	Comments Template on EIOPA-CP-11/006 **Response to Call for Advice on the review of Directive 2003/41/EC: second consultation**	**Deadline** **02.01.2012** **18:00 CET**
Company name:	Reed Elsevier Group plc	
Disclosure of comments:	EIOPA will make all comments available on its website, except where respondents specifically request that their comments remain confidential. *Please indicate if your comments on this CP should be treated as confidential, by deleting the word* ***Public*** *in the column to the left and by inserting the word* ***Confidential***.	Public
	The question numbers below correspond to Consultation Paper No. 06 (EIOPA-CP-11/006). **Please follow the instructions for filling in the template:** ⇨ <u>Do **not** change the numbering</u> in column "Question". ⇨ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a question, keep the row <u>empty</u>. ⇨ There are 96 questions for respondents. Please restrict responses in the row "General comment" only to material which is not covered by these 96 questions. ⇨ Our IT tool does not allow processing of comments which do not refer to the specific question numbers below. ○ If your comment refers to multiple questions, please insert your comment at the first relevant question and mention in your comment to which other questions this also applies. ○ If your comment refers to parts of a question, please indicate this in the comment itself. **Please send the completed template to *CP-006@eiopa.europa.eu*, <u>in MSWord Format</u>, (our IT tool does not allow processing of any other formats).**	
Question	**Comment**	
General comment		

The proposed changes to the measurement of solvency of occupational pension schemes under "Solvency II" raise the following issues.

1. The impact on finances of scheme sponsors and hence on investment and employment prospects
2. The impact on bond markets and potential repercussions.
3. Previous unintended consequences of changes to occupational pension legislation.
4. Lack of consistency with unfunded schemes.

Impact on finances of scheme sponsors and on investment and employment prospects

The change to the discount rate used to calculate the technical reserves of the UK Pension Scheme to the returns available on "risk free" assets, namely UK Government index linked gilts, would increase the size of the UK scheme's technical reserves by more than 50%. There would also be an increase in the cost of accruing benefits. This would lead to a substantial increase, in excess of 50%, in funding costs to the UK sponsoring companies and there would be two likely results.

Firstly the UK sponsoring companies would almost certainly consider the additional funding cost unacceptably high and be forced to close the scheme to future accruals. There have already been many changes to UK pension scheme accrual rates and design as a result of the higher cost of providing pensions benefits due to the low level of yields available and improving longevity. Replacement schemes tend to be of the defined contribution type which transfer investment risk to the employee.

Secondly the sponsor would have to divert considerable resources to make up the deficit even assuming an extended implementation period for the recovery plan. This would have a considerable impact upon the ability of the sponsor to invest in its businesses and its staff. It is plausible that employment would be reduced as a result of the need to divert cashflow in this way.

Reed Elsevier is not in a unique position with regard to its UK pension scheme. On an ongoing basis the scheme held assets worth 93% of its technical reserves at the time of the last triennial valuation in April 2009. Many UK pension schemes have larger deficits. If Solvency II is applied to such schemes there will be considerably less investment by such companies whilst cashflow is diverted away from the business towards the pension fund. This will impact upon employment and over time the competitive position of European companies.

The impact on bond markets and potential repercussions

There are approximately £1,140bn of UK Government Securities but only £313bn of these are fixed interest gilts with a maturity greater than 15 years and £147bn are index linked gilts with a maturity greater than 15 years. It is these longer term bonds that are of most interest to pension schemes with long term liabilities. It is estimated that there are about £1,000bn of assets in UK pension schemes. Therefore the sum total of risk free assets in the UK with a maturity of interest to pension schemes is considerably less than the assets of UK pension funds.

UK pension schemes have increasingly sought to match their assets to their liabilities to reduce interest rate risk. This is without the incentive of being required to hold additional capital against any asset that is not risk free. The proposed EIOPA solvency regime will substantially increase the incentive to hold risk free assets that match UK pension schemes' liabilities and this will have the effect of lowering the yields available on such assets resulting in two potential problems.

1. *Lower yields on risk free assets lowering discount rates.*

   Firstly, lower gilt yields as a result of pension funds switching into risk free assets will increase the valuation of the liabilities in the technical reserves. Although pension schemes are not required to hold matching assets some may feel required to hold such assets to reduce the risk of further declines in interest rates resulting in rising costs. In this way falling yields actually increase the demand for government bonds. We can see some evidence for this in UK government debt markets where pension funds have increased holdings as prices have risen.

It might be thought that these changes would occur over time given an extended period before full implementation of the terms of solvency II. However even if there were to be a 15 year implementation period many schemes would consider early matching to be prudent, especially if yields were falling as seems likely.

2. *Distorted asset values.*

The second problem relates to the distorting effects that excessively low gilt yields can have on both investors and the economy. We have seen over the past decade that when interest rates have been too low, risk has often been underestimated by investors seeking a higher yield and capital has been allocated unwisely. In extremis, poorly allocated capital can destabilise economies. The global economy is still recovering from the poor allocation of capital in recent years.

