

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
Name of Company:	D & L Scott; IORP trusteeships include United Kingdom's Railways Pension Scheme, The Institute of Chartered Accountants of Scotland Retirement Benefits Scheme, and Stagecoach Group Pension Scheme	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
<p>Please follow the following instructions for filling in the template:</p> <ul style="list-style-type: none"> ⇒ Do not change the numbering in the column "reference"; if you change numbering, your comment cannot be processed by our IT tool ⇒ Leave the last column <u>empty</u>. ⇒ Please fill in your comment/response in the relevant row. If you have <u>no response</u> to a question, keep the row <u>empty</u>. ⇒ Our IT tool does not allow processing of comments/responses which do not refer to the specific numbers below. <p>Please send the completed template, in Word Format, to CP-14-040@eiopa.europa.eu . Our IT tool does not allow processing of any other formats.</p> <p>The numbering of the questions refers to Consultation Paper on Further Work on Solvency of IORPs.</p>		
Reference	Comment	
General Comment	<p>By way of introduction, I have been a professional pension trustee in the United Kingdom for over 27 years. I act as chairman or as an independent professional trustee for a number of small and medium-sized IORPS and I have also chaired one of the United Kingdom's largest multi-employer IORPs, the Railways Pension Scheme, between 2007 and 2014, and was a Government-appointed trustee of the Mineworkers' Pension Scheme between 2002 and 2008.</p> <p>I am also a member of OECD's Network on Institutional Investors and Long-Term Investment.</p>	

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

My initial comment is to say how disappointed I was with the length of your consultation paper at 163 pages and the number of questions – 111 – which you have set for respondents. While I appreciate that the solvency of IORPs is an important topic for all trustees and other fiduciaries, I am very, very disappointed that have chosen such a length of consultation document which is, therefore, beyond the ability of almost all trustees to respond. By way of comparison, the scheme annual report with which United Kingdom trustees communicate with their members and other interested parties is typically around 30 pages in length, and summary reports are typically only 4 to 8 pages in length.

I accept that solvency regulation is a technical subject, but I do believe EIOPA should seek ways to engage with the vast majority of trustees and other fiduciaries by using much, much shorter documents. The UK Pensions Regulator, for example, has introduced Essential Guides which are much shorter than underlying non-statutory Codes of Practice. For example, the Essential Guide to the DB [Funding] Code runs to 9 pages only, whereas the most recent Code of Practice Number 3 runs to 51 pages.

What follows are my personal views since it has simply not been possible to engage with fellow trustees in open discussion of your consultation paper given its length and timing (a 3-month period including a holiday period, and spanning part of the calendar in which many IORPs with April or even December year-ends do not normally meet). I regret this, and **would urge EIOPA in future to find better ways of engaging not only with regulated parties such as trustees, both professional and lay trustees, but also with members’ representatives such as trades unions and member-nominated trustees.**

Q1

I do not think the word “contract” is an adequate description of the characteristics of “the set of rules and arrangements governing the provision of benefits”.

In relation to pensions, **an extrinsic contract would generally be a contract between the employer and the employee or member which affects the pension benefits to which the employee is entitled. This agreement will usually be the employment contract or a variation of**

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

that contract. Whilst it can deal with any of the provisions of the IORP, it is more likely to confine itself to issues such as normal retirement date, pensionable salary, and breaking the link to final salary.

One of the principal difficulties arising from the use of extrinsic contracts is how they are to be enforced by the trustees of the IORP who were not parties to the contract. The other significant problem is the courts' reluctance to step outside the formal governing documents of an IORP when considering its provisions. This is because IORPs are generally long-lived, and it is potentially unfair on the members who will not have easy access to expert legal advice to depart from the terms of the formal governing documents ("the trust deed and rules"). The courts have, therefore taken a strict approach to the formalities for amending IORP trusts and construing any associated documents, including any extrinsic contracts.

Going forward, the prudent legal advice to United Kingdom trustees seems to be that a variation of an employment contract (or some other extrinsic contract) is only likely to be effective to alter the provisions of an IORP in so far as it relates to a facet of the benefit structure to which reference must be made outside of the formal governing documents. An example of this is ascertaining a member's salary when calculating the benefit to which she/he is entitled. Another example might be years of pensionable service under a final salary/defined benefits scheme. Again, the trustees would, in any event, have to look outside the terms of the IORP to obtain this figure.

If advising on the enforceability of extrinsic contracts where there has been a failure to properly amend the terms of the IORP, the first question will be whether the agreement contradicts an express term of the trust deed and rules. As resort will only be had to an extrinsic contract if the IORP has not been amended in accordance with any power of amendment in its governing documents, there will always be such a contradiction unless it relates to matters outside the terms of the IORP documents.

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

If that hurdle can be overcome, it will be necessary to consider the following points:

☐

- What are the terms of the agreement?
- Has the employer actually made an offer, or merely announced what the employer and the trustees are going to do?
- If the agreement is to be made by reference to some other document, such as an IORP booklet, what does that document say? Does it expressly state that the deed and rules govern the IORP? If so, it will be conclusive.
- Has the member agreed to the offer made by the employer? Passive acceptance, without express approval, is unlikely to amount to the acceptance of an offer that has the effect of amending pension benefits which are payable at some point in the future.
- Does the agreement fall foul of section 67 of the United Kingdom's Pensions Act 1995? Does it affect subsisting rights, or is there an underpin so as to preserve those rights?

Even if an agreement between the employer and the member can be established, there is still the question of whether that agreement is enforceable by the trustees of the IORP. Although the English Law case of *South West Trains v Wightman* suggests that the trustees can enforce such an agreement, and counsel for the members in another English case, *HR Trustees v German*, did not take issue with Neuberger J's contractual analysis, there is no binding legal authority to that effect, and the issue is surely still moot.

Q2

The objective of the **insurance** principle of "contract boundaries" is to determine when an existing contract ends and a new contract begins. Once that boundary has been determined the expected value of all the cash flows falling within the existing contract should be included in the measurement of the liability. These cash flow estimates are based on the best expectation in respect of both amount and timing.

