

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:	The Hundred Group of Finance Directors (UK)	
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<p>The question numbers below correspond to Consultation Paper No. 06 (EIOPA-CP-11/006).</p> <p>Please follow the instructions for filling in the template:</p> <ul style="list-style-type: none"> ⇒ <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. <ul style="list-style-type: none"> ○ 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. <p>Please send the completed template to CP-006@eiopa.europa.eu, in MSWord Format, (our IT tool does not allow processing of any other formats).</p>		
Question	Comment	
General comment	Introduction The Hundred Group represents the views of the finance directors of the UK's largest companies drawn largely, but not entirely, from the constituents of the FTSE100 Index. Our members are the	

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finance directors of companies whose market capitalisation collectively represents over 80% of that of companies listed on the London Stock Exchange.

We believe that the terms of the current consultation are deeply flawed, given that EIOPA was required to provide advice on **how** a solvency regime for pensions might be constructed starting from the basis of Solvency II, rather than considering **whether** such a solvency regime is appropriate in the first place. We use this General Comments section of our response to set out our fundamental opposition to the principles underlying the consultation as a whole.

IORPs should be regulated by a regime designed for pensions, not for insurance

Our view is that applying a insurance-style solvency regime to IORPs is wrong in principle. Insurance policies are products taken out voluntarily by individuals or companies. IORPs are provided to employees as part of their remuneration package and employees cannot generally choose to join an IORP other than one provided by or on behalf of their employer. Insurance companies act in a commercial environment to deliver commercial products to the public, whereas IORPs provide an social benefit to individuals as a consequence of their employment. We therefore do not believe that the case has been made for insurance regulation to be applied to pensions.

EIOPA's draft response to the European Commission accepts that there are 'important differences between IORPS ... and insurers' (2.6.4), but nevertheless assumes that it is appropriate for a framework designed for insurers to be imposed on IORPS, provided that certain adjustments are made to allow for the security provided to IORPS by sponsor covenant and protection schemes. However, we believe that IORPs should be regulated by regulation designed specifically for IORPs and not by regulation designed for another financial vehicle altogether.

Applying a solvency regime would not meet the Commission's aims for pensions

We also believe that applying a solvency regime to IORPS will not achieve the European Commission's aims for pensions. In its Green Paper for Pensions, the Commission indicated that its goals were adequacy, sustainability and safety. Imposing a solvency regime would certainly increase the security of some IORP promises in the short term, in many cases providing a measure of hyper-security far beyond what is necessary. The cost of such security would, however, be to undermine the sustainability and adequacy of IORPs in many countries, with sponsors responding to the increased funding costs by closing their defined benefit pension schemes, reducing the level of future accrual and/or replacing defined benefit schemes with often less well-resourced defined contribution

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schemes, under which members bear all the risks. Future generations of IORP members may pay the price in terms of lower pensions for the excessive security being provided to current members of defined benefit IORPs. This is an example of intergenerational unfairness.

We also do not think that a solvency regime for IORPs would meet the objectives set out in the current review of the IORP directive. First, harmonising the funding regime for pensions would not be likely to increase the take-up of cross-border schemes. If anything, increasing the funding requirements would make such schemes even less likely. The obstacles to cross-border schemes are rather to be found in the complex legislative framework attaching to such schemes, to the stringent funding standards already applying to defined benefit cross-border schemes (which are required to be fully funded at all times), and possibly to a genuine lack of demand for such schemes. The second reason for the review of the IORP directive is to 'allow IORPS to benefit from risk-mitigation mechanisms'. However, IORPs already have a number of risk-mitigation mechanisms in place that are precisely designed for the needs of pension schemes in specific Member States. Imposing inappropriate risk-mitigation strategies in the context of funding will lead to increased risks in other areas, in particular in terms of the longer term provision of IORPS to employees.

Applying a solvency regime would lead to massive increase in costs for sponsors

We are very disappointed that it appears to be EIOPA's intention to provide advice to the Commission in advance of a quantitative impact assessment. We do not see how EIOPA can be sure that it is giving the right advice to the Commission until it has seen the results of that assessment.

