

<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>		<b>Deadline 31 July 2012 18:00 CET</b>
Name of Company:	<p>Towers Watson UK 21 Tothill Street London SW1H 9LL</p> <p><i>Contact: Mark Dowsey (<a href="mailto:mark.dowsey@towerswatson.com">mark.dowsey@towerswatson.com</a>) or Dave Roberts (<a href="mailto:dave.roberts@towerswatson.com">dave.roberts@towerswatson.com</a>)</i></p> <p>Towers Watson is a global professional services company with operations in many European countries. From these various operations, we provide services to many of the managers and sponsors of the largest pension funds in Europe. This response is written from a UK perspective.</p>	
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 in the relevant row. If you have <u>no comment</u> on a paragraph or a cell, keep the row <u>empty</u>.</li> <li>⇒ Our IT tool does not allow processing of comments which do not refer to the specific numbers below.</li> </ul> <p><b>Please send the completed template, in Word Format, to CP-12-003@eiopa.europa.eu. Our IT tool does not allow processing of any other formats.</b></p> <p>The numbering of the paragraphs refers to Consultation Paper 12-003.</p>		
<b>Reference</b>	<b>Comment</b>	

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<p>General Comment</p>	<p>We recognise that the future health of the European financial system depends critically on EIOPA as an independent expert adviser to the Commission and so we welcome the opportunity to help the development of this key document. It is therefore with regret that we conclude that the technical specifications to be fundamentally flawed in a number of areas.</p> <p>In particular:</p> <ul style="list-style-type: none"> <li>• UK IORPs can raise additional capital only from the sponsor (and members). <b>Carrying out the complex and costly calculation of an SCR does nothing to increase members' benefit security</b></li> <li>• The proposals might actually deter employers from strengthening the security of benefit rights – <b>additional payments can increase an apparent HBS deficit</b></li> <li>• Much more work is required on many elements of the QIS, particularly (but not exclusively) the security mechanism sections; <b>in our view, a series of QIS's is needed</b></li> </ul> <p>More than that, having carried out some 'real life' modelling on some UK client IORPs, we conclude that the proposed framework itself is also flawed – producing, in several instances, perverse results.</p> <p>We are also surprised and disappointed by the complexity and rigidity of the QIS technical specification, which falls far short of including the “appropriate changes to reflect the nature of IORPs” that the Commission had led us to expect.</p> <p>Whilst we welcome the decision to consult, we also regret that, once again, the timescale for consulting is unrealistically short given the importance and complexity of the subject . The reason given in section I.1.10 for contracting the normal three month consultation period by 50% (the “imposition of an external timetable”) seems unsatisfactory given the extent of the potential repercussions from these measures. We believe that neither the Commission nor EIOPA have made the case for such urgency. We would have expected and would urge EIOPA to be forthright in promoting the importance of 'getting it right' rather than trying to adhere to a pre-conceived</p>	

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	<p>agenda.</p> <p>We are very concerned that the scope of the QIS consultation, in its focus on the technical construction of the HBS, gives insufficient weight to the hugely important issue of the supervisory regime surrounding the proposed requirements. This regime is absolutely critical, because it will determine the impact on IORPs and their sponsors, and hence also on jobs, investment behaviours, systemic risk and the impact on future pension provision and national budgets. No quantitative impact assessment can be complete without substantial work in this area, including a consultation. Section I.6.2 indicates that IORPs will be able to complete a qualitative questionnaire as part of the QIS but we understand this might not be possible (directly) for UK IORPs as the UK supervisor will be making an aggregate response to the QIS on their behalf. In any event, IORPs cannot be expected to articulate their own responses to the new requirements until they know the regulatory regime that will surround it.</p> <p>As a further general point, we feel very strongly that the approach reflected in the QIS consultation is inconsistent with the situation in which the UK occupational pension sector finds itself. Pension provision, and defined benefit (“DB”) occupational pension provision in particular, is in serious decline in the UK and this decline is highly likely to have dire economic and social consequences in the decades ahead. There are very few employers that offer DB pension accrual, and even fewer that wish to do so. Most DB liabilities are ‘legacy’ in nature in that they relate mainly to past periods of employment and members who have no current relationship to the sponsor. We are concerned that a sense of the balance between protecting the accrued rights of past generations of employees and providing the environment that encourages greater pension provision for the current and future generations of employees may have been lost. However well-intentioned, the imposition of a more onerous solvency regime for IORPs risks making this situation worse. The result will be to exacerbate the inter-generational inequalities that are already emerging in pension provision and to raise the risk of adverse economic and social outcomes.</p> <p>At a more detailed level, having carried out some modelling based on the QIS technical</p>	