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

The contract boundary uses the following criteria:

The boundary of a given contract is defined by the cash in-flows that are expected to fall within the contract's term. For these purposes the term of a contract is the shorter of the contract's life and the point, if any, at which the policy can be freely re-priced by the insurer at the individual policyholder level (i.e. up until the point at which the insurer has the ability both to reassess the risk profile of the individual policyholder and change the price for an individual without contractual constraint).

Once the contract boundary has been established then the measurement of the insurance liability should take into account the expected value of the cash in-flows to be received within the contract's term. The claims and costs associated with the contract as defined should also be reflected in the liability valuation on an expected value basis.

Funding of trust-based IORPs is not based on "best expectation" but rather "prudent estimation". Cash out-flows are estimated by actuarial advisers. Other out-flows, such as IORP operating costs and levies payable to support regulated "lifeboat" arrangements, like the United Kingdom's Pension Protection Fund, can be estimated by actuarial or other advisers.

Cash in-flows, however, are a combination of investment income and other realised investment returns from investing sponsor and/or member contributions. Their estimation should not be left with actuarial advisers alone, or even with the investment consulting arms of actuarial firms. The views of investment managers should be taken properly into account.

Trustees are expected to hold sufficient funds to pay benefits as they fall due and to that extent have to balance current and foreseeable income requirements with capital preservation and prudent realisable capital growth to fund future benefit payments.

Unfortunately the end of the last century and the initial years of this century have witnessed a weakening of the necessary distinction between capital and income, in the rush to move away from a list-based approach to authorised IORP investments and towards the application to

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	IORPs of so-called modern portfolio investment theory.	
Q3	<p>IORPs of my experience are trust-based, not contract-based. The contributors to the trust (both employers and members) expect their trustees to invest their entrusted capital prudently to deliver the financial benefits as they fall due. Funding and estimated obligations are pooled rather than allocated to individual members or other beneficiaries.</p> <p>The expression more suitable for IORPS would seem to be in terms of “accrued benefits” to distinguish them from “prospective benefits”, which may or may not fall due.</p> <p>http://www.ipe.com/news/regulation/insurance-language-on-contracts-within-eiopa-balance-sheet-unfortunate/10003922.fullarticle</p>	
Q4	<p>The section introduces a concept of “risks building up in the IORP” without defining “risks” and without acknowledging (and defining) the differences between uncertainties and so-called risks.</p> <p>It’s now over forty years since Professor Benjamin Graham warned: “ the standard practice to define ‘risk’ in terms of average price variations or ‘volatility’ [is] more harmful than useful for sound investment decisions – because it places too much emphasis on market fluctuations.” Source: <u>The Intelligent Investor, 4th edition</u></p> <p>It’s even longer since John Maynard Keynes wrote in the 1930s: “ [A]t any given time facts and expectations were assumed to be given in a definite and calculable form ; and risks were supposed to be capable of an exact actuarial computation. The calculus of probability, though mention of it was kept in the background, was supposed to be capable of reducing uncertainty to the same calculable status as that of certainty itself By ‘uncertain’ knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty ; nor is the prospect of a Victory Bond [a form of Canadian government issue during WW1 and WW2, but I think Keynes was referring to undated bonds generally] being drawn. Or, again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest</p>	

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

	<p>twenty years hence, or the obsolescence of a new invention, or the position of private wealth owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatsoever. We simply do not know.</p> <p>When setting investment strategy, IORP trustees should base their decisions on expected, not historic, returns. While it is possible to form an expectation of the total return from a portfolio of assets over, say, the next decade without having an opinion about the contribution from the different components of investment return, it is not sensible to do so. It is preferable to think at least in separate terms of capital gains and yield, and even better to use a form of decomposition analysis, using initial portfolio yield, expected portfolio yield growth and calculating market re-rating impacts. Sensitivity analysis may be introduced by using different expected terminal yields.</p>	
Q5	<p>Having rejected the use of insurance-based “contract boundaries” earlier, I obviously do not think this should be the basis. I also refer and add to the view of Philip Shier, an Irish member of EIOPA’s Occupational Pensions Stakeholder Group: “For a pension where the employer or the IORP can, effectively, unilaterally cease the accrual of benefits at a point in time, then the contract boundaries should really be accrued benefits, because future service benefits aren’t necessarily going to be provided. And if they are, they are going to be funded by future contributions [and investment income and other realisable returns generated by investing those future contributions].”</p>	
Q6	<p>I do not agree with the analysis as it fails to take into account the investment income and other returns to be made from investing the contributions received. I also cannot reconcile the treatment of sponsor support with a trust-based IORP where the contributions and capital entrusted are pooled whether received from sponsors or from active members.</p>	
Q7	<p>I do not agree with the need for the distinction in a trust-based IORP. I also repeat the omission of expected investment income and other sources of investment return from the underlying analysis.</p>	
Q8	<p>Not applicable, as I do not agree with the proposed distinction.</p>	
Q9	<p>In the United Kingdom, such payments to the sponsor only occur on winding up. For that reason, sponsors are unable to anticipate such terminal receipts, which are also subject to taxation,</p>	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	during the going concern phase of both the IORP and the sponsoring corporate's financial statements.	
Q10	Benefits paid out of some IORPs are not dependent on contributions or investment income received but are instead governed by the rules of the IORP which focus on service, not contributions, and set out the level of benefit to be provided. An example is where a member dies "in service" shortly after joining the IORP. In this situation, there is typically an obligation to pay out benefits to the member's immediate family. Through the pooling of invested assets, with or without recourse to additional insurance, such individual payments are made to member's family members without direct specific funding. This is an example of the pooling of mortality risks and uncertainties.	
Q11	I refer you to my earlier comments at Q3 above regarding "accrued benefits" and "prospective benefits". Any analysis of the requirements for paying future benefits when they fall due also needs to take into account the expected investment income and other sources of investment return.	
Q12	<p>The section makes no reference to the use and limitations of market values as an incorrect proxy for intrinsic (or fair) values. I also no reference to the discount rate to be used and would remind EIOPA of the two bases permitted in the 2003 IORP Directive:</p> <p>"the maximum rates of interest used shall be chosen prudently and determined in accordance with any relevant rules of the home Member State. These prudent rates of interest shall be determined by taking into account:</p> <ul style="list-style-type: none"> — the yield on the corresponding assets held by the institution and the future investment returns and/or — the market yields of high-quality or government bonds" <p>The relevant "rules" in the United Kingdom are to be found in the Occupational Pension Schemes (Scheme Funding) Regulations 2005 which essentially repeat the IORP Directive wording in its entirety.</p>	
Q13	The estimation of technical provisions for IORPs of my experience already makes allowance for	

