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:	Derek Scott of D&L Scott, a professional pension trustee since 1987	
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:

- ⇨ Do **not** change the numbering in column "Question".
- ⇨ Please fill in your comment in the relevant row. If you have no comment on a question, keep the row empty.
- ⇨ 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.
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Question	Comments	
General comments	The extension of the deadline (compared to the first consultation) for responding to EIOPA's second consultation is to be welcomed, but fair and adequate consideration of the consultation's main issues still demands far, far longer than the timescales which have been allowed so far (both consultation periods ending 15 August 2011 and 2 January 2012 include significant holiday periods for many interested parties, including members of occupational pension schemes and their representatives, i.e. member nominated trustees and trades unions). It is unacceptable that public pension plans, including PAYG basis arrangements, are subject to far less regulation and accountability than other occupational pension plans. We have seen pension strikes in the UK partly because government here is unwilling or unable to provide up to date actuarial information and also to explain how contributions to contributory arrangements are being used within government finances. It is also difficult to retain sight of the founding principles of the EU's Pensions Directive (IORP) when confronted with the 517-page response of the European Insurance and Occupational Pensions Authority (EIOPA) to the European Commission's call for advice last April on its review of the legislation. My own understanding of the background to the current Directive is this: A pan-European pension goal was already alive in the 1990s, and the IORP Directive accepted the European Federation for Retirement Provision's 2000 proposal for a European IORP that would pool assets in a single vehicle while beneficiaries' entitlements remained subject to national social and labour laws. Multinationals were presumed to be the target audience, that the likes of Unilever and Shell would eagerly embrace the concept. In fact, today, there are currently only just 84 cross-border pension funds, many of which are active in the UK and Ireland – the two EU member states also with arguably the most in common, in terms of pensions legislation. Beyond that, the complexities start: in the IORP Directive's current version, a cross-border entity is subject to a funding standard that references Solvency I – the Directive will therefore be obsolete by	

	the enactment of Solvency II. Now the original aim of the IORP Directive has been equalled by the Commission's apparent desire to maintain consistency in financial services legislation to avoid regulatory arbitrage. The idea is that all EU member states should enact an economic risk-based approach to pension supervision. This is surely inadvisable for several reasons. First, an "economic risk-based approach" seems to be bureaucratic code for one based on Solvency II to a greater or lesser extent. Solvency II itself is based on Basel risk-capital requirements for banks. The flaw is that these require notions of 97.5% or 99% certainty of capital ratios – themselves based on backward-looking investment return assumptions. In practice, these promote herd behaviour and almost certainly discourage prudent long-term investment behaviour. Second, the Commission accepts the inherent differences between insurance companies and pension funds with a company as sponsor, so surely it must accept the need for a 'different systems, different standards' approach. EU member states are also moving away from traditional defined benefit systems toward more flexible, hybrid, risk-sharing approaches. Given the long-term nature of the liabilities of what are in many cases now simply legacy DB arrangements, and noting the economic cost of moving to immediate full funding, member states like the UK and Ireland are surely going to have to continue with very long recovery periods anyway. The revised IORP Directive should focus on promoting cross-border activity and harmonising defined contribution pensions – particularly since the latter are likely to provide the main source of growth for the former. This would seem to align a revised Directive with some of the main principles that informed the first. The Chairman of EIOPA has signalled his intention to change the way in which consumers – including pension scheme members – are protected. Speaking at a Consumer Strategy Day in Frankfurt, the Chairman is reported as saying: "We need to question the strategy tools and policy tools that we traditionally use to address information asymmetries, conflicts of interest and market inefficiencies, to protect the rights of policyholders, pension scheme members and other beneficiaries."	

I agree, but I genuinely fear that some of the changes you may think are going to help, will have the opposite effect. Greater disclosure to address information asymmetries is costly, and the costs are ultimately borne by consumers not intermediaries. Conflicts of interest can be managed better, but more attention should be given to alignment of interests (i.e. fund managers made to co-invest and generally take their rewards only when their returns are beneficial to policyholders and other beneficiaries relative to maintaining purchasing power). Market inefficiencies can be exploited by re-designing investment mandates away from index-relative strategies which simply mimic market movements, and instead to mandates demanding absolute returns relative to purchasing power which focus on fundamentals, buy-, hold- and sell-disciplines based on relative valuations and with the income component of total returns restored to its original pre-eminence.

Over the last two decades, there has been a significant change in the conventional methodology employed in actuarial valuations. In particular, two related changes can be noted:

1) The switch from an assessed value of assets (typically using discounted cash flows) to the marked-to-market value; and
2) The use of market interest rates (typically, bond yields) for the assessed value of liabilities.

