FINANSINSPEKTIONEN

Proposed capital requirement regulation for undertakings for occupational retirement provision

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To the Swedish Ministry of Finance

On 16 March 2017, the Government assigned Finansinspektionen the task of submitting a proposal for a national capital requirement regulation for undertakings that take the risk for and only provide occupational pension benefits. Finansinspektionen hereby submits its proposal.

Stockholm, 1 September 2017

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Director General

Summary

Finansinspektionen (FI) received a mandate from the Government to propose a capital requirement regulation for undertakings providing occupational retirement. The objective is to provide comprehensive protection for consumers (beneficiaries) while at the same time enabling effective management of occupational pensions. The capital requirement consists of two components: a standardised minimum requirement and a risk-based requirement. A central issue is the level of the protection chosen for the risk-based capital requirement. This decision is so fundamentally important that it should be decided at a political level. However, FI makes the assessment that a capital requirement in line with FI's supervisory tool, the traffic-light model, is a reasonable starting point. A level of protection that is lower than in this model could have a negative impact on the protection for beneficiaries. A higher level could improve FI's possibilities for identifying undertakings that could be susceptible to problems. Too high of a level of protection could result in lower pensions in the long run.

BACKGROUND

The Government intends to propose a regulation for a new type of undertaking that will be called *institutions for occupational retirement provision*. The regulation will cover undertakings that only provide occupational retirement benefits. It will be based on the proposals set out in the report, *En ny reglering för tjänstepensionsföretag* (SOU 2014:57), which in turn is based on the amended Occupational Pension Directive[1] (*IORP 2 Directive*). In order to strengthen consumer protection, the EU regulation will be supplemented with an enhanced solvency regulation, the objective of which will be to provide satisfactory protection for consumers while at the same time enabling effective management of occupational pensions. This means that national capital requirement regulations governing undertakings for occupational retirement provision will be introduced. The Government assigned FI the task of proposing such a regulation.

Under this assignment, FI shall use the following as a basis for its proposal: that the management of occupational pensions consist of very long-term operations, that the operations ultimately are based on agreements in the labour market and that there is a need for good returns through, for example, effective capital management and low fees. The Government furthermore states that there shall be a standardised capital requirement, a risk-based capital requirement and an own funds requirement. FI shall also propose the level of protection and the length of time that is appropriate to use when calculating the risk-based capital requirement, as well as which items should be included in the own funds.

1 Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs) (revised)

A TWO-TIERED CAPITAL REQUIREMENT REGULATION

Following an assignment from the Government, FI has proposed a capital requirement regulation that consists of two components: a standardised requirement and a risk-based requirement. The standardised requirement sets a minimum level, which if breached demonstrates that the ability of the undertaking to fulfil its commitments is threatened. The second part is a risk-based requirement. The risk-based requirement is always larger than the standardised requirement. This provides an additional buffer against losses, which strengthens the beneficiary protection. The requirement also sets a limit on the size of the risks an undertaking can take. This prevents weak undertakings from undermining the beneficiary protection, for example by holding too large a share of high-risk assets.

Many of the undertakings that will apply the new regulations governing undertakings for occupational retirement provision are today covered by one capital requirement, the solvency margin. These firms also apply FI's risk-based supervision tool, the traffic-light model. However, there is no formal intervention regulation linked to the traffic-light model. By introducing a risk-based capital requirement and giving FI intervention possibilities regulated by law, the protection for beneficiaries is strengthened.

If an undertaking's own funds fall below the risk-based capital requirement, the undertaking should prepare a long-term action plan and submit it to FI for approval. The action plan should describe what actions the undertaking intends to take to comply with the capital requirement once again. Since the operations of undertakings for occupational retirement provision are normally very long-term in nature, action plans that stretch over several years may be sufficient. By giving the undertaking time – under FI's oversight – to rectify the situation, the risk-based capital requirement clearly serves as a buffer.