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

	actuarial estimates of future discretionary benefits that may arise from surplus, to the extent they are permitted benefits to be provided by the IORP. I see no value in trying to apply the insurance-based structure of Solvency II to address this type of benefit issue.	
Q14	EIOPA's continuing persistence with "contract boundaries" in these questions seems disingenuous to me. I have already rejected this approach in Q1-Q3 above. I also struggle with the very idea of risk-free cash-flows, especially if these are believed to be policies with insurers or obligations backed only by government or other "high-quality" bonds. I refer you to my general comments on "risk" at Q4 above.	
Q15	Ditto	
Q16	Ditto	
Q17	Categorically no, for the reasons given earlier above.	
Q18	No, because the definition is unhelpful and unnecessary.	
Q19	There are additional rights under the United Kingdom legislative framework, depending on whether a sponsor is trying to reduce, terminate or abandon IORP obligations. The role of Member State Regulators alongside IORP trustees' rights needs to be recognised in any analysis.	
Q20	It is not clear to me what allowed is being made for expected investment income and other realisable returns. If the discounted present value of obligations is simply being compared with the (flawed) mark-to-market values of assets then, while I agree this offers a form of "balance sheet", it is not particularly helpful. A framework based on cash flow forecasts, budgets and projections is altogether more helpful. One may draw an analogy with other businesses – it is surely preferable to manage a retail business, say, through the use of budgetary control based on forecast and actual cash flows, than to "manage" it using a snapshot/point-in-time "balance sheet", holistic or otherwise.	
Q21	EIOPA is still trying to work with "contract boundaries", a concept which I have rejected altogether earlier in this consultation response.	
Q22	Ditto	
Q23	Only Example 8 is similar to the United Kingdom IORPs of my experience. I am concerned that in trying to fit a definition (which comes from contract-based insurance, not trust-based	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	occupational pensions) to all these different examples EIOPA is creating a model of regulation which will be both marginally costly and materially unhelpful to trustees and other fiduciaries in a carrying out their day-to-day and year-on-year responsibilities to sponsors, members and other beneficiaries.	
Q24	EIOPA's analysis should allow for elements of discretion where there are multiple parties involved in exercising that discretion. For example, an IORP's rules may refer to the ability of the IORP's trustees to provide for additional benefits but only with the consent or agreement of the sponsor. Where such complexity exists, no account should be taken of the discretion unless and until the discretionary element has been removed and funding of the benefits becomes « contractual » (either additionally funded or through existing pooled funding) with the sponsor.	
Q25	I agree the level of discretionary obligations provided in practice by an IORP can be influenced by its funding position. I see little merit, however, in including conditional or discretionary elements within technical provisions unless and until the discretionary element is replaced by certainty and the benefits become contractual. In practice, United Kingdom actuaries allow for the probability of unfunded discretions being exercised within technical provisions, even if typically the probability is treated as zero.	
Q26	United Kingdom actuaries already take precedents, if any, into account when estimating technical provisions. If the trustees are in the habit of allowing discretions to be exercised then an estimated value on accrued discretionary benefits is added to technical provisions.	
Q27	United Kingdom trustees work with “prudent estimates” rather than “best estimates” . United Kingdom actuarial profession, however, provides information to trustees on the difference between “prudent” and “neutral” assumptions as part of its Pensions TAS and TAS : R reporting – see https://www.frc.org.uk/Our-Work/Codes-Standards/Actuarial-Policy/Technical-Actuarial-Standards/Pensions-TAS.aspx	
Q28	Ditto	
Q29	The United Kingdom Pensions Regulator has already suggested that trustees should have a “complete financial management plan” which, in my experience, leads trustees to forecast and project cash flows in various scenarios. Best estimate, however, is not usually the basis of the core budget or plan, where “prudent” estimates are used instead.	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	http://www.thepensionsregulator.gov.uk/docs/pension-scheme-funding-in-the-current-environment-statement-april-2012.pdf	
Q30	In my experience of United Kingdom IORPs, I have seen contingent escrow accounts used. The valuation approach has then usually followed your Option 2. I am less familiar with so-called “book reserve” accounting in other Member States and whether the IORP has contractual or other access to such ancillary funds retained by sponsoring employers.	
Q31	Option 2 seems to me to be preferable, although my earlier comments regarding probabilistic determination of future uncertainties at Q 4 above seems relevant too.	
Q32	One problem with a snapshot/point-in-time approach towards balance sheet “surpluses” is that their valuation will change and when first known may already be historic. In some of my experiences, the trustees have discounted perceived “surplus” in the light of “post-balance sheet events”.	
Q33	The use of “full stochastic calculations” is another example of the flawed thinking on risks and uncertainties referred to earlier at Q4. I can only agree with two of your options on that basis.	
Q34	I prefer Option 3 as part of a “complete financial management plan” referred to earlier at Q29.	
Q35	<p>Benefit reduction mechanisms are quite common in the United Kingdom, so I would suggest EIOPA’s analysis underestimates the significance of these options. One of the schemes for which I act as a trustee has reduced future accrual rates from n/40ths to 1.5% pa ; capped pensionable pay increases at levels below inflation ; used profit-related pay and other national insurance saving schemes to reduce pensionable pay accrual rates ; introduced longevity risk sharing for active members, whose prospective benefits are marginally reduced for improvements in expected longevity as measured by Member State official national statistics ; changed the basis of Member State contracting out of certain second-pillar state benefits to re-introduce “contracting in”; and closed to new members. The overall effect has been to reduce technical provisions by over 20% and solvency funding requirements by an even higher proportion.</p> <p>We have also seen examples of ex-post benefit reduction through changes in the United Kingdom official index for inflation-proofing, from the generally higher RPI to the generally lower CPI. These indices are used to revalue deferred benefits within the United Kingdom legislative framework.</p>	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	In my experience, trustees find it much easier to understand the impact of such benefit reduction mechanisms when valued relative to liabilities, whether on an ongoing basis of technical provisions or on a winding up basis of so-called “solvency”.	
Q36	<p>While I prefer principle-based approaches to rules-based approaches, I have some reservations about the specifics being left to Member States’ supervisors. In the United Kingdom, for example, the Pensions Regulator has a conflicted interest between reduce the risk of calls being made against the lifeboat support of the Pension Protection Fund and maintaining decent pension provision for all.</p> <p>I would leave the specifics to IORPs, subject of course to scrutiny by professional actuaries and auditors and also (conflicted) regulators.</p>	
Q37	<p>The exaggerated claims made for «market consistency» through the use of mark-to-market valuations and so-called «modern» portfolio theory (which in turn is based on the so-called Efficient Markets Hypothesis and the Capital Asset Pricing Model) make this a dangerous basis for setting overarching principles.</p> <p>I look forward to a day when regulators such as EIOPA and TPR here in the United Kingdom, as well as many of the so-called professional advisers, address to the many well-documented criticisms by both academics and practitioners where such valuations and theories are adopted uncritically.</p> <p>My personal criticisms of mark-to-market valuations start with the lot sizes used within markets to establish prices, and extend to the failure to differentiate between short-term resale value and longer-term «value-in-use».</p>	
Q38	<p>I would refer again to the basis for setting discount rates set out in the IORP Directive of 2003 and its equivalent wording in Member States’ regulatory frameworks, as mentioned earlier at Q12.</p> <p>I would suggest that where an IORP has a proven track record of meeting its expected returns, it is entitled to use a prudent discount rate taking into account the current yield on the current</p>	