Applying a solvency regime to pensions is likely to lead to massive additional costs for the sponsors of defined benefit IORPs. Research carried out by Punter Southall in December 2007 suggested that increasing technical provisions for the UK FTSE350 to Solvency II levels (including a switch to a risk-free discount rate and the application of a solvency capital requirement) could lead to an increase in funding of 85-90% compared to technical provisions on the funding basis used for the scheme's formal triennial valuation. Whilst market conditions and the precise composition of Solvency II have developed since that date, we think this still remains a useful indicative figure showing that the impact of a solvency regime being applied to pensions would be very substantial and would have a devastating impact on sponsors funding defined benefit IORPs.

We have neither the time nor resources to calculate accurately the likely impact of a Solvency II approach being applied to the defined benefit schemes provided by our member companies.

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However, we believe that this exercise must be carried out before the European Commission publishes a revised draft of the IORP directive so that their review of the directive can be informed by that evidence.

In order to provide some indicative evidence of some of the possible costs, we have carried out some research amongst our membership on the difference between technical provisions on the funding basis used for the scheme's formal triennial valuation and the cost of securing those benefits with an insurance company (also known as the 'buy-out' cost). We believe that the latter is a reasonable proxy for the valuation of liabilities on a risk-free basis plus a risk margin as proposed in the holistic balance sheet (excluding any additional allowance for a solvency capital requirement). The evidence from our member companies responding to the consultation is that a move to a risk-free basis plus a risk margin would increase technical provisions by between 18% and 52% based on the most recent valuation results. The average increase, weighted by liabilities, would be 45%. The effect of applying a solvency capital requirement in addition would obviously increase the funding costs significantly more.

In addition to the funding costs, we also stress that imposing additional regulatory requirements, including the need to calculate solvency capital or place a value on the employer's covenant, would add considerably to the advice costs faced by IORPs and their sponsors. These could easily run into tens of thousands of pounds per annum for each of the around 7,000 UK defined benefit pension schemes. The quantitative impact assessment should also address these costs.

We would also note that, even if a proposal is relatively minor and unobjectionable in itself, it will bring in its wake considerable advice costs, at least in the initial stages of introduction, as IORPs seek advice on the implications of each measure for their pension scheme. In many Member States, neither the trustees or managers of the IORP nor their advisers will have any expertise in the Solvency II regime and therefore there will be additional costs as they seek to understand concepts that are being applied to IORPs for the first time and that seem fundamentally removed from their experience of pensions regulation to date. This is another argument as to why it is better to start from the text of the IORP directive itself, a text designed for pension schemes, rather than from the Solvency II directive.

Applying a solvency regime to pensions would have impacts on the wider economy

Applying a regime based around a risk-free discount rate and solvency capital requirement would

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lead to a change in pension schemes' asset allocation. Instead of investing in a wide range of assets including equities, corporate debt, derivatives and gilts, schemes would be likely to switch to 'risk-free' investment in gilts. This could lead to a substantial disincentive for long-term investment in corporate debt and equity, which could have permanent impacts on the willingness of pension schemes to invest in the wider corporate economy.

Further, if additional capital was required to provide additional scheme funding, it would create additional pressure on corporate credit ratings. The consequences of this would extend beyond the availability and cost of finance, impacting on core commercial matters such as supplier payment terms, bank credit availability and conditions around property leasing. More strategically, it would fundamentally restrict companies from implementing capital investment programmes, thereby stifling growth and putting pressure on dividends, both impacting valuations and therefore share prices, resulting in a compounded impact on equities.

Finally, if companies were required to fund increased liabilities as a result of applying Solvency II type regulations, then this may affect financial covenants held within bank facilities or issued debt in public or private markets. This would potentially require companies to renegotiate these covenants at a material cost or at worst result in a cancellation of those facilities/repayment of debt with potentially serious consequences.

Now is not the right time to consider this issue

The proposal to apply Solvency II to pensions with minimum alterations is premature in any case, since Solvency II remains untested for insurance companies. We believe that the regime should be tested in practice for a period of years before there is even any consideration of applying the same regime to pensions.