Underlying this change in actuarial (and regulatory and accounting) methodology has been the general acceptance — implicit or otherwise — by the actuarial profession of the so-called Efficient Markets Hypothesis ("EMH"). This came at a time when the EMH, initially formulated in the 1960s, had come under such intense scrutiny by economists and other critics that its status even as an acceptable working hypothesis could no longer be generally accepted. Of course, this was hardly surprising given the TMT Bubble of 2000-2003 and the later Sub-Prime Crisis of 2007-2008.

Reference to the part played by EMH thinking is appropriate, indeed essential, because better investment strategy (questioning the "traditional tools") should instead be based on convictions that:

a) Firstly, asset markets are inefficient; and
b) Secondly, these market inefficiencies can be exploited consistently under common sensible investment mandates.

Traditional portfolio management mandates — whether peer group-based, index-based or absolute-

	return — all suffer from one basic flaw: namely, that there is nothing in the mandates that induces an appointed portfolio manager to take those decisions enabling him/her to achieve his/her agreed investment performance objective in the best interests of policyholders and other intended beneficiaries. Investment strategies can be designed to exploit market inefficiencies over the longer term by focussing on: i) The more permanent, rather than the transitory, sources of return; and ii) Improvement in the earning capacity of an investment portfolio through continual recycling of capital through reinvestment discipline. In the simplest case, the return on any asset can and should be decomposed into: Interest or Dividend (Income) Yield; Income Growth (if any); and Market Re-Rating (Capital Gains or Losses). By contrast with Market Re-Rating which is transitory in nature, Income Yield and Income Growth are much more permanent phenomena and far more reliable in the sense that they can be the subject of proper investment research and analysis undertaken by an investment manager and, hence, to a greater or lesser extent, under the control of a properly aligned and incentivised portfolio manager.	
1.	No. The European Commission should surely state explicitly what it wishes to achieve from this review, supporting its assertions with evidence of how the current regime fails to meet those achievement objectives. Members of schemes and their representatives, i.e. member nominated fiduciaries and trades unions, should then be allowed to comment on how any new proposals are likely to affect them in both the immediate and longer term. There is a recent and long history of regulatory intervention, both here in the UK and also in the wider Community, adversely affecting the best interests of lower paid employees who rely heavily on a combination of first and second pillar	

	pensions from the state and their occupational schemes.	
2.	The Solvency II Directive for insurers is not fully operational until January 2013. Consideration as to whether pension schemes should be subject to a regime based on the capital requirements of the Solvency II Directive should surely await practical experience of operating under that new regime. This is particularly pertinent given that some of the consequences of the provisions agreed to within that Directive were not anticipated and are only now being realised. Other unanticipated issues – which might prove detrimental to pension schemes, members' benefits and the broader economy - will undoubtedly emerge, if past experience is anything to go by, and there is frankly no compelling case for urgent (if any) action. UK defined benefit liabilities account for over half of European funded defined benefit liabilities; thus appropriate weighting should be given to the views of UK stakeholders, particularly scheme members and their representatives. Regulation to date has, however, tended to be developed by professional advisers rather than by market participants and end users of occupational schemes or their representatives, i.e. member nominated trustees and trades unions. The business models of many of these professional firms are not aligned with the interests of those seeking to provide or to receive decent pensions on affordable bases, including contributory bases.	
3.	Do nothing, unless/until question 1 is addressed.	
4.	There are bound to be, yes and yes. It is inequitable that unfunded arrangements are excluded from the Directive, when such arrangements are inherently less secure than funded plans. But the presumption that a single directive should attempt to cover all occupational pension schemes is presumptuous and, like so much pensions regulation of the last decade or so, will have unintended and harmful consequences for many long-suffering members of schemes and their dependants and other beneficiaries.	
5.	If, as suggested, the review is an endeavour to facilitate the development of cross-border pension plans, the Commission should publish evidence from social partners of the appetite for such plans.	