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	<p>specification, we consider that even the deterministic calculations are far too complex for all but the largest IORPs (and possibly just a few of these - even in those Member States where supplementary, pillar 2, occupational pensions represent a significant proportion of overall retirement provision). Assessing a QIS-style exercise based on the consultation document has been challenging within the short consultation period and we had to make a number of assumptions. In part this is due to the wide range of proposals that are still under consideration. However, there is also ambiguity within the calculation methodology and there are also some errors. As an overall assessment, we believe that the QIS is trying to consider too many options and in too much detail.</p> <p>We believe that a staged approach to the QIS should instead be adopted with a first stage designed to reduce the number of options under consideration, for which a much less detailed (and less onerous) consultation would be appropriate. A subsequent, detailed consultation could then focus on a narrower range of proposals. This was the approach adopted for the Solvency II project - an approach that helped to identify major issues largely unforeseen at outset in the development and implementation of Solvency II for insurers. Notwithstanding the imposed timescale, we believe it is essential to follow a similar process for IORPs, so that all issues can be addressed prior to implementation rather than cleaning up the mess afterwards.</p> <p>We cite the SCR as a particular example of an area of the proposals that does not recognise the current situation of UK IORPs. The majority of UK IORPs are ‘closed’ to new entrants and ‘on a journey’ to settlement – through the final discharge of their remaining liabilities by buying out with one or more insurers. Unlike insurance companies, UK IORPs do not exist to transact business for profit. As soon as they reach the level of funding at which they could pass their liabilities to the insurance market, they will do so. Sponsors are, in general, funding the shortfalls in their pension plans as quickly as they can reasonably afford. We question, therefore, whether the SCR has more than a theoretical relevance and therefore whether producing the figures required to construct it would be cost-effective.</p> <p>As mentioned above, we note the absence of any suggestion as to the regulatory response in the</p>	

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	<p>event that the HBS does not balance. Although paragraph I 3.2 states that “it is not the scope or mandate of the QIS to consider the wider implications of this approach to determining funding obligations”, we consider this to be key to assessing the “Impact” of the “Quantitative Impact Study”. If the regime leads, whether directly or indirectly, to an increase in contributions to IORPs, there are certain cases where this could cause significant problems for members. In the UK, some IORPs are set up on a ‘shared cost’ basis. Within such arrangements the cost of funding benefits is shared between the employer(s) and members, either informally or with the ‘split’ enshrined in the IORPs’ constituting documents. It follows that an increase in contributions in these arrangements will directly affect members. For some, in the current economic climate, this is likely to encourage them to cease membership altogether or, where the IORP’s provisions permit, opt for a lower level of benefits. This would be a retrograde step.</p> <p>In carrying out QIS calculations for some UK IORPs, we have observed that the area of the SCR has given rise to some results that seem particularly questionable.</p> <p><b>It should not be inferred from the <i>technical</i> points that we make about the SCR that we support its application; we are opposed to its use</b></p>	
Q1.	<p><i>Do stakeholders agree with the general set-up of the QIS exercise as put forward in the Introduction (Chapter 1)? What improvements do stakeholders suggest?</i></p> <p>Our general comments above raise a number of concerns about the general scope and set-up of the QIS. We can see that the QIS may result in the production of some useful data but we cannot conclude that the QIS specification is ‘fit for purpose’ without clarity about the regulatory actions that would accompany any change to the solvency regime for IORPs. What will the consequence be if the HBS does not balance (ie assets do not cover liabilities, taking into account all security mechanisms)?</p> <p>We have carried out QIS specification calculations on some ‘real’ UK IORPs. One aspect that this has revealed is that capping sponsor support (as described in HBS.6.45 to HBS.6.54) and the value of pension protection schemes (as described in HBS.6.75 to HBS.6.78) restricts the asset side to a</p>	