Also, the current European market turmoil strongly suggests that now is not the time for Europe to be considering any major changes which could destabilise investment markets through changes to asset allocation by pension schemes. The current crisis has also challenged the very notion of 'risk-free' investment and it will be necessary to form a revised understanding of what risk-free means in practice before such concepts can be applied to pension schemes.

For these reasons, we believe that the review of the IORP directive (and in particular the funding and

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	<p>security proposals contained in EIOPA’s draft response) should be deferred for three to five years.</p> <p>Our response to the specific questions asked in the document</p> <p>As we have set out above, we fundamentally disagree with the basic premise of this consultation that a regulatory regime based on Solvency II should be imposed on IORPS. All the specific questions in this consultation are based on this premise and therefore we have seriously considered making no response on any of the specific questions asked in the consultation.</p> <p>However, on balance, we have decided to answer some of the specific questions asked in the document. Whilst we believe that, in many cases, all of the options under consideration are wrong, some may be worse than others and therefore we have taken the opportunity to draw attention to these cases. The fact that we are responding to some of the specific questions should not however be taken as implying our agreement to any of the proposals, or the principles underlying them.</p> <p>Given the limited time at our disposal to respond to this consultation, and the fact that the funding and security areas are the most significant areas in the consultation, we have limited our response to some of the questions under CfA5 and CfA6. Absence of a reply to the other questions should not be taken as signifying our agreement.</p>	
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12.	<p>We are opposed to the concept of the holistic balance sheet, because it starts from a position that Solvency II is the right framework for IORPs, and then attempts to force IORPs into that framework. It is simply the wrong starting point. It is not clear that many of the security elements identified can easily be valued in monetary terms – or that, even if a number can be arrived at for the value of the sponsor covenant or pension protection scheme, that number actually encapsulate the role being played by that security mechanism. We therefore regard the holistic balance sheet as misconceived.</p> <p>We believe that the distinction between sponsor-backed and non-sponsor-backed IORPs should be retained.</p>	
13.	<p>The insistence on market-consistent valuation approaches is misplaced. Pension schemes adopt equity investment strategies that match expected cash inflow with benefit outgo. From the perspective of the pension scheme, the appropriate valuation method should reflect the discounted value of future cash flows as well as the current market value of any particular stock.</p>	
14.	<p>As noted in our answer to Q13, we think that the insistence on market-based consistent valuations is misplaced. We believe that an approach that also allows for future cash flows on both the asset and liability side would be preferable.</p> <p>In addition, we do not believe that 'market-consistent' in the context of liabilities should be interpreted to mean 'risk-free'. The discount rates should be selected to suit the requirements of the fund and discussed with actuaries and auditors, who are best placed to assess the specific risk profile of the scheme. We therefore prefer Option 1, which is to leave the IORP directive unchanged.</p> <p>We also note that the term 'risk-free' is undefined, with the selection of a risk-free rate having recently become much harder, as the assumption that sovereign debt represents the lowest risk may no longer be true in many countries. It may be that schemes invested in corporate bonds are exposed to lower risk than those holding the sovereign debt of many countries.</p>	

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16.	<p>The purposes of supervisory valuation standards and accounting standards are different, and we therefore do not see that there is a fundamental requirement for compatibility (although for practical reasons it might be desirable for similar measurements to be used).</p> <p>We note that, under the EIOPA proposals, the two standards would not in fact be compatible because of the different discount rates being used.</p>	
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18.	<p>If one of these options has to be selected, then option 1 should be chosen, i.e. 'explicit risk margin in technical provisions calculated according to the current IORP directive'. This is the closest to the current situation, where technical provisions are calculated on a prudent basis. The separate disclosure of the risk margin as an explicit rather than implicit item may provide useful information to trustees and companies; however, this option should not lead to a different overall assessment of technical provisions to that applying at present.</p>	
19.	<p>We do not believe that technical provisions should take any account of future accruals.</p>	
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21.	<p>As noted in the 'General Comments' section and in our answer to Q14 above, we do not believe that a risk-free interest rate should be used at all. However, in the circumstances in which it has been determined that a risk-free interest rate is required to be used, then we would prefer option 2 under which there would be two levels of technical provisions, Level A calculated on a risk-free basis and Level B with a discount rate calculated by reference to the expected return on assets. We believe that the Level B technical provisions should be the required level on which funding requirements would be based, with Level A technical provisions existing simply as an item for disclosure both to supervisors and to members.</p> <p>It should not be assumed that Level B technical provisions will converge to Level A technical</p>	

