Supervisory Statement | LSS5/13

Pension obligation risk: treatment under the Individual Capital Adequacy Standards (ICAS) for insurers

April 2013

BANK OF ENGLAND
PRUDENTIAL REGULATION
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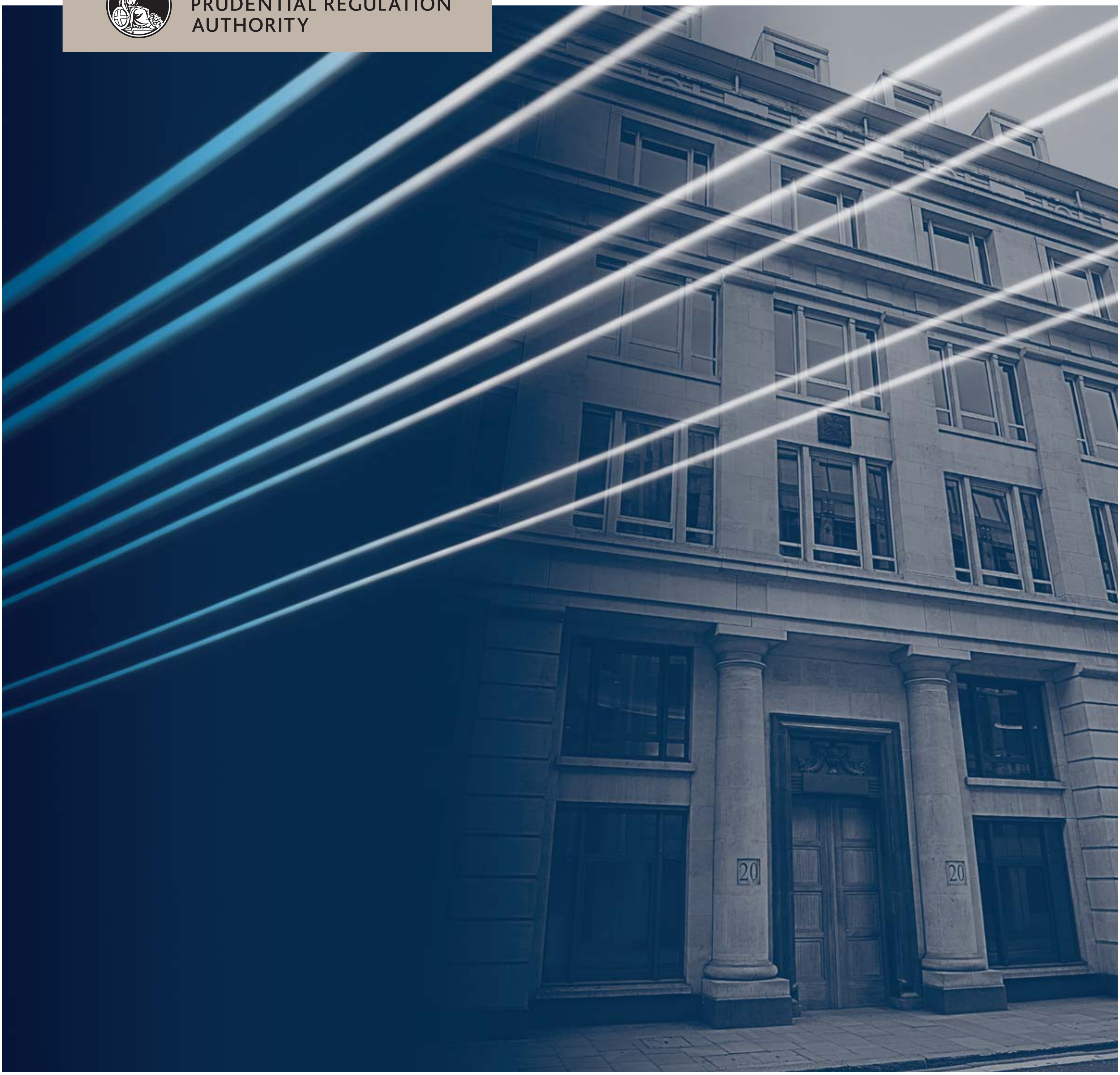