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	<p>maximum equivalent to the Level A technical provisions (ie best estimate of cash flows plus the Risk Margin). Although additional sponsor support and pension protection scheme coverage can then reduce the SCR, or eliminate it, <b>the HBS will never balance unless the pension protection scheme provides 100% coverage (or unless the physical assets in the IORP already exceed the Level A technical provisions plus the SCR)</b>. Is this the intention? If so, this supports our view that the SCR has little or no relevance to UK IORPs.</p> <p>UK IORPs cannot raise additional capital other than from sponsor support, which would not improve the HBS. Moreover, some IORPs operate on the basis of defined benefit accrual costs being shared between members (participants) and the sponsor. Any increase in cost could, in such cases, render membership unaffordable to some participants, forcing them to opt out. We consider this to be an undesirable outcome. Unless there are positive actions that can flow from consideration of the HBS, without adverse consequences for jobs, growth and investment markets, then we do not see the merit in imposing a complex and costly regulatory regime.</p> <p>The proposed calculations are very complex, with multiple iterations such as calculating the SCR three times: gross, net of the loss-absorbing capacity of security mechanisms, and net of the loss-absorbing capacity of technical provisions. Our experience with helping insurers through the various QIS stages of Solvency II and our work on carrying QIS ‘consultation’ specification-based calculations for several UK IORPs leads us to consider that it is unlikely that many UK IORPs will have the ability or resource to carry out their own QIS process sufficient accurately to adequately inform responses to this consultation. We also doubt that many (if any) UK IORPs will currently have data to the required level of detail to be able to carry out these calculations, or to demonstrate the reliability of simplifying models. We know that the UK supervisory authorities intend to carry out the QIS for UK IORPs in aggregate and, in such circumstances, it follows that supervisory authorities will similarly lack these detailed data. Aggregate results are unlikely to be a reliable indicator of the impact of the proposals and may well result in unrepresentative results and ill-conceived conclusions.</p> <p>Our experience of attempting to calculate results using the technical specification is that a</p>	

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	<p>number of sections are not sufficiently clear and that some logical interpretations can lead to unexpected outcomes. For example, the impact of the sponsor paying a contribution into its IORP should be to leave the overall HBS largely unchanged, or to improve it slightly. This is not the case in some scenarios, which can result in a higher shortfall in the HBS after payment of a sponsor contribution. We urge EIOPA to review the draft specification with a focus on ensuring that the proposals do not create inconsistencies potentially leading to undesirable incentives, such as to encourage deferment of contributions to IORPs.</p> <p>In order to provide balanced input into EIOPA’s consideration of the practicalities, we urge EIOPA to gather data from Member States’ supervisory authorities as to the actual cost to insurers of meeting the requirements of the Solvency II QIS exercises and the expected total cost of development and implementation of the Solvency II regime. Our own experience points to this running into many €millions and, as such, it is an essential aspect to consider when assessing the likely impact. Finally, we strongly recommend that EIOPA and the Commission consider the alternative proposal put forward by Towers Watson in its letter to Commissioner Barnier on 11 June 2012, whereby no quantification of sponsor support and other security mechanisms would be necessary. Our view is that this aspect is currently subjective in nature and, coupled to assessing the effect on the SCR, contributes greatly to the complexity and therefore prospective costliness of the calculations . Our recommended approach would allow EIOPA first to gain significant experience with the diversity of pension arrangements in the European Union before imposing a regime that appears to us to be inappropriate for the objectives set.</p> <p>In our view, EIOPA should therefore:</p> <ul style="list-style-type: none"> <li>• wait until the Solvency II details have been finalised before starting the QIS. We note the intention to allow for all developments in this aspect up to the start of the QIS, but we consider this does not go far enough. In particular, discussions on the ‘matching premium’ could have relevance to IORPs (provided the ‘ring-fencing’ condition can be made more workable).</li> <li>• ensure the QIS takes account of the possible regulatory actions, in the event that the</li> </ul>	

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	<p>Holistic Balance Sheet does not ‘balance’. Not to do so calls into question how an assessment of the ‘impact’ can be properly made</p> <ul style="list-style-type: none"> <li>• consider the behavioural changes that are likely to follow the adoption of market consistent measures and review the QIS findings as a result of the corresponding changes to market yields</li> <li>• consider alternative ways of taking sponsor support into account as our calculations evidence that there are some shortcomings with the proposals in the specification consultation</li> <li>• back test the volatility of the quantitative information by reviewing the results of the Holistic Balance Sheet at different valuation dates</li> </ul> <p>Although much of the focus of the responses will, naturally, be considered in the context of the consequences for defined benefit provision (or, non ‘pure’ DC), EIOPA should bear in mind that any change in market/investment behaviour that, for example, increases the cost of ‘low risk’ investments, will also affect pure DC provision. Low risk investments typically form a core of DC provision in the years immediately prior to benefits being taken. Any reduction in the yields from low risk investments would be likely to impact negatively on DC retirement incomes and the amount of future DC pension provision.</p>	
Q2.	<p><i>Do stakeholders believe that the adjustment (discretionary and conditional benefits, last resort benefit reductions) and security mechanisms (sponsor support, pension protection schemes) IORPs dispose of are taken into account adequately?</i></p> <p>We believe that the adjustments and security mechanisms do indeed represent one approach of taking these features into account. However, there appears to be considerable scope for different Member States (or, within an individual country, different IORPs) to make their own judgements as to whether a particular benefit is unconditional, conditional, discretionary or mixed. This could</p>	