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	provisions over a transitional period as suggested in the consultation. It would need to be demonstrated that Level B provided inadequate security before this could be considered.	
22.	We do not think it is appropriate to require the inclusion of the capitalised value of all future expenses in respect of accrued pension in the valuation of technical provisions.	
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24.	We have no objection to the inclusion of allowances for options exercised by members (such as the commutation of pension into cash), provided that the requirement can be applied proportionately where the exercise of the option is not expected to make a significant difference to the overall level of technical provisions.	
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30.	No. Supervisors already have substantial powers to monitor the setting of technical provisions and it is not appropriate to allow them additional powers to impose technical provisions on IORPs.	
31.	We are opposed to this proposal which would seem to give the Commission wide powers to impose additional requirements on IORPS without full scrutiny and accountability.	
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33.	There can be no doubt that the existence of sponsor support constitutes one of the most important differences between insurance companies and IORPs, and therefore it should certainly be taken into account as part of the regulatory regime for IORPs.	

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	<p>However, we believe that the insistence on the inclusion of sponsor support explicitly in a holistic balance sheet is unnecessary, and would lead to considerable costs on the part of schemes (and their sponsors). Our view is that the existence of sponsor support means that a solvency regime for pensions is simply not necessary, and therefore makes Solvency II the wrong starting point for IORPs.</p> <p>We believe that the approach of requiring a quantitative assessment of sponsor covenant is fraught with difficulty and would be at best an extremely expensive and time-consuming exercise. If the Commission insists on an explicit assessment of the level of the sponsor support, then a better approach would be to allow a broad-brush qualitative assessment of the strength of the covenant and what that means in terms of the likelihood of benefits being paid to members.</p>	
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36.	<p>The types of security provided to IORPS across Member States are so various that it is completely impractical to impose a uniform security level for IORPS across Europe.</p>	
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38.	<p>We do not believe that solvency capital requirements should apply to sponsor-backed IORPs in any form. For sponsor-backed IORPs, holding assets to cover technical provisions (with a recovery plan in place where necessary to fill the gap) is sufficient protection.</p>	
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41.	<p>As with sponsor support, pension protection schemes represent one of the key differences between insurance companies and IORPs and therefore it is essential that they should be taken into account as part of the security provided to pension schemes.</p>	

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	<p>As we have set out above, we do not agree with the concept of a holistic balance sheet deriving from the Solvency II framework. If, however, this approach were to be pursued, then the pension protection scheme must be given full value, as providing complete security in respect of all benefits covered by that protection scheme.</p>	
<p>42.</p>	<p>We do not believe that capital requirements for operational risk should be applied to DC schemes. Any such requirements would have to be funded either directly by the member, or by the sponsoring employer who would be almost certain to reduce the contributions it pays to the scheme on behalf of the member. Either way, the member would receive lower retirement income in consequence.</p> <p>We believe that operational risks are better addressed through governance and supervisory measures rather than through a quantitative approach of this kind.</p>	
<p>43.</p>	<p>Given that deteriorating conditions in the context of IORPs generally arise from market conditions, it seems unnecessary for IORPs to have to inform supervisors when these circumstances occur. It is not clear what benefit there would be for the UK Pensions Regulator to receive notifications from 7,000 schemes that they are affected by deteriorating financial conditions. We therefore disagree with this proposal.</p>	
<p>44.</p>	<p>We do not believe that solvency capital requirements should be applied to IORPs at all and therefore do not think there is a role for a recovery plan in this context.</p> <p>We do think, however, that there is a role for recovery plans in the context of sponsor-backed schemes that are not yet fully funded on the basis of their technical provisions. Such recovery plans should be set at a level that sponsors can reasonably afford and may therefore last for as long as 15-20 years provided that there is continued backing for the deficit recovery contributions in the form of sponsor covenant and/or contingent assets.</p> <p>We welcome the recognition by EIOPA that it is reasonable for recovery periods to be longer for</p>	

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