Executive Summary

- This paper discusses the effect of various funding regimes for defined benefit (DB) occupational pension schemes. It considers why these might differ from those applying to insurance companies and, in particular, why an insurance-type solvency regime would be inappropriate for pensions. It also explores the implications throughout the EU if a solvency regime were to be applied to pension schemes.
- The paper should be considered against the background of Solvency II (the new insurance company funding regime) and any future review of the Institutions for Occupational Retirement Provision (IORP) Directive, together with the EU's aims of encouraging private pension provision and reducing the reliance on state benefits, developing an effective single market and ensuring protection for members and beneficiaries.
- Although it has been confirmed that Solvency II will not be applied to occupational pension schemes, a prescribed funding standard such as a solvency regime may still be imposed through an amended IORP Directive. A solvency regime for pensions would mean the use of a prescribed prudent basis to value liabilities, together with additional solvency margins. This may result in funding requirements similar to those of Solvency II, although alternative solvency regimes are possible. Qualitative requirements may be imposed in addition, similar to the second and third pillars of Solvency II.

Insurance and pensions

- Insurance and pensions are fundamentally different and have different economic and social objectives. They should therefore be subject to different funding requirements and regulatory regimes.
- The key difference is the covenant of the sponsoring employer to pension schemes. A pension scheme generally has recourse to further income if needed in the event of adverse experience (assuming the employer remains solvent). Additionally guarantee funds operate in some countries (notably the UK and Germany) which provide security in the event of the sponsoring employer's failure. This reduces the need to hold solvency margins in the same way as insurers must do.
- More generally, pensions are deferred remuneration, designed to provide an income in retirement. Schemes do not operate on a competitive or commercial basis but rather on a not-for-profit basis. Schemes are often closely linked to social and labour law, and may be formed through collective bargaining or labour agreements, with membership generally offered across a whole workforce and at the same benefit levels. It is often possible to change the benefit promise over time and schemes operate with a long time horizon, enabling investment in more illiquid and return-seeking assets.
- In contrast an insurance contract is a legally binding agreement that operates on a competitive and commercial basis, with an insurer aiming to maximise profits (or bonuses). Benefits are generally fixed at the outset and determined at the individual policy level. Time horizons for most classes of business are fairly short, resulting in a need for assets that are liquid with low volatility.
- One argument for applying a solvency regime to pensions is that harmonisation of security levels will avoid regulatory arbitrage and reduce barriers to cross-border provision. However, any barriers are more likely to come from differences in social and labour law and tax systems, meaning that any market in cross-border provision is likely to be limited to investment management. It should also be noted that studies suggest that very few cross-border schemes have been set up since the implementation of the IORP Directive, which was intended in part to facilitate the introduction of such schemes.

Impact on EU Member States

- On a pan-European basis, future provision is likely to be affected, since DB provision is likely to become prohibitively expensive in all countries. This could result in a general move towards DC provision which typically provides a lower level of benefits. The impact of a solvency regime might well be to inhibit the development of new pensions provision in those Member States (especially the newer Member States) that have yet to develop significant supplementary pensions.
- Again this is in contrast to the EU's aim of "adequate retirement incomes for all" and "promoting the affordability and the security of funded and private schemes". Beneficiaries themselves will suffer as a result of a solvency regime.
- The impact of a solvency regime on individual Member States is likely to vary widely due to the different pensions systems that exist.
- In the UK, technical provisions for a "typical" scheme could increase by around 90% compared to those on an existing funding basis. The impact for the FTSE350 is estimated to be an increase in technical provisions of a similar magnitude, which represents over 15% of the market capitalisation of FTSE350 companies. Employer contributions are likely to need to increase significantly in order to fund the increased deficits. This could increase the number of employer insolvencies, and we may also see schemes and employers looking to reach agreements with the Pension Protection Fund (PPF). For surviving employers, balancing increased contribution requirements with investment in the business could be difficult, and we are likely to see an increase in the number of schemes closing. Since solvency funding is likely to be at a higher level than the cost of buying out benefits with an insurer, we might expect some employers to proceed to a buyout. It is also likely that schemes will reduce equity holdings in an attempt to reduce the solvency margin.
- This could lead to falling equity markets combined with increased demand for bonds, which would in turn lead to lower bond yields. A consequence of this is a spiralling effect, whereby technical provisions would increase and assets would reduce, further increasing deficits and contribution requirements for remaining schemes. This would affect other investors in the equity and bond markets, including insurance companies and defined contribution (DC) pension schemes. Future pension provision is likely to be DC in nature, which typically results in lower benefits as a result of lower contribution rates (a pension of 30% to 40% of final salary might not be uncommon, compared to a common target DB pension of 67%).
- The impact of a solvency regime on members could be serious: we would see accrued benefits reduce where schemes enter the PPF following employer insolvency; this, combined with lower benefits from future pension provision as described above, would result in members receiving a lower income in retirement.
- The PPF levy could reduce because higher scheme funding levels reduce the risk of calls on the PPF. However, we might expect an increase in claims on the PPF as a result of higher insolvency rates, which could lead to increased levies. The application of a solvency regime to the PPF, rather than individual schemes, should also be considered, although this would itself lead to higher PPF levies in order to fund the increase in PPF funding levels.
- In Ireland, a similar impact to the UK is likely, although the magnitude of the financial impact on schemes will differ due to the different funding regimes currently in place. One key difference is that there is no guarantee fund in Ireland, so an increase in company insolvencies with underfunded schemes is likely to result in affected members seeing reductions in benefits (possibly by a greater degree than reductions to PPF benefit levels in the UK) and, consequently, lower incomes in retirement.
- In the Netherlands, funding is likely to increase by between 20% and 30%. Employers will be forced to look for alternative means of reducing the cost of pension provision, such as investment strategy changes in order to reduce the size of the solvency margin. This is likely to increase demand for bonds, pushing down yields, although the impact on equity markets might be less significant since Dutch pension funds tend to hold lower proportions of domestic equities.
- Denmark also has a sophisticated and well-developed system of private pension provision. However, in contrast to the UK, Ireland and the Netherlands, little or no impact is expected since pension arrangements are either based on insurance contracts, in which case insurance regulations apply, or are provided by credit institutions such as banks, in which case they are viewed as savings products and different regulation applies again.