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From its commencement on 1 April 2013, the Prudential Regulation Authority (PRA) has adopted a number of legacy FSA policy publications relevant to the advancement of its objectives. This document, initially issued by the FSA in the form of a letter to the ABI in February 2011, has been adopted by the PRA as a Supervisory Statement as part of this process. The PRA may choose to review this legacy publication at a later stage.

Section 1.2 of the General Prudential Sourcebook (GENPRU) includes guidance on Pillar 2 pension obligation risk capital (P2PRC). The purpose of this document is to provide further information on how we expect firms to evaluate their pension obligation risk, and on how we assess their submissions to us.

Recognising that there are some important sectoral differences, there is a separate Supervisory Statement for banks and building societies including a very similar description of our approach to, and expectations regarding, P2PRC calculations. These two Supervisory Statements concern our expectations relating to firms that are subject to the Prudential Sourcebook for Insurers (INSPRU) or the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU), but pension obligation risk may also need to be considered by PRA-regulated firms which fall outside this scope.

The future of the PRA's P2PRC regime

The PRA expects a firm to provide in its Individual Capital Assessment (ICA) an assessment of the risk to the firm that its actual contributions to a pension scheme would need to increase. We believe that many insurers have made a good effort to assess their pension obligation risk within their ICA. We are not, therefore, making any changes to our rules or guidance with respect to P2PRC at this stage. Instead, the focus of this document is on clarifying our current approach, as we believe that improvements can still be made to the ways in which both firms and ourselves approach the Pillar 2 assessment in practice.

We recognise that there are a number of complex but important issues, with a potentially material impact with respect to this risk, which we are not addressing now. The treatment of pension obligation and pension risk under the Solvency II regime is not yet settled. Once there is sufficient clarity as to the details of the regime we shall consider how to achieve a transition to an effective application, consistent with PRA objectives, when Solvency II is implemented.

The PRA's pension obligation risk framework

The PRA does not have a remit to protect members of defined benefit pension plans against the failure of those plans. A firm is required by GENPRU 1.2.26R to 'at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due'. Accordingly, our basic philosophy towards pension obligation risk capital is that it exists to enable a firm to meet its pension obligations throughout a period of stress and beyond.

Pension obligation risk is defined in GENPRU 1.2.31R(5) as the 'risk to a firm caused by its contractual or other liabilities to or with respect to a pension scheme (whether established for its employees or those of a related company or otherwise)'. A firm's (or group's) obligations to overseas pension plans must be included in any assessment of pension obligation risk. Defined contribution plans offering guaranteed returns that are not fully matched by underlying investments and hybrid schemes are considered to be defined benefit pension plans.

P2PRC should be calculated in accordance with GENPRU 1.2.30R, GENPRU 1.2.79G to 1.2.86G, and INSPRU 7 on ICA, which requires firms to make an assessment of their capital resources 'comparable to a 99.5% confidence level over a one-year timeframe that the value of assets exceeds the value of liabilities' (INSPRU 7.1.42R). When calculating P2PRC, firms should consider that their contributions to their pension schemes will, in most cases, depend on the triennial (or more frequent) actuarial funding valuation prepared for the scheme's trustees rather than the valuation required under accounting standards (FRS 17 or IAS 19). Therefore, it is the trustees' actuarial funding valuation that is more likely to provide firms with the most relevant starting point from which to assess their P2PRC. This is consistent with our guidance that firms' ICA submissions should provide the 'best estimate, calculated in discussion with the scheme's actuaries or trustees, of the cash that will need to be paid into the scheme in addition to normal contributions over the foreseeable future' (GENPRU 1.2.81G). P2PRC may be an amount higher than the 'defined benefit liability' or the 'deficit reduction amount' (as defined in the Handbook Glossary) because the P2PRC calculation 'may differ from the approach taken in assessing pension scheme risks for the purposes of calculating resources to meet the CRR (Capital Resources Requirement), where a firm may not need to consider funding obligations beyond the next five years' (GENPRU 1.2.81G; see also GENPRU 1.3.9R and GENPRU 1.2.26R). We interpret 'the foreseeable future' in GENPRU 1.2.81G as including the time horizon over which a deficit is planned to be cleared in full, as set out in the schedule of contributions agreed between the firm and the pension scheme trustees.