At the same time the rapid selling of equities and corporate debt to reinvest in risk free securities would impact share prices and corporate bond yields and would potentially be devastating for companies and the economy. It would also depress the market value of pension fund assets. Thus the distortion of asset prices as a result of predictable changes in asset allocation by pension schemes could increase the risks facing pension schemes, rather than reduce them. This is contrary to the aims of this proposal.

Previous unintended consequences of changes to occupational pension legislation

The UK government has previously made attempts to improve the security of pension arrangements and these have had the unintended consequence of reducing occupational pension fund provision in the UK. The Pensions Act 2004 (c. 35) allowed for the introduction of Occupational Pension Schemes (Employer Debt) Regulations 2005 under which the liabilities of UK occupational pension schemes were no longer to be funded on a "best efforts" basis but became a legal liability of the company. As a result many companies reduced the risk of a pension scheme funding shortfall by buying government bonds and selling equities. The projected cost of providing pension to employees rose and a great many schemes closed to new members and some to future accrual.

	There are striking similarities between the attempt to improve the security of pension benefits under the Pension Act 2004 and the proposed Solvency II directive. The latter will in all likelihood result in pension schemes reducing their exposure to equities and increasing their bond holdings. The substantial increase in cost of providing pension benefits will lead to the closing of many schemes to new members and future accrual. In all likelihood overall occupational pension provision will decline substantially leaving a great many current and future employees in a worse position in their retirement. In summary, we believe that the limited additional security provide by these proposed regulations is more than offset by the additional cost to employers, which will affect competitiveness and future unemployment levels, and the direct detriment to active members of pension schemes, who will find themselves no longer accruing pension benefits. ***Lack of consistency with unfunded schemes*** Pension funds established under laws of trust were launched during the early 20th century in order to provide security to employees that their pensions would be backed by a fund separate from the sponsoring company. Funded pension schemes were seen as more secure than unfunded liabilities and most of the legislation in the UK has been aimed at improving that security. The proposed Solvency II legislation is a further attempt to improve the security of funded occupational pension schemes. If enacted as proposed the disparity between the security of funded and unfunded schemes would become even larger and we question whether attention might be better given to unfunded arrangements.	
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12.	We believe that a satisfactory holistic balance sheet will be impossible to achieve and that ultimately it will reduce clarity. Some of the elements will be difficult to value e.g. the sponsor's covenant or the PPF guarantee. It will create dissatisfaction from those who feel they have been treated unfairly and may distort the asset allocation in unpredictable ways. We believe that there is clearly a difference between sponsor backed and non-sponsor backed pension schemes and that the distinction in the regulations should be maintained.	
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16.	Supervisory valuations and accounting valuations have different purposes so compatibility is not necessary.	
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18.	The current method allows for the use of a prudent basis dependent on various risk factors. Option 1 is the closest to this approach and is the least worst alternative.	
19.	Technical provisions do not currently take account of future accruals and nor should they. Schemes can be closed to future accruals and many will be as a result of the implementation of this directive. Therefore we believe that future accruals should not be taken account of in the calculation of technical reserves whether or not solvency II is introduced for pension schemes.	

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21.	We believe that the basis for the calculation of technical reserves should allow cashflows to be discounted at the rate of return expected from the assets held by the IORP. Any use of a risk free rate of return in the valuation of liabilities will create serious practical problems for pension schemes. We believe that the notion of a "risk free" rate is itself misguided. It must be clear now, given the crisis in European sovereign debt, that what was once considered to be a risk free security is no longer. Many sovereigns are now rated single A or lower. Corporates in these counties have higher credit ratings. The concept of "risk free" is no longer valid and cannot be applied to pension schemes as EIOPA recommend. The change to the discount rate used to calculate the technical reserves of the UK Pension Scheme to the returns available on risk free assets, namely UK Government index linked gilts, would increase the size of the UK scheme's technical reserves by more than 50%. There would also be an increase in the cost of accruing benefits. This would lead to a substantial increase, in excess of 50%, in funding costs to the UK sponsoring companies and there would be two likely results. Firstly the UK sponsoring companies would almost certainly consider the additional funding cost unacceptably high and be forced to close the scheme to future accruals. There have already been many changes to UK pension scheme accrual rates and design as a result of the higher cost of providing pensions benefits due to the low level of yields available and improving longevity. Replacement schemes tend to be of the defined contribution type which transfer investment risk to the employee. Secondly the sponsor would have to divert considerable resources to make up the deficit even assuming an extended implementation period for the recovery plan. This would have a considerable impact upon the ability of the sponsor to invest in its businesses and its staff. It is plausible that employment would be reduced as a result of the need to divert cashflow in this way. Reed Elsevier is not in a unique position with regard to its UK pension scheme. On an ongoing basis	

the Scheme held assets worth 93% of its technical reserves at the time of the last triennial valuation in April 2009. Many UK pension schemes have larger deficits. If Solvency II is applied to such schemes there will be considerably less investment by such companies whilst cashflow is diverted away from the business towards the pension fund. This will impact upon employment and over time the competitive position of European companies.

