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FOOD for THOUGHT

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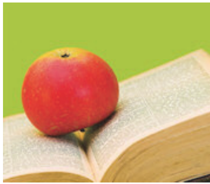
SOLVENCY II - ARE WE CHAINED TO THE THEORY?

The 'Food for Thought' articles aim to stimulate creative and innovative thought in the field of international employee benefits reflecting the fundamental values of IEBA knowledge sharing and educational opportunity.



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Solvency II - Are we Chained to the Theory?

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One of the pleasures of being an expatriate living in Munich in Germany is the ability to observe the goings-on in the UK with a little detachment knowing that events don't directly affect me (although Brexit will do somehow!).

I'm an avid reader of the European version of the Financial Times in the morning and one of the stories that has been repeatedly reported is the closure of the UK Universities Superannuation Scheme pension plan to further accrual and replacement with a defined contribution plan. The FT's editorial succinctly pointed out in its editorial of 21 February that "Part of the problem is in the way long-term risks to pension funds are calculated from a contemporary snap shot of the economy. A sharp rise in interest rates, for example, could clear the forecasted pension deficit which has necessitated the UK's proposed cuts".

So the future employment conditions of university lecturers and staff are being decided by a market snapshot at a particular time based upon a bond market essentially created by the Bank of England through its quantitative easing program (or a series of snapshots over a relatively short period). I'm not privy to any of the discussions that have taken place, but it does seem that policy may be being driven by a very short-term and restricted view of risk and return. The future cash-flows and thus the current value of liabilities maybe bond- like to a certain extent (i.e. the idea that the matching asset portfolio for the expected cash-flows is by definition a bond portfolio) but that doesn't mean that the discount rate to measure the present value of the liabilities should simply be current bond market yields. Surely some allowance for non-bond investment returns is warranted in deciding upon the discount rate? Should a relative short series of deficits (or even surpluses) warrant material changes to benefits? Furthermore, in today's world of quantitative easing, should one not look forward to a period when quantitative easing will end even if that date is uncertain?

However, one should note that this change alone would not save private sector defined benefit plans. Governments have over the years consistently gold plated accrued pension promises and the nature of the guarantee offered by sponsoring companies to win votes (or perhaps at least avoid losing them). This has ultimately simply pushed up the price and risk of offering such plans, whatever the discount rate used. It probably makes sense for purely private sector companies to move away from them for this reason alone.

This issue arises in discussions of the Solvency II Directive (2009/138/EC) of the European Union ("Solvency II"). Essentially, Solvency II sets the amount of capital an insurance company needs to hold to reduce the risk of insolvency. The discount rate used to measure that value of liabilities is ultimately that on government bonds despite all the evidence that government bonds are not as risk- free as we like to imagine. How many of us know for example that one of the biggest defaulters of government bonds has been the various incarnations of the German state prior to 1948? And the current issue of the Eurozone is really about the mispricing of Government bonds of states with very different fiscal outlooks. However, we use the tautology that the matching asset is bonds, so insurance companies invest in them, so that is the return that is achieved, so that's how it should be measured. Now since it has got to be "risk free" we use Government bonds to measure the discount rate. Thus pension provision is made unnecessarily expensive whoever provides it.

Which gets me back to Brexit – all conversations at the moment seem to end on this – will Brexit UK take the opportunity to move away from Solvency II? Or will wider social issues continue to be sacrificed at the altar of a financial theory? - in this sense Katy Perry should have really sung "We are all chained to the theory". ❖

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Disclaimer: The content of articles appearing in the column "Food for Thought" reflect the views of the individual and do not necessarily reflect the views of IEBA.