This applies in particular if the requirement is breached due to large falls in asset prices during a financial crisis. In such a case, there are no grounds for forcing the undertakings to quickly reallocate their asset portfolios. The crisis that the requirement is intended to cover has already occurred. If many undertakings transfer (reallocate) at the same time large parts of their portfolios between, for example, shares and treasury bonds, this could amplify the fall in prices, which is to the benefit of neither the beneficiaries nor financial stability. Taking into consideration consumer protection and financial stability, in extreme market situations FI should also be able to temporarily review the risk-based capital requirement in its entirety.

A central issue in the design of the risk-based capital requirement is the choice of the level of protection. The protection level establishes an acceptable risk for beneficiaries not receiving their entire guaranteed pensions. On the other side of the scale is the flexibility the undertakings have to take financial risks in order to offer larger pensions via higher returns. Thus, the protection level is a way of expressing the trade-off between a security for promised benefits and risk-taking. Setting the protection level in the risk-based capital requirement is therefore of such fundamental importance that it should be set by the legislator.

FI has analysed the effects of different levels of protection. Given that the undertakings as a whole currently have a satisfactory capital situation, FI makes the assessment that a risk-based capital requirement along the lines of the traffic-light model is a reasonable starting point. A lower level would risk hurting the protection for the beneficiaries, in part by allowing weaker undertakings to take larger risks. A higher level could improve FI's possibilities for identifying in time undertakings that might experience problems and ensuring that an undertaking jeopardising the security of its pension payments takes the necessary measures. Too high of a level could result in lower pensions in the long run.

FI would also like to emphasise that the risk-based requirement is a buffer in that it is meant to absorb shocks. It is not in the interest of the beneficiaries for strong undertakings to reduce their financial risks in order to build up large margins to the risk-based requirement. This lowers the expected return, which can result in lower pensions. FI therefore does not expect strong undertakings to reallocate their assets when the requirement is introduced.

THE RISK-BASED CAPITAL REQUIREMENT

The risk-based capital requirement should cover the most significant risks in occupational pension business. The requirement should be set using a simple Value-at-Risk approach. The calculation should take into account losses that may occur over the upcoming twelve-month period. It should also take into account risk-mitigating measures. In order to have a functional supervision ladder in the event of a lack of capital, the risk-based capital requirement should always be larger than the standardised capital requirement.

The risk-based capital requirement should be calculated by aggregating the capital requirements for market risk, benefit risk and operational risk. The capital requirement for market risk in turn should be calculated by aggregating the capital requirements for equity risk, interest rate risk, real estate risk, spread risk, currency risk and concentration risk. The capital requirement for benefit risk should be calculated by aggregating capital requirements for longevity risk, mortality risk, morbidity risk, lapse risk and cost risk. When aggregating market risk and benefit risk, diversification effects should be taken into account. FI has proposed that it receive a mandate to regulate in more detail the calculation of the risk-based capital requirement.

Covered bonds should be treated as less risky than other types of corporate bonds. It should be possible to classify investments in infrastructure as investments in real estate or listed shares in the calculation of the risk-based capital requirement. FI will investigate the forms for this in future work related to the design of the risk-based capital requirement.

THE STANDARDISED CAPITAL REQUIREMENT AND THE GUARANTEE AMOUNT

The standardised capital requirement should be designed in accordance with the provisions on the solvency margin in the IORP 2 Directive. Calculations of standardised requirement for primary benefits should therefore be based on the size of the technical provisions, positive risk sums and net operating costs. Calculations of the standardised requirement for supplementary benefits should be based on indices for fees paid in and indices for benefits handling.

The capital requirement regulation for undertakings for occupational retirement provision should also include a guarantee amount. It will function as an entry threshold for new firms and as an absolute minimum for own funds. The amount should be 790 basic amounts. If there are special grounds, FI should be able to decide to lower the guarantee amount for mutual undertakings for occupational retirement provision and occupational pension associations by up to fifty per cent.

OWN FUNDS

An undertaking for occupational retirement provision should at all times, in addition to the assets requirement for liability coverage, hold own funds of at least the highest of the risk-based capital requirement and the standardised capital requirement or the guarantee amount.

