

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

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

Name of Company:	PricewaterhouseCoopers LLP	
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"> <li>⇒ Do <b>not</b> change the numbering in the column "reference"; <b>if you change numbering, your comment cannot be processed by our IT tool</b></li> <li>⇒ Leave the last column <u>empty</u>.</li> <li>⇒ 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>.</li> <li>⇒ Our IT tool does not allow processing of comments/responses which do not refer to the specific numbers below.</li> </ul> <p><b>Please send the completed template, in Word Format, to <a href="mailto:CP-14-040@eiopa.europa.eu">CP-14-040@eiopa.europa.eu</a> . Our IT tool does not allow processing of any other formats.</b></p> <p>The numbering of the questions refers to <b>Consultation Paper on Further Work on Solvency of IORPs</b>.</p>		
<b>Reference</b>	<b>Comment</b>	
General Comment	<p>The following submission is made by the UK firm of PricewaterhouseCoopers LLP.</p> <p>We have provided comments below on some of the questions posed by EIOPA. However, we continue to have major reservations which we have summarised here along with some alternative suggestions.</p> <p>Although our comments are critical in nature we would wish to balance them by recording our appreciation of the work EIOPA has done which is helping to make risk management central to the effective management of IORPs. We firmly believe that finding an appropriate holistic way of balancing those risks is necessary and we will continue to engage constructively in that debate.</p>	

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Aside from some responses we have made in respect of particular questions, there are two main areas where we have particular concerns:

- 1) We question whether a “value of sponsor support” is required. The *maximum* value of sponsor support is a far more insightful concept
- 2) Valuing sponsor support should be about business valuation, not debt valuation

**The *maximum* value of sponsor support is all that’s required**

We continue to question why a calculation of the value of sponsor support as described in the consultations is actually needed. In practice, and before turning to benefit reductions, it is necessary to understand the ultimate capacity of the sponsor to underwrite the scheme risks, including investment risk, and also to determine what levels of contributions are affordable without damaging the sponsor strength on which the scheme relies. This capacity is closer to expressing the *maximum* value of sponsor support which still seems to be given a back seat in the paper. We see the *maximum* value of sponsor support as the far more useful concept which obviates the need for a calculation of the value of sponsor support.

Leaving aside the method of calculation for the moment, the *maximum* value of sponsor support surely tells the user all they need to know. The *maximum* value of sponsor support is either sufficient or it is not sufficient. If it is sufficient or more than sufficient then sponsor support effectively becomes a balancing number in the HBS. If it is not sufficient then presumably the *maximum* value of sponsor support and the value of sponsor support are equivalent anyway.

In summary we think there is an opportunity to significantly simplify the guidance by only defining and requiring one measure of sponsor support - the *maximum* value of sponsor support. We also believe this can be done using business valuation principles in a way which addresses the concerns expressed about the calculation of *maximum* value of sponsor support laid out in the

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QIS. We have set out these business valuation principles in our paper – “PwC research, in Institute and Faculty of Actuaries, Options for assessing employer covenant and the holistic balance sheet, Research Report, January 2013, Edinburgh/London” referenced in footnote 35 of the consultation.

The question of how much sponsor support should be attributed to the pension scheme could simply be taken as the enterprise value of the sponsor, less any prior or equal ranking obligations, as described in the above discussion paper. At the HBS date (balance sheets are designed to show a point in time position) it is a fact that the pension scheme would have legal recourse to that value based on its ranking as a creditor. This measure captures the investment requirements of the sponsor (as it is a post capital expenditure measure), but obviates the need to make subjective estimates of things like dividend payments to equity holders.

**Sponsor support is about business valuation not debt valuation**

The proposed methodology for valuing sponsor support is driven by a view of sponsor support as being akin to a debt-like item. This is also in turn driving the distinction between 1) the value of sponsor support (as defined in the QIS and the Alternative Approach) and 2) the *maximum* value of sponsor support. As described above, we question whether 1) is even necessary.