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	Furthermore, the new regime should apply only to those pension funds that are 'open' to new members/participants. Any pension funds that are closed to new members will not be used for cross-border purposes, so cannot possibly be hindering the development of such arrangements. Clarification of (a) the definition of cross border activity and (b) what is prudential regulation versus social and labour law is welcomed. However, if the Commission contends that harmonising funding regimes is necessary to deliver broader cross-border pension provision, it should publish evidence to demonstrate this, including that such harmonisation is a proportionate measure for achieving this.	
6.	There is no single "view", but rather a range of views.	
7.	There seems to be an error in this question (at least in the English translation). Should "to" be "do"?	
8.	See 6. above.	
9.	Ditto.	
10.	No.	
11.	Quick fixes should be resisted. The flexibility of option 1 should be respected.	
12.	A key element of EIOPA's proposal for the holistic balance sheet is the inclusion of the sponsor covenant as an asset. We support this wholeheartedly, but are concerned at the scale of the challenge that this represents. In carrying out quantification of the covenant there is a balance to be struck between simplicity and fairness. At one extreme, a detailed covenant assessment is likely to be complex – and therefore expensive – to undertake. At the other, a simplistic and low-cost approach is likely to be inequitable. Undoubtedly, it is possible to strike an appropriate balance, but this will take time to establish. Any proposition as to how to value the sponsor covenant should be considered within the framework Directive; it should not be left for implementation measures and it should be accompanied by a quantitative impact assessment.	
13.	EIOPA needs to do far more research on the limitations of mark-to-market valuations applied "consistently". Valuation lot sizes are often very small in comparison with the total security holdings of institutional investors. While some markets are more efficient than others, the necessary assumptions of the efficient market hypothesis are not met in practice. Mark-to-market valuation is also pro-cyclical in nature.	

	An alternative measurement basis could be to focus on the original cost of investments, including transaction and holding costs, the initial income yield (if any), the growth or deterioration in yield and the expected realisation value, as well as the point-in-time comparison with mark-to-market values. Instead of marking to market, disclosing relative to market would force those responsible for institutional investment to justify their buying, holding and selling disciplines. More attention also needs to be given to the liquidity of intended exit markets.	
14.	The consultation discusses technical provisions (liabilities) and discount factors in some detail. In all but one of the options presented, future liabilities are discounted at a (near to) risk-free rate. Even within the option where a discount rate linked to the return on assets is mooted, this might be no more than a transitional measure; a risk-free rate would still be used to determine the 'big picture'. The implicit assumption that a risk-free rate is appropriate has not been proven and should not be accepted without evidence.	
15.	Not when valuing liabilities, but certainly when monitoring counterparty and other agency risks.	
16.	See 13. above. It is difficult to reconcile the efficient market financial theory and capital asset pricing model assumptions of mark-to-market accounting with real world investment markets and the need for more effective investment in public works (such as infrastructure) and engines of economic growth. Accounting standards were a "root cause" of the financial crisis and should be subject to a comprehensive review, according to the UK's Local Authority Pension Fund Forum ("LAPFF"). The LAPFF 'post-mortem' report into the UK and Irish banking losses of 2008 argues that the International Financial Reporting Standards fully adopted in the UK in 2005 are not "fit for purpose" and led banks to overstate their solvency in the run up to the banking crash. The report argues that banks that appeared perfectly solvent required a massive taxpayer bail-out within months - a discrepancy in financial reporting that shareholders have yet to adequately question.	

	The 54-member LAPFF, worth €120bn in assets, argues there has been a "deficit in analysis" from institutional investors on how the banks came to lose an estimated €180bn of capital. LAPFF chairman councillor Ian Greenwood said if investors are to contribute to banking reform they must first understand what went wrong. He commented: "The forum's analysis as set out in this publication leads to some radical conclusions, not least the need for a comprehensive review of financial reporting where we believe there are significant deficiencies. The failure of several major UK and Irish banks had a major impact on our members in particular, and market confidence in general. Therefore it is vital that we understand precisely what went wrong, including why the failures were initially misdiagnosed as a problem of liquidity, rather than a capital crisis." The report argues that banks overstated not only the size but also the quality of the capital in their accounts by as much as 600% in one case. The LAPFF's analysis states that UK and Irish banks were at a greater risk in the crisis because the UK appears to have adopted the IFRS standards more comprehensively than other European nations, for example compared with banks in Spain, Germany or France. LAPFF also claims the refinancing of the banks is largely due to losses on ordinary lending not investment banking trading losses. Greenwood added: "Our analysis clearly points to the fact that flawed international financial reporting standards played a significant contributory role. This implies that significant reform of both accounting standards and the standard setters is required."	
17.	No. Given the severe limitations of mark-to-market (see, for example, 13. above) this market "consistency" should be resisted.	
18.	Risk-free discount rates derived from markets distorted by quantitative easing and other issues of restricted supply and regulated demand suggest this area needs further work, with input from both the actuarial profession and market participants.	

