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Pensions sector says Solvency II ill-suited

By Sophia Grene



The good folks at the European Insurance and Occupational Pensions Authority have a busy few weeks ahead. They are sifting through more than 3,000 comments on the consultation paper draft response to call for advice on the review of directive 2003/41/EC.

In plain English, they are reading the [pension industry's](#) response to a suggestion that a Solvency II type regime should be applied to funded defined benefit pensions. There is of course more to the consultation paper, which is more than 500 pages, but the [Solvency II proposal](#) is the most controversial.

Total investment in pension funds 2006

| | \$m | % of EU total |
|-------------|-----------|---------------|
| Austria | 15,611 | 0.45 |
| Belgium | 16,769 | 0.48 |
| Denmark | 89,570 | 2.57 |
| Finland | 149,497 | 4.28 |
| France | 25,094 | 0.72 |
| Germany | 122,764 | 3.52 |
| Ireland | 110,093 | 3.15 |
| Italy | 55,681 | 1.60 |
| Netherlands | 860,877 | 24.67 |
| Poland | 37,964 | 1.09 |
| Portugal | 26,581 | 0.76 |
| Spain | 92,527 | 2.65 |
| Sweden | 36,397 | 1.04 |
| UK | 1,831,290 | 52.48 |

Source: Association of Pension Lawyers

“The short answer is no,” says Niels Kortleve of Dutch pension fund service provider PGGM. Mr Kortleve serves on the Dutch pension funds association’s (Pensioenfederatie) committee for international affairs and is a member of Eiopa’s stakeholder group. “The holistic balance sheet concept is good, but it is very questionable whether it could or should be implemented.”

The Solvency II directive requires insurance companies to meet certain standards of governance, risk management and, crucially, valuation and calculation of minimum capital requirements. These standards are designed to ensure insurance companies stand no more than a one in 200 chance of going bust in any given year (a 99.5 per cent confidence level).

The analogous solvency regime proposed would have significant implications for funded schemes, and so is strictly relevant only to the UK and Netherlands, which between them have more than 75 per cent of the European Union’s funded pension schemes by value of assets.

Accordingly, pensions professionals in both countries have been busy pointing out why it would not be reasonable to apply a regime designed for insurance companies.

In the UK, there is a significant practical obstacle to implementation. It would require schemes to value liabilities with a lower discount rate, increasing them significantly and therefore requiring them to increase their level of funding.

Since UK pension funds are already struggling to plug deficits with the current valuation of liabilities, this would effectively mean sponsor companies having to put a

lot more money into the pension funds, making them less attractive to provide and speeding up the demise of the occupational DB scheme.

“Forcing companies to divert money away from business investment could do serious damage to the pace of economic recovery in Europe,” says the Confederation of British Industry in its submission to Eiopa. According to its estimates, UK companies would have to contribute up to an additional €500bn (\$650bn).

The kind of assets held by pension funds would be likely to have to change too, from equities to government bonds. Such a switch “would destabilise British and international finance markets when the stability of the economy and financial markets remains fragile”, the CBI says.

Merely calculating the requirements of a Solvency II type regime would be next to impossible, according to the Association of Consulting Actuaries, which is not in favour.

“Overall, there would not be enough actuaries in Europe to deal with the workload, should the complexities described in this consultation ever be visited upon us, regardless of the simple truth that a Solvency II regime is inappropriate, unaffordable and unnecessary,” says Paul Kelly, chairman of the ACA’s international committee.

While the CBI and ACA dwell on the practical implications, other market participants point out that the idea does not make sense on a theoretical level.

The European Association of Public Sector Pension Institutions lists five key differences between pensions and insurance companies that make it inappropriate to use insurance regulation in the context of pensions.

Their social aims, collective nature, efficiency and solidarity and the inbuilt security mechanisms such as implicit guarantees from the sponsor or the ability to change the benefits all mark out pensions from insurance companies.

Con Keating, head of research at the European Association of Financial Analysts Societies, says in the UK system “the sole risk faced by the pension beneficiary is sponsor insolvency”. This means the risk a scheme member faces from potential insolvency of the scheme is conditional on the risk of the company going bankrupt.

“Given the historic average default rate of 0.6 per cent [a year], this conditional member risk may reasonably be considered to be around one two-hundredth of the unconditional scheme risk,” he says in an unpublished paper analysing UK private sector occupational pensions.

While UK respondents are vociferous in their rejection of the Solvency II concept for pensions, Dutch respondents are more measured. Although the current Dutch solvency requirements are not as stringent as such a regime would be, they are not as far off as the UK's.

“We don't think it's sensible or wise to make a decision yet,” says Mr Kortleve. He welcomes the fact that Eiopa chairman Gabriel Bernardino has “taken on board that Solvency II is not appropriate”, but he does think some aspects could be usefully applied.

Since Eiopa's aim is to ensure sustainability of pensions and their harmonisation across the EU, Mr Kortleve welcomes the idea of common standards of governance, transparency and metrics for valuing liabilities.

However, the latter may not be realistic, according to a [study](#)* from the Organisation for Economic Cooperation and Development, which concluded “international standards of funding regulations is unlikely”.

**Yermo and Severinson, 2010, The impact of the financial crisis on defined benefit plans and the need for counter-cyclical funding regulations*