions, sponsor covenant, PPF support, other forms of insurance, assets and liabilities, and

- the risk factors associated with the proposed solvency capital requirement: operational, market, liquidity, credit and health risks, liability risk and intangible asset risk

so not many schemes will be in a position to contribute directly.

Comment on this in the media has again been negative, with the NAPF expressing disappointment that the holistic balance sheet approach is still being considered and some consultants reported as arguing that the QIS exercise misses the point and does not address how the output numbers will be used to support the policy decision to be made by the European Commission.

We believe that some form of combined and comprehensive analysis covering assets, liabilities and covenant is necessary to assist in the financial and risk management of pension schemes. It makes little sense to consider investment strategy separately from liability management and, particularly in these current times of record deficits, the scheme asset supported by the employer covenant - i.e. the Recovery Plan - is often one of the most valuable resources a pension scheme has at its disposal.

The vexed question of liability discount rates is key: the proposed QIS technical specification suggests starting at a risk-free rate and establishing a factor sensitivity to changes in this rate. We are concerned about a behavioural 'anchoring' effect that is likely to push policymakers towards setting an unreasonably low spread to gilts and hence force schemes and sponsors to build in an unnecessary and unbudgeted credit enhancement by substituting the UK's credit rating - or that of a heavily regulated insurance company - for that of the employer.

The UK defined benefit pension market is radically different to the insurance market and a simple cut-n-paste of insurance Solvency 2 is likely to result in increased risks and costs out of all proportion to the benefits provided. Engagement and analysis by industry participants is therefore crucial.

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