Sponsor support as debt

EIOPA equates sponsor support with the contributions required to meet the IORP shortfall and provides a simplistic method of valuing such a payment stream, driven by a desire to achieve market consistency. The required support is devalued by default risk and (unsurprisingly) fails to meet the shortfall in almost all cases: the value of sponsor support will equal Level A shortfall only when a AAA/AA sponsor meets the shortfall in a one year period which appears an astonishingly high hurdle.

In every other case the HBS will fail to balance. In the context of providing an overview of security

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for members this is a significant flaw. Also, and paradoxically, where a scheme is fully funded, and there is no shortfall, the Alternative Method would value sponsor support as zero. This is a surprising result for, in all likelihood, the strongest possible sponsor.

These counter-intuitive results point to a fundamental flaw in the HBS methodology.

Funded pension schemes look to their investments as a significant source of meeting the liabilities and, unlike an insurer, can also look to their sponsor to underwrite the risk in those investments as well as other risks. By discounting liabilities at risk free rates and equating sponsor support with the ability to make immediate payment of the resulting shortfall stretches both the logic of funded schemes and economic reality. It is, if implemented, likely to lead to investment decisions with damaging consequences both for the security of member benefits, capital markets and the wider economy.

We believe the valuation of sponsor support is a business valuation question and the methodologies applied should therefore be based on commonly applied business valuation methods such as market multiples approaches and discounted cash flow. The main advantage of such approaches is that they would be simpler to understand and more familiar to participants (from their experience of financial reporting, mergers & acquisitions etc). The simplifications these valuation approaches embody (for example a fixed CAPM derived discount rate) make them no more flawed than the simplified debt valuation approach currently outlined with its use of broad credit rating scores which cannot sufficiently take into account the particular circumstances of individual sponsors.

Using these methods a high degree of consistency between valuations of different assets could still be achieved by setting out valuation principles which require a basis of valuation of the sponsor which is typically defined as "market value". A common definition of market value being:

*"the price which an asset might reasonably be expected to fetch on a sale in the open market between a hypothetical willing buyer and a hypothetical willing seller, each of whom is deemed to*

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*be acting for self-interest and gain and both of whom are equally well-informed about the asset and the markets in which it operates“*

A market basis of valuation would address the desire for “market consistency” because it would require inputs that were derived from, or benchmarked to, market observable inputs. Most importantly the approaches would be recognized and more easily understood by users as well as being more consistent with the simplified valuation approaches used by equity analysts and for the purposes of financial reporting.

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	<p>Yes</p> <p>Non-legally enforceable sponsor support can be significant in some cases, and should therefore be included. For example, an overseas group parent company may provide support to a UK pension scheme even though the overseas group entity has no legal obligation to do so. The factors driving the magnitude and duration of that support will indeed vary on a case-by-case basis, but it would be possible to make an assessment of the value of such support. Although it would be based on a subjective set of assumptions, EIOPA could provide useful guidance on appropriate considerations. For example :</p> <ul style="list-style-type: none"> <li>• The geographic market of the employer being essential to the commercial success of the group.</li> <li>• The employer having some heritage or brand strength which is vital to the wider group.</li> <li>• A presence in the employer's location being needed for licencing or regulatory reasons.</li> <li>• The employer's location being a key regional supply hub.</li> <li>• The employer having staff with unique skills which are essential to the wider group.</li> </ul>	
Q29	These are just some examples of circumstances when it would be in the commercial interests of	

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	the wider group to provide non-legally enforceable support to the sponsor, even if they have no legal obligation to do so.	
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Q36	<p>Yes – a principles based approach at the EU level makes most sense.</p> <p>A highly prescriptive valuation approach is very likely to produce materially wrong answers for large numbers of sponsors whose specific circumstances can not be adequately addressed using such a formulaic approach.</p> <p>Consistency of method is a worthwhile sacrifice to derive more sensible conclusions which are sponsor specific. A principles based approach would also be consistent with how business and asset valuation is addressed in the world of accounting and financial reporting more generally. For example, under International Financial Reporting Standards, the concept of <i>fair value</i> as it relates to un-listed businesses (the majority of sponsors) is defined and guidance is provided on how this should be interpreted, but there is no prescriptive methodology set out telling the valuer <i>how</i> the calculation should be performed.</p>	
Q37	<p>No – A more appropriate principle would be market value rather than market consistent, although in practice they are both driving at the same thing.</p> <p>The concept of market consistency is one which is commonly used in the actuarial and life assurance industry, but would not be generally familiar to sponsors or trustees. As such we believe it is likely to confuse participants.</p>	
Q38	Yes – but only if a market consistent valuation of sponsor support as outlined is actually	