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

	<p>investment portfolio and expected future returns, preferably using decomposition analysis into components of return such as yield, yield growth and realisable re-rating. This approach is further supported by having a comparatively stronger sponsor, although I would argue this is not a necessary condition, since the support for pensions obligations comes mostly from expected investment contributions rather than from sponsor and/or member contributions.</p> <p>On the other hand, where the IORP has no such track record and/or where the sponsor is unable to offer material support, then I would favour discounting using a so-called risk-free discount rate based on government bonds. I am less persuaded – despite their use by accounting standard setters – of the merits of so-called «high quality» (for example, AA-rated) corporate bonds.</p>	
Q39	<p>Sponsor support may be considered as a «balancing item» in the context of a balance sheet approach, but I would suggest a different analysis should be applied in the context of a cash flow forecasting approach. More attention in the latter needs to be given to the potential of the investment portfolio to pay benefits as they fall due.</p> <p>The balancing items in a cash flow approach include the ability to realise assets at the margin to supplement investment income and other contributions.</p>	
Q40	My answer here is the same as for Q39.	
Q41	In a cash flow approach, the sponsor offers an alternative source of contingent cash flows in the event of income deficiencies and/or limited asset realisation prospects in times of market crisis, such as some of us experienced in 2008.	
Q42	I see parallels here between the multiples found in Price/Earnings ratios and the suggested «M». In the context of IORP funding, however, I would favour a considerable degree of prudence when setting values for «M» over market average or sponsor-specific P/E ratios.	
Q43	A pension protection scheme only operates in the event of the cessation of the IORP as a going concern. I think we are in danger of mixing and/or confusing going concern concepts with no-longer-going-concern concepts.	
Q44	In the United Kingdom, the current level of «pension protection» is around 90%, although in some respects (eg annual indexation, but also mortality assumptions) it may be less than that ; in the United Kingdom the current level of protection is not guaranteed and, therefore, may be varied in	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	<p>future, and more likely to be a reduction of protection.</p> <p>We have also witnessed Poland, Hungary and Bulgaria reducing second-pillar pensions to address public sector debt and borrowing capacity issues.</p>	
Q45	<p>It is difficult to generalise about different protection schemes. In the United Kingdom, the scheme is funded by levies which apply at much higher levels for larger and, arguably, better run IORPs than they do for smaller IORPs where the likelihood of failure may be greater. It seems double counting to me to insist on a separate minimum funding level and/or additional sponsor support where there is such funding. If the protection scheme is «unfunded» then I can see a different rationale applying.</p> <p>I would also urge improvements in both Member State governments' accounting and protection scheme accounting to explain their reasons for setting separate minimum funding levels. I would also extend national government accountability for pensions (whether funded or unfunded) to local government/municipal pensions (whether funded or unfunded).</p>	
Q46	<p>My earlier answers to Q12 and Q36-38 apply. I favour IORP specific valuation, subject to professional and regulatory scrutiny through actuarial and audit processes.</p>	
Q47	<p>I would prefer that EIOPA restricts its guidance to short, principle-based frameworks. My general comments at the outset about this current 163-page consultation with its 111 questions does not inspire me with confidence that EIOPA is capable in its present mindset of providing such brief, overarching principles.</p> <p>As a professional trustee, I have operated within the four Cardinal Virtues of Prudence, Justice, Temperance and Fortitude, with Prudence pre-eminent among these four. As a professional account, I have operated within an overarching principle of a True & Fair View. I have also used Prudence within accounting, although regrettably the accounting standard setters in a far more rules-based approach in recent decades have downgraded Prudence and given primacy to Consistency, while at the same time being oblivious to the shortcomings in terms of Neutrality of their influence.</p>	
Q48	<p>Critiques of stochastic models are often ignored – by the consultants who are peddling the</p>	

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

models as part of their own business, by the regulators who appear to have been «captured» by the consultants and others.

Using a holistic balance sheet approach, indeed any balance sheet approach, inevitably defines and restricts the analysis to managing «risks» that arise due to mismatches between the IORP's assets and liabilities.

Taking the United Kingdom Pensions Regulator's concept of matching, for example, this is seldom made explicit, but if one bothers to look far enough (as I have) it is set out in Table 3, page 34 of the Pension Protection Fund 's Combined annex for the consultation on the future development of the pension protection levy, published in November 2008.

The Pension Protection Fund's «proxy asset allocation» is: for active member liabilities, a 50% geared portfolio consisting of 100% in long-term fixed interest bonds, 100% in long-term index-linked bonds and 100% cash borrowing ; for deferred member liabilities, a similar 50% geared portfolio as for active member liabilities ; and for pensioner member liabilities a 100% allocation to long-term fixed interest bonds. In so doing, the Pension Protection Fund (and one of the Pensions Regulator's statutory objectives is to restrict calls on the protection scheme) were associating a fairly accurate estimate of bond asset duration with what might be described as a central estimate of a liability duration.