- In some Member States, a solvency regime might be expected to have relatively little impact on existing pension provision because funded DB provision is not widespread. In some countries (Austria, France and Italy) most provision is by means of state arrangements. The Eastern European countries in general have relatively undeveloped pensions industries, giving limited scope for the impact of a solvency regime. In other countries (Finland, Germany, Sweden) DB provision is fairly common but either the benefits provided are fairly low, are limited to certain categories of employee only, or advance funding is uncommon. However, where other means of funding exist (e.g. the book reserve arrangements in Germany), it is possible that a solvency regime could be applied in due course in order to ensure greater harmonisation. In this case other Member States, particularly those where book reserving or pay-as-you-go funding is common, may see a significant impact.
- A solvency regime will effectively penalise those countries that already provide a substantial proportion of post-retirement income through private occupational DB schemes rather than state schemes, and would place these countries on an uneven footing in Europe, which is contrary to the aim of achieving an effective single market.

Existing protection for members

- Looking at the qualitative aspects of a solvency regime, comprehensive regulation already exists in most pensions industries and in some cases (including the UK, Ireland and the Netherlands) this already meets the second and third pillars of Solvency II, as well as providing adequate security and protection for beneficiaries. Examples are funding requirements (most Member States), investment restrictions (Ireland, the Netherlands and the UK), disclosure requirements (Ireland and the UK), governance and internal controls (Ireland, the Netherlands and the UK) and guarantee funds/insolvency insurance (Germany and the UK). This further reduces the need for the imposition of a solvency regime, particularly when combined with the security provided by employer covenant.

Cost of pension benefits

- Analysis suggests that in several Member States, the cost of providing the same nominal amount of pensions on a common funding basis varies quite widely as a result of additional benefits or revaluation which may be guaranteed or discretionary. In particular, the cost in the UK is notably higher than in Ireland, Germany and the Netherlands, reflecting the guaranteed nature of benefits such as indexation in the UK.
- However, other than Germany (where funding is most commonly through book reserves which have no advance funding), the cost of providing pensions is fairly similar, taking into account the benefits associated with the pension (such as indexation) and the typical funding bases used in each country. This suggests that a broadly level playing field already exists in funding, implying that there is not such a need to harmonise funding levels.
- Security of the pension promise is a benefit and therefore has a cost. The value of the pension promise should not be based on benefits or security in isolation, but should take both into account. Any meaningful consideration of the harmonisation of pensions across the EU should therefore allow for the relative balance between these two factors in each Member State.

Conclusion

- A solvency funding regime applied to occupational pension schemes on a "one size fits all basis" and consistent with the Solvency II Directive would have adverse consequences for existing schemes, sponsoring employers and the economy as a whole in the UK, Ireland and the Netherlands in particular, putting those countries on an uneven footing with other EU Member States. More widely, it would also have the effect of impeding the development of private pensions provision across the EU.