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	<p>necessary. We question whether it is necessary.</p> <p>We question what purpose is served by a calculation of the value of sponsor support, when a valuation of the <i>maximum</i> value of sponsor support would be far more informative for users. As defined in the guidance, a valuation of sponsor support is in fact just a present value calculation of the cash flows required to satisfy a technical provisions measure of the deficit. It is not a valuation of the sponsor. A sponsor's capacity to support may be greater than or less than the deficit, but why bother to do two calculations when the <i>maximum</i> value of sponsor support can capture affordability and credit risk?</p>	
Q39	<p>A balance sheet which doesn't balance is something which we struggle with conceptually. Surely a principle objective of a holistic balance sheet exercise should ultimately be to achieve a balance, whether that is by reducing the liabilities or by reflecting relevant assets / support mechanisms. To the extent that a shortfall in the asset side of the HBS can be remedied by including a balancing item for sponsor support which is less than or equal to the <i>maximum</i> value of sponsor support, that would seem like a sensible and proportional thing to do.</p> <p>With respect to paragraph 4.127, some of the valuation methods suggested to assess the maximum value of sponsor support are not theoretically sound. For example, an accounting measure of shareholders' funds may bear no relation to the sponsor's value. Similarly, the workforce measure has no basis in any valuation theory we are aware of. For listed sponsors we suggest that it would be sufficient to use market capitalisation. For unlisted sponsors (the majority) the simplest methodology would be a market multiples approach as used throughout the financial community. In circumstances where such an approach still did not provide a sufficiently reliable valuation, the next step would be a discounted cash flow approach. These approaches are explained in our paper "PwC research, in Institute and Faculty of Actuaries, Options for assessing employer covenant and the holistic balance sheet, Research Report, January 2013, Edinburgh/London".</p>	
Q40	<p>The principles for allowing sponsor support to be treated as a balancing item are set out in our paper "PwC research, in Institute and Faculty of Actuaries, Options for assessing employer covenant and the holistic balance sheet, Research Report, January 2013, Edinburgh/London".</p>	



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	Essentially there needs to be sufficient headroom between the <i>maximum</i> value of sponsor support and the gap in the HBS. The question of course is what does sufficient mean ?	
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Q42	<p>M should vary broadly by industry, determined by a measure of industry enterprise value volatility.</p> <p>For example in the regulated utilities sector, where the volatility of sponsors' values is typically relatively low, it may be safe to specify M at a level of say 1.5x. This would be justifiable on the grounds that empirical evidence shows that there is only a very small chance of value swings which would reduce sponsor value by more than 33% (0.5/1.5). For another sector with more volatile sponsor valuations an M of 2-3 may be more appropriate to provide that safety cushion.</p> <p>This analysis could be performed and guidance issued on the value of M for different industry sectors.</p>	
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Q46	<p>Yes</p> <p>A highly prescriptive valuation approach is very likely to produce materially wrong answers for large numbers of sponsors whose specific circumstances can not be adequately addressed using such a formulaic approach.</p> <p>Consistency of method is a worthwhile sacrifice to derive more sensible conclusions which are sponsor specific. A principles based approach would also be consistent with how business and asset valuation is addressed in the world of accounting and financial reporting more generally. For example, under International Financial Reporting Standards, the concept of <i>fair value</i> as it relates to un-listed businesses (the majority of sponsors) is defined and guidance is provided on how this should be interpreted, but there is no prescriptive methodology set out telling the valuer <i>how</i> the</p>	

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	calculation should be performed.	
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Q59	Yes  Sponsor affordability can be captured by a definition of <i>maximum</i> value of sponsor support which equates to the equity value of the sponsor.	
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