The implicit rationale is in terms of identifying a correspondence based on an approximate equality between the assumed sensitivities of an asset class to interest rates and inflation and each liability type. There is a well-known technical term for this: modified duration.

The matching concept assumes that appropriate government securities are available so that the assets to be held have the same modified duration as the liability stream, and for a marginal change in the interest rate the discounted present value of the liability stream will continue to be equal to the market value of the asset portfolio. Assets and liabilities are thus matched in an aggregate value sense, the technical term for which is « immunisation ».

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

So-called “liability driven investment” (LDI) aims to match returns to the time frame over which the liabilities arise (say 20 years), so as to make the IORP fund less vulnerable to interest rate and inflation risks. Typically, LDIs use swaps and other derivatives to hedge against the risk of changes in the economic climate that might affect the value of their investments in the medium or long term. The United Kingdom Pensions Policy Institute reported that LDI assets under management in the UK increased from £243 billion at the end of 2010 to £312 billion at the end of 2011, an increase of almost 30%. These hedging arrangements can be highly complex and require specialist advice.

The United Kingdom’s National Association of Pension Funds in evidence to the English Law Commission commented that UK regulation 4 (which encompasses Article 18.1 of the IORP Directive) militates against the use of derivatives, which may only be used “in so far as they contribute to a reduction of risks; or facilitate efficient portfolio management”.

It seemed right, however, to the English Law Commission that pension funds should only use derivatives if trustees fully understand the implications. If this warning is required for large IORPs, it is even more necessary for smaller IORPs.

It is apparent with LDI investment policies that the concepts of modified duration, duration-matching and immunisation are applied (almost?) exclusively to government bond portfolios, whether consisting solely of fixed interest or inflation-linked securities or both, with swaps and other derivatives used to «perfect» the matching.

This approach is unnecessarily restrictive for at least two reasons:

1. An alternative description of duration is the «discounted mean term» meaning the duration of an «optimal» portfolio as the money-weighted average number of years to the receipt of the cash flows. Thus, duration concepts have been applied to fixed interest bonds in particular (following the mantra that «pensions are bond-like») because the cash flows can be expressed in nominal terms, both coupon and redemption values, and

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

after allowing for or abstracting from defaults, the interest rate used for discounting the cash flows is the yield to redemption. Similar application to index-linked bonds is a little more complicated as, although the index-linking conditions are specified, it is necessary to make an assumption about future inflation. But why is not considered possible to extend the concept of duration to other income-generating assets such as equities or real estate?

An equity can be regarded as an irredeemable bond with a variable coupon, so common sense indicates that such a security is likely to have a long duration. I can also argue that an equity has characteristics in common with an index-linked bond because there is typically a regular income payment (dividends rather than coupon interest) with a growth component (and history tells us that the average rate of dividend growth has exceeded the average rate of price inflation over long periods).

A real estate asset again has similar characteristics with a regular income payment (rents rather than coupon interest) and may have a realisable, albeit variable, exit valuation.

There seem to be two explanations for why the duration concept is not conventionally applied to equities or real estate. First, the future cash flows cannot be defined with the same degree of certainty as for bonds, and, second, the expected rate of return for discounting purposes cannot be identified with a similar degree of certainty.

Dechow, Sloan and Soliman's 2004 paper, Implied Equity Duration: A New Measure of Equity Risk, and Schroder and Esterer's 2012 working paper, A New Measure of Equity Duration: The Duration-Based Explanation of the Value Premium Revisited, have, however, provided a theoretical basis for and empirical estimates of equity duration. Their estimates of the mean equity duration are similar to the United Kingdom Pension Protection Fund's estimate of the mean index-linked gilt duration.

Since the Pension Protection Fund's proxy asset allocation is not based on an exactly accurate comparison of estimated asset and liability duration, there seems to me to be an argument in

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

favour of allowing equities and real estate to be considered in any list of assets for inclusion in the IORPs' proxy asset allocations.

2. The Pensions Regulator's approach is also inconsistent with the Occupational Pension Schemes (Scheme Funding) Regulations 2005, which we have seen earlier above at Q12 are consistent with the IORP Directive 2003. This is because the Regulator is only permitting government or other high-quality bonds to be taken into account, rather than allowing each IORP's actual asset allocation and expected future asset allocation to be taken into account exclusively or as well.

I am left with the clear impression that the exclusion of long-duration asset classes such as equities and real estate has been motivated, at least in part, by two underlying misconceptions.

The first of these is the widespread acceptance in the actuarial and accounting professions of the idea that market values are good measures of (many even equate them with) «fair values», the only rationale for this being the discredited Efficient Markets Hypothesis. This has crept in at the same time as a loss of faith in the validity of assessed values of assets and liabilities as dependable indicators of the expected long run position. Consequently, the far more volatile market value of assets is compared with the less volatile assessed value of liabilities, although when the assessment process uses mark-to-market yields rather than long run averages then the volatility of liabilities is often not dissimilar to asset valuations.

John Maynard Keynes in The General Theory of Employment, Interest and Money observed that «A conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield, since there will be no strong roots of conviction to hold it steady».

There is also the simpler point that there is no comparable market in liabilities to the ones which exist for most asset classes in an IORP portfolio. In the United Kingdom, for example, the trades in