The use of the risk free rate for UK pension schemes en mass also creates some practical difficulties. There are approximately £1,140bn of UK Government Securities but only £313bn of these are fixed interest gilts with a maturity greater than 15 years and £147bn are index linked gilts with a maturity greater than 15 years. It is these longer term bonds that are of most interest to pension schemes with long term liabilities. It is estimated that there are about £1,000bn of assets in UK pension schemes. Therefore the sum total of risk free assets in the UK with a maturity of interest to pension schemes is considerably less than the assets of UK pension funds.

UK pension schemes have increasingly sought to match their assets to their liabilities to reduce interest rate risk. This is without the incentive of being required to hold additional capital against any asset that is not risk free. The new regulations will substantially increase the incentive to hold risk free assets that match UK pension schemes' liabilities and this will lower the yields available on such assets resulting in two potential problems.

1. *Lower yields on risk free assets lowering discount rates.*

   Firstly, lower gilt yields as a result of pension funds switching into risk free assets will increase the valuation of the liabilities in the technical reserves. Although pension schemes are not required to hold matching assets some may feel required to hold such assets to reduce the risk of further declines in interest rates resulting in rising costs. In this way falling yields actually increase the demand for government bonds. We can see some evidence for this in UK government debt markets where pension funds have increased holdings as prices have risen.

   It might be thought that these changes would occur over time given an extended period before full implementation of the terms of solvency II. However even if there were to be a 15 year implementation period many schemes would consider early matching to be prudent,

	especially if yields were falling as seems likely. 2. *Distorted asset values.* The second problem relates to the distorting effects that excessively low gilt yields can have on both investors and the economy. We have seen over the past decade that when interest rates have been too low, risk has often been underestimated by investors seeking a higher yield and capital has been allocated unwisely. In extremis, poorly allocated capital can destabilise economies. The global economy is still recovering from the poor allocation of capital in recent years. At the same time the rapid selling of equities and corporate debt to reinvest in risk free securities would impact share prices and corporate bond yields and would potentially be devastating for companies and the economy. It would also depress the market value of pension fund assets. Thus the distortion of asset prices as a result of predictable changes in asset allocation by pension schemes could increase the risks facing pension schemes, rather than reduce them. This is contrary to the aims of this proposal. In summary we believe that the limited additional security provide by these regulations is more than offset by the additional cost to employers, which will affect competitiveness and future unemployment levels, and the direct impact on active members of pension schemes, who will find themselves no longer accruing benefits. If a risk free approach is used, despite the obvious drawbacks, we suggest that level B is employed that would provide a discount rate with some allowance for the expected return on assets.	
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24.	Allowance for guarantees and options should be allowed for in the technical provisions	
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30.	The new rules should provide IORPs with the stability required to make the necessary provision. There have been enough changes to the UK regulations in recent years without allowing supervisors to make changes at will. Supervisors have considerable authority already.	
31.	We believe that this would give too many powers to the Commission. We believe that all rules relating to the Articles should be available for debate and comment.	
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33.	Proper consideration needs to be given to the support of the employer. This is the most significant difference between an insurance company and an IORPS. Even if all forms of sponsor support are taken account of we do not believe that the support of a strong employer will be given sufficient value in any 'holistic balance sheet'. Nor do we believe it will be possible to quantitatively assess the sponsor's covenant. We therefore believe that the company will be disadvantaged by changes to the current regulations as proposed.	
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36.	We do not believe it is practical to introduce a uniform level of security across Europe.	
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44.	It is preferable to allow significant flexibility in any regulation of the length of a recovery period given the very long life of a pension scheme and the variety of unpredictable financial and economic scenarios that may face a pension scheme during its life. Accelerated recovery plans can have a detrimental impact on the health of the employer and its ability to remain competitive and provide employment. In extremis, if the health of the employer is sufficiently weakened, it will impact upon the security of the pension scheme. We would support setting a normal limit of 15 - 20 years with the length dependent upon the stength of the sponsor's covenant. It is probably wise to allow the domestic regulator input into establishing recovery plans. This would allow the local regulator to set longer periods if conditions warranted such action. The conditions when a recovery period could be extended would include: • Extreme unforeseen financial or economic conditions, such as very low and unsustainable bond yields resulting in an unrealistic deficit against technical reserves • General sustained economic weakness, similar to a depression, that made rapid payment into recovery plans a systemic risk • Specific conditions relating to a company that might make it particularly vulnerable to a more rapid rate of recovery payments	
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51.	We agree to the continued prohibition on borrowing	
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