Guest Editorial

Solvency II: Friend or foe?

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There is never a shortage of activity in the world of (international) pensions. This certainly applies to European pension schemes. Barely has one European Directive on pensions been issued, then another one comes along. All these EU Directives have one thing in common: they intend to place the funding of occupational pension schemes on a sounder footing. Of course, as the poet reminds us, the best laid plans of mice and men often go awry. But this does not detract from the need for some form of funding-regime to be in place for occupational pension schemes. The alternative would be for each pension scheme to muddle along in its own way, with the risk that a fair few of them would go to the wall.

However, even though sensible, effective and targeted regulation is therefore welcome, regulatory overkill is not. The European Directive 2003/41/EC, the IORP-Directive, laid down some ground rules pertaining to the funding of occupational pension schemes. Essentially, pension schemes now have to meet a requirement to be fully funded at all times, with underfunded schemes having to put in place a recovery plan showing how scheme solvency can be restored within a set timeframe. In the United Kingdom (UK), the Pensions Act 2004 incorporated much of this Directive by introducing the scheme-specific funding regime. Much of the terminology in the relevant parts of that Act is taken directly from the Directive; for example, the requirement for schemes to meet their technical provisions (that is, to be 100 per cent funded).

Since the Pensions Act 2004 came into force (early 2005), the Pensions Regulator has overseen implementation of the new EU requirements. The old minimum funding requirement has

now been phased out, and almost all schemes have moved onto the new scheme-specific funding standard. This, together with the presence of a pro-active Pensions Regulator equipped with the dreaded moral hazard powers of contribution notices and financial support directions, has led to a shift in the balance of power between trustees and the employer. Where previously trustees were less likely to insist on additional funding obligations being imposed on employers, they are now actively encouraged by the Pensions Regulator to treat their scheme as effectively being a creditor of the employer. Like every creditor, schemes should ensure that their debtors pay them the money they owe. The basic rules of finance have been made to apply to the pensions sector.

Within the UK, the impact of the Directive on pension schemes has been great. Certainly, the usual funding problems have not been solved overnight – nor is it likely that they ever will be. Pension schemes are struggling with the twin pressures of ageing and excess regulation, making it more and more difficult to finance their members' benefits. But at least the new legal framework has provided some structure and homogeneity to what was until then a fairly shapeless and toothless funding regime.

Does this mean that a new Solvency Directive is now really needed, and could it improve things? This is a big question. The EU has now passed Directive 2009/138/EC, due to come into force in October 2012, known in the trade as 'Solvency II'. Although it does not directly impinge on occupational pension schemes, as it is intended for insurance companies, it is likely to affect such schemes.

What does Solvency II do? Basically, it sets out stricter requirements on capital adequacy and risk

management for insurers, with the aim of increasing protection for policyholders. The new regime is intended to apply to all insurance firms with gross premium income exceeding €5 million or gross technical provisions in excess of €25 million. The Solvency II Directive is contained within a pillared structure. Pillar 1 covers the financial requirements, setting out how regulatory capital requirements should be calculated. Pillar 2 deals with standards of risk management and governance. Pillar 3 seeks to improve levels of transparency and introduces new disclosure requirements for firms.

Solvency II, therefore, introduces further harmonisation and tighter regulation into the insurance market. The question is whether this will also have a knock-on effect on pension schemes. After all, the new guidelines contained in Solvency II should make little direct difference to most occupational pension schemes. Such amendments as Solvency II does make to the IORP-Directive only modify article 17, which deals with regulatory own funds. Most UK occupational pension funds do not classify themselves as such, and therefore one might be tempted to think that for them Solvency II is a bit of a red herring. Funded occupational pension schemes in other countries, like the Netherlands, might be more directly affected, but the bulk of the new provisions in Solvency II will not be aimed at them either.

Where, then, could occupational pension funds face difficulties emanating from Solvency II? Put simply, the worry is that Solvency II will force up the price of annuities. The reason for this is that Solvency II requires insurers to hold more capital to cover their annuity books. The cost of holding extra capital will be passed on into annuity pricing, making annuities more expensive. This will result in buy-out exercises for defined benefit schemes becoming dearer (and potentially less likely). It will also have an impact on members of defined contribution schemes: they, after all, use their accumulated pension pots on retirement to purchase annuities. The more expensive these annuities are, the more this will eat into the member's pot, leaving a smaller pension at the end of the day.

The impact this could have on the buy-out market is therefore an issue worth worrying about. In recent years, more and more pension funds have attempted to provide benefit security by means of a buy-out exercise, whereby trustees enter into an annuity contract with an insurance company. The insurance company effectively assumes the liability of providing the stated benefits (that is, the benefits are 'bought out'), instead of the trustees having to pay benefits out of general pension fund assets. The advantage of this is that members' accrued rights are better protected against the vagaries of underfunding. Of course, there is a price tag attached to this: after all, pension funds are effectively purchasing a benefit guarantee for their members, and this does not come cheap. Trustees are always keen to ensure that their members' benefit security is enhanced, and buy-out exercises seem to make this possible. Buy-out options have therefore become more common in recent years.

Clearly, any change that drives up the price of annuities will throw a spanner in the works in this respect. If trustees of occupational pension plans (or indeed, outside the UK, directors of boards of pension schemes) find that the cost of securing a buy-out is becoming increasingly expensive, they may well think twice before going down this road. This would mean that the buy-out alternative might lose its lustre. Members of defined contribution pension plans would feel the pinch even more directly if annuity prices go up, although the removal of compulsory annuitisation in the UK might have an ameliorating effect on this point.

Defined benefit arrangements that are directly insured with an insurance company (common in, for example, the Netherlands) could also end up being squeezed through Solvency II, as their underlying insurance contracts could face increasing costs. This could lead to a further dismantling of 'collective' pension arrangements. After all, employers may well find that the most attractive option would be to do the bare minimum for their employees in future: simply promising to pay monthly contributions into a personal pension plan might well be the way forward. The performance of the member's

dc-pot (and the size of the annuity) will then really be a matter for the members themselves. Certainly, countries with a collectivist tradition in pension matters (like the Netherlands) would have misgivings about such an outcome.

Is Solvency II, then, a friend or a foe of occupational pension schemes? The answer seems to be that, at the very least, further moves to tighten the insurance market through additional regulation could well make life more difficult for pension schemes. Few would dispute the need to have sensible and effective regulation in this area – but it has to be done in a thought-through way. The concern has to be that, like the late, great Eric Morecambe, Solvency II is playing all the right notes, but not necessarily in the right order.

Occupational pension schemes have been buffeted by the storms of different regulatory challenges in recent years. New laws and regulations have helped to impose a degree of coherence on what used to be a fairly ineffectual funding framework – but now occupational pension schemes need a breathing space to get on with what they should be doing: looking after the accrued pension rights of their members. Endless new regulation, however well intentioned, will not necessarily improve things and may well make matters worse.

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