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

	<p>liabilities are measured in billions, whereas the assets are measured in trillions.</p> <p>The second misconception is the mantra that pensions should, at least according to regulators, and increasingly to trustees and their advisers, be funded only by investment in low risk assets, which currently is interpreted as being government bonds, either fixed interest or index-linked or some combination of both. If this is the case, then it appears the sole dimension of «risk» being emphasised is that due to default on either coupon or redemption receipts. While this dimension has some validity nevertheless, it is not the only dimension and it is restrictive because it ignores the essential dimension of investment risk identified by both John Maynard Keynes and Benjamin Graham.</p> <p>Benjamin Graham argued that we should think of risk as the «loss of value which is the result of the payment of an excessive price in relation to the intrinsic worth of the security». For example, we might note the gross redemption yield on United Kingdom’s index-linked gilts has been consistently negative in recent years. This is only a recent phenomenon – similar periods in the 1990s showed average real yields well in excess of 3%.</p> <p>For further reading on these themes, I suggest the following:</p> <ol style="list-style-type: none"> 1. ON KEYNES AS AN INVESTOR, Cambridge Journal of Economics, Volume 37, Number 2, March 2013, pp 423–442. 2. CHRISTIAN BIDARD: EN HOMMAGE CORDIAL in Economie, Mathematique et Histoire: Hommage à Christian Bidard, eds.F Tricou & D Leeman, Paris: Presses Universitaires de Paris Ouest, 2014, pp 145–152. 	
Q49	No. Few. Most.	
Q50	As it is generally inappropriate, I suggest that EIOPA do nothing further with this.	
Q51	No. It would not be a helpful addition to the «complete financial management plan » referred to	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	earlier above at Q29.	
Q52	My answer is the same as Q50 above.	
Q53	No. My views on stochastic models are introduced at Q48. Barrie & Hibbert also developed models for the United Kingdom's Pension Protection Fund. I am aware that Barrie & Hibbert have also sold a similar model to private sector clients, including Standard Life. I consider their interests to be conflicted by such commercial actions.	
Q54	EIOPA may do this, but I would still view these as unhelpful in the context of developing and maintaining a «complete financial management plan» referred to earlier above at Q29.	
Q55	No.	
Q56	See my earlier answers to Q50, Q52 and Q54. The disadvantages listed in section 4.186 seem quite serious to me.	
Q57	Yes.	
Q58	No.	
Q59	Yes, but in the context of a «complete financial management plan» using a cash flow approach rather than a balance sheet approach.	
Q60	No. The United Kingdom Pension Protection Fund is conflicted in that its objective is to minimise calls and to maximise private sector contributions by sponsors and active members. EIOPA may wish to consider criticism of both the former Dun & Bradstreet and the current Experian (ASA ?) approaches from IORPs paying levies to the protection scheme. The analysis from Germany and Sweden should also be published.	
Q61	In my experience of «complete financial management plans» while we may forecast liability cash flows over the whole life of the IORP (typically over 80 years or more), it is unrealistic to forecast investment cash flows over periods longer than 10 to 20 years. I tend to a similar view on sponsor covenant estimates, when the rating agencies typically model default rates only for periods up to 15 years. Because of ongoing monitoring (covenant and investment outturns can be monitored as frequently as trustees and other fiduciaries meet), it is practical to use these shorter time horizons. Contribution levels in the United Kingdom are typically re-set at least every 3 years with annual actuarial reporting during the interim years.	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
Q62	I am in broad agreement.	
Q63	I presume that single sponsors have «complete financial management plans», using a cash flow approach rather than a balance sheet approach, for each of the multiple IORPs. My experience, however, suggests that many IORPs have not yet developed fully worked up plans.	
Q64	In my experience with the United Kingdom Railways Pension Scheme, the position is more complex. The IORP is operated on the basis of shared cost, which means active members often have to contribute 40% of funding. Some sponsors – for example, train operating companies with relatively short franchise terms remaining – expect United Kingdom Government to underwrite future franchise periods. Some sectionalised IORPs may be sponsored on a joint and several basis (sometimes referred to as «last man standing»).	
Q65	EIOPA may wish to take further evidence from regulators in Member States.	
Q66	I am in broad agreement with this and suggest some publicity is given to examples of such guarantees by Member State regulators to encourage more of the same.	
Q67	As a supporter of a number of charities, I am quite concerned that donations made to support operations are instead diverted to fund legacy pensions arrangements. I suggest EIOPA or Member State governments or charity regulators need to do work analysis of this issue. In the United Kingdom, the Pensions Trust appears to operate a form of «last-man-standing» IORP for a range of charities, large and small. This IORP may be able to provide more evidence to assist EIOPA and government in its analysis.	
Q68	See Q67 above.	
Q69	The approach to considering pension protection schemes will value markedly depending on the type of IORP and sponsor. For example, legal guidance to trustees of United Kingdom IORPs is that they should not consider the backstop support of the United Kingdom Pension Protection Fund in their funding approach. It would, however, appear to be appropriate to consider support from an insurance company under an arm's length commercial arrangement (a «buy in» type policy structure, for instance). I suggest the sponsor support arrangements offered by insurers and Member State protection schemes are likely to be so idiosyncratic as to be better left for the	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	IORPs and their sponsors, with oversight from national regulators, to determine.	
Q70	Ditto.	
Q71	In principle, yes, but in practice I have argued throughout this template that a cash flow approach is far superior and may constitute a «complete financial management plan» which is capable of being used to practise budgetary control with regular monitoring of performance and actual events against plan and plan assumptions.	
Q72	<p>I consider it neither appropriate nor necessary to establish EU capital/funding requirements for IORPs, as part of Pillar 1. The existing funding and supervisory regimes in individual Member States should already provide sufficient protection for members and other beneficiaries. The United Kingdom supervisory regime, while still evolving in certain respect, does not appear to have deficiencies which need addressing further at EU level.</p> <p>Some of the IORPs for which I act as one of the trustees are shared cost arrangements with 40% of total contributions, including in many cases those required to meet any shortfall of assets relative to technical provisions, being met by contributing members to the schemes. Members and their trades unions would have very serious concerns that any EU capital/funding requirements for IORPs and proposed «adjustment mechanisms» could have a very significant and adverse financial impact on them (as well as on the businesses of the IORP employer and government sponsors). Many members may effectively be forced to leave the scheme because of unaffordable (and, in my view, unnecessary) levels of required contributions.</p>	
Q73	<p>No. I have attempted to explain throughout these comments the limitations of a balance sheet approach, and also the unhelpfulness of stochastic modelling forwards from an initial balance sheet.</p> <p>A much better approach is based on forecasting and/or projecting cash flows as a basis for budgetary control and accountability to stakeholders.</p> <p>By way of analogy, it would be foolish to attempt to manage a retail business based on snapshots of its retail outlets. Far, far better to manage such a business – indeed, any business, including an IORP – by having a complete financial management plan, based on annual cash flows (and more</p>	