If it differs from our guidance in GENPRU 1.2.81G, firms should justify why the deficit valuation basis they use to assess their P2PRC is the most appropriate. Recent experience has suggested that under conditions of stress, particularly when credit spreads are high, accounting valuations may not satisfy this guidance, and therefore careful consideration should be given before using them. The PRA will, in any case, ask firms to submit the latest full trustees' funding valuation, together with any updates. The PRA prepares its own assessment of a firm's P2PRC at the ICA effective date, which drives the firm's Individual Capital Guidance (ICG), by using an update of the trustees' funding valuation as its starting point and making appropriate adjustments. The update and adjustments will take into account material changes to the valuation up to the ICA effective date (the date as at which the assets and liabilities in the ICA are stated). In preparing its assessment, the PRA will adjust the updated trustees' funding valuation downwards only if the firm has made a clear and compelling case, with which the PRA agrees, that a lower valuation better satisfies our capital adequacy rules. The PRA may, however, adjust the updated trustees' funding valuation upwards without a case being made by the firm if, in the PRA's opinion, a higher valuation better satisfies our capital adequacy rules. In such circumstances we would inform firms of both the quantum of this adjustment and the reasoning behind it.

Key components of pension obligation risk

While different firms' pension schemes will be subject to some common risks, the actual scenarios used by a firm also need to take account of the particular circumstances of both the pension scheme and the firm. Firms should be mindful of the need to update their stress testing assumptions to reflect changing circumstances. We expect firms to explain their choice of scenario in their ICA submission.

The common (and significant) risks to which most schemes are subject include:

- equity value fall;
- property value fall;
- long-term interest rate fall;
- credit spread change;
- price and salary inflation rise; and
- longevity improvement.

This list is not intended to be exhaustive, nor will every pension scheme be exposed to all of these risks. However, our review of firms' ICA submissions will start by looking at the materiality, methodology and calibration they apply to these risks.

Outline of P2PRC calculations

Firms must consider risks to the funding of their pension schemes consistent with a 99.5% confidence level over one year (INSPRU 7.1.42R). We expect firms to use stress and scenario testing where appropriate to quantify the gross impact on the existing scheme surplus or deficit. We do not necessarily favour a stochastic approach over a deterministic one. Firms should decide which approach is the most appropriate, be that using stochastic techniques or some other method.

P2PRC may be reduced by offsets and management actions. Offsets are reductions in a firm's Pillar 2 capital requirements to reflect factors present at the ICA effective date which would reduce the overall net impact of a stress on the firm. Management actions are actions the firm could and would take when a stress occurred in order to reduce its impact.

We expect firms to account for and explain any offsets or management actions they propose. Ideally, where practical, management actions will be formulated after discussion with the pension scheme trustees. The PRA considers offsets and management actions on a case-by-case basis, and applies a prudent approach when doing so. Firms must clearly demonstrate that offsets are valid and that management actions are realistic. They must also demonstrate that both offsets and management actions do not result in double counting and would be effective under stressed conditions. However, we recognise that it will be helpful to firms to have some indication as to what categories of offsets and management actions would, *prima facie* and subject to the merits of the specific case, be likely to be acceptable. The following three criteria therefore offer an indication as to whether a given category of offset or management action is likely to be acceptable to the PRA with respect to P2PRC:

(1) **Financial performance.** Offsets and management actions are more likely to be acceptable if their efficacy does not depend on assumptions as to the future financial performance of the firm, either before or after a stress.