	I do not consider it appropriate, for example, to introduce a separate risk margin, as this would add significant prudence to already prudent technical provisions. I also reject the concept of a separate pensions risk margin, which may be suitable for insurance companies. It is not appropriate for UK defined benefit pension schemes due to the inherent differences between insurance companies and UK defined benefit pension schemes, such as the regulatory attention to schemes' covenants and the funded-by-levy compensation regime of the UK Pensions Protection Fund.	
19.	No. I strongly believe that no account should be taken of future accrual of benefit when calculating technical provisions. Current regulation and accounting is already based on PBO with the actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date, which already goes further than ABO with the actuarial present value of benefits (vested or unvested) attributed by the pension benefit formula only to employee services rendered before a specified date, and based on employee service and compensation prior to that date. The ABO differs from the PBO in that it includes no assumptions about future compensation levels.	
20.	Yes, for going concern purposes. Not necessarily for other purposes.	
21.	I reject both of the options presented, as both would involve the use of risk-free interest rates. In my experience of comparing technical provisions valuations with solvency or buy-out valuations, I estimate that the use of risk-free interest rates for the schemes to which RPTCL is a trustee would increase the technical provisions by around 50%, ie doublingthe amount of capital considered adequate for day-to-day requirements. The diversity of pension schemes across the EU means that offering just two options for the setting of interest rates to be used to establish technical provisions is not sufficient. I am also very concerned about the potential damaging impact on investment strategies of pension schemes as a consequence of any requirement to use a risk-free interest rate within the technical provisions. The sale of return seeking assets, together with the sale of return seeking assets by other European pension schemes, could be expected to have a large impact on European stock markets and its economy. The corollary investment strategy would be a huge increase in demand for gilt-edged securities, causing even more distortion to market yields used as a basis for discounting.	
22.	Yes. They already are through the current technical provisions funding.	

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29.	I do not agree with this proposal. The UK’s regulatory system, involving the Pensions Regulator, is a well tested system in operation since 1997, with appropriate mechanisms already in place to monitor the appropriateness of technical provisions. I do not consider it necessary or appropriate for the UK Pensions Regulator’s powers to be extended in the way suggested.	
30.	Ditto.	
31.	I do not agree with this either. The introduction of measures such as these will not only have a huge impact on people’s pensions but they will potentially have a huge impact on the sustainability of those UK defined benefit pension schemes which currently offer benefits in respect of future service. Furthermore, the Solvency II Directive for insurers is not fully operational until January 2013 and any consideration as to whether pension schemes should be subject to a regime based on the capital requirements of the Solvency II Directive should as a minimum await several years of practical experience of operating that new regime in the insurance industry.	
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33.	I agree with the principle of placing a value on the forms of sponsor support, and this is already at the heart of UK pensions regulation, as best practice since the 1980s and reinforced by regulation since 2004. If a value were to be placed on sponsor support, I suggest this should be treated as an intangible asset, subject to impairment review.	
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38.	I oppose the application of Solvency II-rules to UK pension schemes. Pension benefits in the UK are already well protected by trust law and pensions regulation.	
39.	In the UK we already have annual reports from actuaries under the Pensions Act 2004 to supplement the triennial valuation cycle from trust deeds and best practice.	
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42.	I strongly disagree with the proposal to include an 'operational risk' buffer for pension schemes that are purely DC. In the UK, there is significant case law that is based on the premise that in situations where a member has suffered loss through error, that he/she must be put back in the position that he/she would have been had that error not occurred. Moreover, this requirement is applied against the party that has been responsible for the loss. A buffer is, therefore, unnecessary – indeed it might perversely act as a moral hazard.	
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44.	I do not think it is necessary to make any changes to the existing recovery period regime, which is based on affordability of contributions and approval by the Pensions Regulator, as this generally works well. Regulatory guidance was developed to be consistent with the existing IORP Directive.	
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58.	Different countries have different approaches to pension scheme supervision, which have been developed over time to suit local requirements. Harmonisation introduces change, which adds unwelcome costs (ultimately paid for by citizens). This must surely be justified within an impact assessment.	
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95.	While the proposals in relation to disclosures to members might appear reasonable, there is considerable risk in leaving, as is proposed, much of the detail of these to subsequent implementing measures. The framework Directive will need to be sufficiently focused such that it does not allow for requirements beyond those reasonably expected (protecting against 'mission creep'). Implementation measures will require careful scrutiny and must themselves be subject to a full cost/benefit analysis. Of concern in the UK, for example, is the presumption that pensioners should	

	receive annual statements and that there need be no difference between DC and DB pensioners.	
96.	EIOPA's strong recommendation that there should be a full cost/benefit analysis of proposals is arguably its most helpful contribution to this review. The analysis should include quantitative and qualitative impact assessments, on both pension schemes and the broader economy e.g. how the capital requirements might affect equity and bond markets. Given the significant implications, this analysis should take place before the Commission considers the options.	