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

	<p>frequent period cash flows if helpful to day-to-day management).</p> <p>The actuarial profession have historically presented trustees and other fiduciaries with a balance sheet valuation. Prudent trustees should, however, go behind that valuation balance sheet to understand the nominal cash flows on which it is based. Some may argue the liability cash flows are easier to forecast than the asset cash flows, but that is not my experience.</p> <p>Asset cash flows can be forecast, especially when expected investment returns are decomposed in terms of investment income (yield plus growth), planned asset realisations and reinvestments (an efficient way to recycle realised investment capital to support future income and growth), as well as identifying transaction and management costs which accompany strategic management of the IORP investment portfolio.</p> <p>While I understand Basel II's use of three pillars – (1) minimum capital requirements, (2) supervisory review, and (3) market discipline – it is frankly confusing and unhelpful to trustees and other IORP fiduciaries when pensions are also analysed in terms of three pillars – (I) compulsory Member State Pension, usually funded from taxation and other fiscal policy on a pay-as-we-go basis ; (II) supplementary (and typically funded) occupational pension schemes, which often include some life assurance cover as well ; and (III) private savings, which may also include some life insurance.</p>	
Q74	No.	
Q75	No. The United Kingdom Pensions Regulator has advised trustees to have a «complete financial management plan» which goes far beyond what a holistic balance sheet may entail. I believe such a plan is far more helpful to trustees for decision-making and monitoring.	
Q76	As the question is framed in relation to a holistic balance sheet only, I support neither option. Non-legally enforceable support is already taken into account by United Kingdom IORP trustees in their objective assessment of employer covenant, as required by regulatory codes of practice, which are also strictly non-legal.	
Q77	I exclude pension protection schemes on a going concern basis. They are relevant only in relation to termination or winding up of IORPs, although in the United Kingdom levies are paid by going	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	concern IORPs to support the costs of failed IORPs.	
Q78	I expect actuarial advice to consider precedents and probabilities of discretionary benefits being paid as part of their assessment of technical provisions. In addition, in many cases in the United Kingdom when discretionary benefits are being proposed the trustees will negotiate additional specific contributions from the sponsor for funding purposes.	
Q79	I prefer option 3 as it seems to be the only one which is not framed solely in the context of the holistic balance sheet.	
Q80	Again the options are only framed in the context of the holistic balance sheet, so I prefer none of them. I have earlier explained the materiality of ex ante and ex post benefit reductions under Q35.	
Q81	I believe trustees and other fiduciaries should evaluate ex ante and ex post benefit reductions, both proposals and implemented proposals, in terms of their impact on technical provisions and also on full solvency valuations. My answer to Q35 above gives examples of how material these can be. My sense is that EIOPA (and others) may underestimate the materiality of such reductions.	
Q82	I see no need for «tiering rules» and would expect any prudent evaluation of contingent support to take account of ancillary own funds and other off-balance sheet capital instruments, as well as surplus funds, escrow funds and subordinated loans.	
Q83	Since surplus funds are part of the own funds of an IORP I can see no reason for not recognising them in either balance sheets or cash flow forecasts.	
Q84	Again, if the subordinated loans can be considered as part of the own funds of an IORP I see no reason for not recognising them. I am less supportive of recognising them as part of the own funds of an IORP if the prudent likelihood of their receipt is sufficiently remote or unlikely.	
Q85	I have referred earlier at Q27 to the United Kingdom actuarial reporting of both prudent and «neutral» (or best estimate) values. I am uncomfortable with the proposed Level B if it is insufficiently prudent. But I also think the implication with Level A that liabilities must at all times be covered 100% by assets, i.e. a balance sheet approach, is inappropriate. I would consider the cash flow forecast approach to be superior, and one which will provide analysis of whether 100% or higher cover in asset terms is always required. In some cases, it may be. In many cases, where future cash flows, forecast prudently, are sufficient to meet liabilities as they fall due, then there	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	is no need for 100% cover at all times.	
Q86	I do not support the Level B approach as it appears to be inconsistent with required prudence.	
Q87	My comments in answer to Q85 apply.	
Q88	My comment in answer to Q86 applies.	
Q89	My understanding why the additional requirement that cross-border IORPs be fully funded «at all times» was included in the IORP Directive 2003 was because of perceived wide variations between Member States' national social and labour laws. I would suggest there has been considerable convergence since then by at least the larger Member States and also by some of the smaller Member States. I am hesitant to leave responsibility with national prudential regimes, since at least in the case of the United Kingdom the Pensions Regulator adopted the IORP Directive 2003 requirement for cross-border schemes in an inflexible way. I contrast the United Kingdom approach with the Republic of Ireland's Pensions Board which implemented the same IORP Directive 2003 requirement with some flexibility, using a three-year recovery plan as a default, which may be disregarded in specific circumstances at the discretion on the Board.	
Q90	No. There are differences in national social and labour laws and prudential regimes.	
Q91	The funding regime is supposed to be IORP-specific. I find the suggestion of both short or extensive recovery periods as a default to run contrary to that regime. I would suggest «at all times» is unrealistic and look, for example, at the Irish example of three-year default recovery periods, with different (longer or shorter) periods allowed in exceptional circumstances on an IORP-specific basis.	
Q92	I agree there should be prior approval of the national supervisor, but in the case of the United Kingdom supervisor their approach to the cross-border funding regime required under the IORP Directive has to date been inflexible and unhelpful to the development of well-run cross-border IORPs.	
Q93	No. My earlier answer to Q90 applies.	
Q94	Non-compliance with the SCR is the norm rather than the exception here in the United Kingdom. This seems to support a range of recovery periods to be assessed on an IORP-specific basis rather than with an inflexible «short» or potentially imprudent «more extensive» time period.	
Q95	My answer to Q92 applies. Trustees should have a «complete financial management plan» for	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
	addressing the requirement to meet the SCR over an extensive period.	
Q96	United Kingdom IORPs already submit a recovery plan to the national supervisor. I do not see a role for supervisory responses at an EU level except through a form of legal appeal if the national supervisor regulates in an inflexible or otherwise inappropriate manner.	
Q97	United Kingdom contractual arrangements and national social and labour law has already been impacted by the existing European prudential framework and I must assume that if framework changes have the force of law (and the support of the European Parliament) then further impacts are inevitable.	
Q98	There is always scope for reasonable transitional measures to be permitted.	
Q99	<p>I have earlier commented at length on the limitations of matching concepts at Q48 above.</p> <p>I note «a 1-year horizon» underlying the SCR calculation which seems to me to be both inflexible and unworkable. I would also refer you to my answer at Q94 above.</p> <p>The solutions are expressed in terms of the sponsor financing the IORP up to the required level within one year. Such solutions would not work in the shared cost form of IORP I described earlier at Q72, or would only «work» with members facing unacceptable levels of contribution.</p> <p>Why have EIOPA not gone beyond a balance sheet approach by looking at cash flow forecasts and other elements to be found within a «complete financial management plan»?</p>	
Q100	No.	
Q101	Example 2 is preferable to Example 1, but I am uncomfortable with the replacement of desirable prudence with «best estimates».	
Q102	No, for the reason expressed in commenting on Q101 above.	
Q103	I reject Example 3 because it seems to be framed solely in terms of a balance sheet approach.	
Q104	No.	
Q105	I again refer to my lengthy comments at Q48 above. The analysis in terms of matching relative to government bonds is flawed and underestimates the potential for prudent investment in certain equity and/or real estate assets.	