(2) **Third parties.** Offsets and management actions are more likely to be acceptable if their efficacy does not depend on assumptions as to the future agreement or behaviour of third parties, either before or after a stress.

(3) **Immediacy.** Offsets should reflect a risk mitigation benefit that is already effective when the offset is taken. Management actions should be capable of taking effect quickly enough to mitigate the stress to which they are proposed as a response.

Note that these three criteria are not requirements that an offset or management action must meet in order to be acceptable. Instead, firms should look at these criteria as a helpful tool for their own assessment. An offset or management action which fails to meet these criteria will not be precluded from consideration, and the PRA will take into account the specific merits of the case. Conversely, an offset or management action that meets these criteria may still be found unacceptable on other grounds.

Acceptable offsets and management actions will depend on the particular circumstances of the firm and scheme, and no guarantee of acceptability can be given in advance of considering a specific case. However, examples of acceptable categories of offsets might include:

- A reduction in capital requirements arising from diversification of risks within the pension scheme and between the pension scheme and other risks faced by the firm (acceptable only insofar as diversification was not taken into account in calculating the gross stressed pension deficit).

- Passing costs on to with profits policyholders where this is in compliance with relevant rules.

- The firm (as opposed to the pension plan) having portfolio or other insurance in place at the ICA effective date to hedge the risks in its pension plan.

Examples of acceptable categories of management actions might include:

- Removal of the link between active members' pension benefits and their final salaries.

- Removal of discretionary pension benefits.

- A reduction in the future normal contributions which are already provided for within the firm's pension liabilities, achieved by a cut in the benefits relating to future service of current scheme members.

Stress and scenario testing can indicate some large potential P2PRC requirements for firms. To many firms this will not be surprising as there have been significant pension scheme deficits announced in recent years. There will nonetheless be some cases in which more scenario testing is needed and where a full assessment of scenarios for the first time may provide surprising results to firms. However, offsets and management actions may significantly reduce the capital requirements indicated by scenario testing.

We do also expect firms to present a separate projection, over a three to five-year period, of how their capital resources and capital requirements would change in a severe but plausible economic downturn (see GENPRU 1.2.73AG on capital planning). Within this projection, a firm should consider how the calculation of its P2PRC requirement would change during the downturn. The projection does not directly impact the firm's current P2PRC calculation, although it may inform the evaluation of offsets and management actions, and the judgement as to which stresses and correlations are consistent with a 99.5% confidence level over a one-year period.

Pension obligation risk in firms and groups

Firms should ordinarily hold P2PRC against the total liability resulting from:

- past and present employment within the firm (including any legacy or overseas entities); and

- past and present employment outside the firm, pro-rated according to whether the pension fund principal beneficiaries' service was performed for the benefit of the firm.

Firms should also consider whether they may be exposed to pension obligation risk greater than that captured by these general criteria, given the particularities of pension risk (such as the potential for The Pensions Regulator to impose a contribution notice or a financial support direction on any company associated with an employer).

When P2PRC is calculated at group level (either for a UK consolidation group or an insurance group, as defined in our Glossary), these expectations apply to the group as a whole rather than to the individual entities within the group. GENPRU 1.2.52R applies with respect to the allocation of P2PRC within groups. Accordingly, firms must allocate P2PRC to entities within a group in a way that adequately reflects the nature, level and distribution of the risks to which the group is subject, and the effect of any diversification benefits.

Data required for our own assessment

Where we are not provided with sufficient information in a firm's ICA submission, we will seek to gain a better picture of the risks presented by a pension scheme by asking for reasonably obtainable information. This will include a copy of the latest trustees' funding valuation report and the most recent funding updates. Additionally, we may ask for specific data which should be readily available at only reasonable additional cost.