FI proposes the items that should be included in the own funds and the items which, following approval from FI, may be included in the own funds if certain conditions are met. The items that should be deducted from the own funds are also specified. The measurement of items related to own funds should primarily follow the measurement regulations for financial accounting.

OTHER CONSIDERATIONS AND PROPOSALS

Link to employer and employee organisations

Employer and employee organisations contribute to the beneficiary protection in the occupational pension. However, this should not be taken into account in the calculation of the capital requirement, but rather in FI's assessment of an undertaking for occupational retirement provision's action plan, plan for restoration of a satisfactory financial position or plan for rapid restoration of own funds.

Variable contribution and guarantees from employees

Taking into account the variable contribution and guarantees from employers in an undertaking for occupational retirement provision's own funds or in the calculation of the capital requirement poses a risk that the protection in the risk-based capital requirement will be less effective. These circumstance should instead be taken into account in FI's assessment of an undertaking for occupational retirement provision's action plan, plan for restoration of a satisfactory financial position or plan for rapid restoration of own funds.

Reduction in benefits

A potential possibility to reduce occupational pension benefits should not be taken into account in the own funds or in the calculation of the capital requirement. This poses a risk of undermining the ultimate purpose of the capital requirements, namely to strengthen the beneficiary protection.

Group aspects in the capital requirements regulations

Individual undertakings in both the insurance sector and the occupational pension sector can be affected if there is no group regulation in the business regulations for institutions for occupational retirement provision. To avoid regulation arbitrage, rules should be introduced for group supervision regarding undertakings for occupational retirement provision. To avoid regulation arbitrage, rules should be introduced for group supervision regarding undertakings for occupational retirement provision. Capital requirement regulations should also be introduced at the group level for undertakings for occupational retirement provision in order to make it possible to assess an individual undertaking for occupational retirement provision's financial position when it is part of certain group structures. Express provisions on conglomerate supervision for undertakings for occupational retirement provision should also be introduced.

CONSEQUENCES OF THE PROPOSALS

Based on the results of FI's test reporting, the authority conducted an impact assessment of the proposed capital requirement regulation. The different confidence levels that were tested are compared in the analysis.

The results of the test reporting should be viewed given the undertakings' current financial strength. A capital requirement at a higher confidence level requires greater financial strength. Good capital protection now when the market is favourable gives good protection to unwelcome, dramatic portfolio changes, for example following a future fall in stock prices.

If the capital requirement is based on a 95-per cent confidence level, all 32 tested undertakings meet the capital requirement. At a 98-per cent confidence level, three undertakings have a solvency ratio below 1.0, and at 99.5-per cent, six undertakings have a solvency ratio that falls below this level and should therefore submit an action plan to FI. However, these undertakings are small and currently financially weaker. Their assets constitute only 2 and 12 per cent, respectively, of the total assets in undertakings with occupational pension operations. FI determines that market risk is the single largest risk in undertakings for occupational retirement provision; market risk constitutes just under 90 per cent of the total capital requirement, of which equity risk represents approximately half.

FI's proposal primarily impacts the undertakings' asset allocation. The extent to which the undertakings will reallocate today's asset portfolios and thus affect return is largely steered by the undertakings' perceived need to hold internal buffers in addition to the risk-based capital requirement. FI determines that assets may be reallocated, both to less and more risky assets, depending on the confidence level. At the 95-per cent confidence level, the undertakings may reallocate to more risky assets than today. At a confidence level that gives a capital requirement above the capital need in today's traffic-light model, reallocations to less risky assets are more likely the higher the confidence level that is chosen.

The analysis also shows that potential reallocations are not judged to have major effects on prices in the financial markets if the reallocations occur under normal market conditions, particularly if the undertakings are given plenty of time to adapt. If the risk-based capital requirement is breached during a future financial crisis, the conditions are in place for preparing a plan for gradual, long-term stabilisation of the balance sheet. It is therefore FI's assessment that a sufficiently high and well-designed capital requirement could reduce undertakings' procyclical behaviour, i.e. the risk, for example, that they will sell shares after they have fallen sharply in value.