Comments Template on Consultation Paper on Further Work on Solvency of IORPs		Deadline 13 January 2015 23:59 CET
Q106	No.	
Q107	The use of «market-consistent» bases is worrying and I have referred earlier above in commenting on Q48 about the use of market values as good measures of «fair» (or intrinsic) values.	
Q108	No.	
Q109	<p>I have commented at length on earlier questions about EIOPA’s apparent closed mindset to use only a balance sheet approach. Much better risk management tools are to be found by using a cash flow approach, tools which enable trustees to make prudent decisions and to monitor actual outcomes against earlier assumptions. The same applies to Example 6.</p> <p>I detect narrow and flawed thinking by EIOPA (and others) of risk measurement following Markowitz’s assertion (to be found at page 59 of his 1952 Journal of Finance article, Portfolio Selection) that «if the term ‘risk’ were replaced by ‘variance of return’, little change of apparent meaning would result». I have referred instead to Graham’s essential concept of risk in terms of the relationship between the market prices and the intrinsic values of securities. Graham rejects the Markowitz impact on generally accepted practice as follows: «the standard practice to define ‘risk’ in terms of average price variations or ‘volatility’ [is] more harmful than useful for sound investment decisions – because it places too much emphasis on market fluctuations».</p> <p>This flawed thinking then extends to supervision of investment portfolio management, where a distinction may be drawn between asset allocation between or among different asset classes and security selection within each asset class. Primacy is given by supervisors (and also by many so-called professionals advising IORP trustees) to asset allocation, and the example I would cite here is from the United Kingdom Pensions Regulator’s code of practice number 3 as follows:</p> <p>«The long-term ability of the [IORP] to meet its benefits is likely to be more affected by attention given to identification of risk [undefined, but presumably in the sense of Markowitz], expected reward and appropriate asset allocation than to investment manager selection and monitoring. Focus and resources should be allocated accordingly.»</p>	N on

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

This flawed thinking seems to follow on from often quoted, seldom read but often misinterpreted research by Gary Brinson and others dating from 1986, that «Although [market timing and security selection] can results in significant returns, these are dwarfed by the return contribution from investment policy – the selection of asset classes and their normal weights» in the Financial Analysts Journal voume 42, number 4, at page 39. The Brinson research «[indicates] that investment policy dominates explaining on average 93.6 per cent of the variation in total [IORP] return».

The Brinson research was conducted using quarterly data on large USA IORP portfolios in the SEI Corporation universe: 91 IORPS over the decade 1974-1983, and in later 1991 research (which replaced 93.6% «dominance» with 91.3% «dominance») 82 IORPs over the decade 1977-1987. Despite the purpose of the research being to assess the relative importance of the variations in total return from the three aspects of portfolio management (investment policy, security selection and market timing), Brinson and his colleagues did not have any data on the investment policy (strategic asset allocation) of any of the IORPs. Instead, the researchers assumed that the 10-year mean average holding period of each asset class was sufficient to approximate the normal policy holding ! Since the two periods covered overlap the claims being made for general application to investment portfoio management seems to be based on essentially only one empirical study.

Criticisms have generally gone unreported, although in one case – by David Swensen, the Yale CIO – it is contained in his year 2000 book, Pioneering Portfolio Management, as follows: «Investors often treat asset allocation’s central role in determining portfolio returns as a truism. It is not. The Brinson study describes investor [behaviour] not finance theory.» What Swensen meant was further explained by Blake, Lehman and Timmermann in Journal of Business volume 72, number 4, as follows: «... This finding reflects more on managerial beaviour (i.e. the absence of extensive attempts at active management) than on the economic role of asset allocation.» Even more damning was their conclusion that «the empirical regularities we observe in these data are a consequence of the incentives arising from the [investment industry] organisation and regulatory environment facing the UK pension fund industry».

**Comments Template on
Consultation Paper on Further Work on Solvency of IORPs**

**Deadline
13 January 2015
23:59 CET**

	<p>That such flawed thinking also appears to be shared by the large investment consulting firms who advise many IORPs was not all that surprising when the 2001 Myners Review in the United Kingdom found that the «top four providers hold at least 70 per cent of the market in investment consulting. The Herfindahl-Hirschman Index for the [investment consulting] industry is around 1800. As a point of comparison, US anti-trust authorities regard a Herfindahl-Hirschman Index of anything over 1000 as a matter of possible concern.»</p> <p>In summary, the regulatory and advisory approaches presume that asset markets are efficient so that, according to Fama, «prices of securities must be good indicators of value» ; they further presume that pensions cash flows are bond-like and that given such liabilities the assets used to fund them should be based on securities characterised by minimal default risk, i.e. government securities.</p> <p>I have earlier in commenting on Q48 pointed out the flawed rationale in terms of modified duration which lies behind the matching concept. I contrasted this with a concept of the discounted mean term of the liabilities which is all about cash flows, whereas modified duration is all about market values for interest rates and inflation.</p>	
Q110	No.	
Q111	<p>The simplification which I would propose, quite seriously, is to scrap the holistic balance sheet approach and move over to a much more useful approach based on IORP-specific cash flows. I say the approach is more useful, both as a tool for trustees to make decisions and monitor and manager their IORP, and also as a tool for supervisors to review and assess the prudence and robustness of the IORP's «complete financial management plan».</p>	