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	<p>call into question the reliability of the results. As mentioned previously, we consider that a more iterative process – along the lines undertaken in the Solvency II project for insurers – would be prudent. This would allow EIOPA and others to publish further guidance to ensure greater consistency.</p> <p>In our view, the issue of valuing ‘sponsor support’ needs far more thought particularly in the context of complex corporate structures. For example:</p> <ul style="list-style-type: none"> <li>• the sponsor of an IORP is often one of a group of associated undertakings</li> <li>• companies often sponsor multiple IORPs</li> <li>• multiple IORPs may have multiple sponsors dispersed across the EEA and beyond in common with cross shareholdings and cross-entity guarantees.</li> </ul> <p>QIS calculations we have carried out have shown in one case that the value of the support of the actual sponsor would be multiple £billions greater than looking through to the group level. The QIS does not identify which of these ‘sponsors’ should be included within the calculation.</p> <p>Furthermore, the proposed approach to valuing sponsor support seems technically complex and precise but the results are sensitive to some of the subjective judgements required. We would argue that this is not a desirable quality for any model. For example, arbitrarily determined variables are applied in a number of critical points, such as the 50% recovery rate (HBS 6.17); the assessment of future profits and sponsors’ earnings (HBS 6.36); the proportion of shareholder funds available for the IORP; the 50 bp adjustment to allow for the illiquidity premium (HBS 8.12); the inflation and salary increase assumptions (HBS 8.23 and 8.24, respectively); the mortality and longevity shocks of 15% and 20 % (SCR 7.17 and 7.29, respectively) and the figures in the counterparty default risk module (amongst others). In addition, the calculation of the actual value of security mechanisms means that the HBS will almost always show a shortfall, regardless of the strength of the sponsor, which seems flawed.</p>	

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	<p>We therefore consider that the QIS should consider other methods of taking account of these adjustments and mechanisms allowing for the approaches that have developed in the UK market since the implementation of IORP 1. The timescale for the consultation exercise has not allowed <b>adequate</b> consideration of all the possible approaches, but one simplification that seems worth considering is to include only the maximum value of sponsor support and security mechanisms in the HBS. Only the gross SCR would then be shown on the liability side (although see our earlier comments about the relevance of an SCR calculation for IORPs).</p>	
Q3.	<p><i>Do stakeholders believe that the draft technical specifications provide enough information and are sufficiently clear and understandable? Which parts could be improved upon?</i></p> <p>We consider that the technical specification is far too complex to be widely understood, and that this is a greater obstacle than it might appear. In addition, the derivation of many of the parameters and formulae is not explained, particularly in the SCR (see Counter-party Risk Module). Much of this detail seems to be focused on ensuring a calibration to a specific probability (such as 99.5%) but it is not at all clear that this calibration has been derived in the context of, or is appropriate for, IORPs.</p> <p>In our view, rather less detailed information would be more appropriate, since we believe that for the review to result in a regime flexible enough to apply across the EU, it would be better to set out higher level principles to be interpreted according to local circumstances. It might well be that it would then be appropriate to carry out further QIS's – ie a staged, iterative process akin to that adopted for Solvency II.</p>	
Q4.	<p><i>Do stakeholders believe that the calculations proposed in the technical specifications are feasible at appropriate costs and with appropriate accuracy within the given timeframe of the QIS?</i></p> <p>No. not generally.</p> <p>We expect that a small number of the very largest UK IORPs might be able to carry out the deterministic calculations and we have worked with some in doing so. However, this necessitates using significant simplifications and approximations and we are concerned that there is</p>	

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	<p>insufficient time to analyse their impact fully. This could introduce biases into the results of the QIS that could make the results difficult to interpret. In addition, certain elements of the calculations are formulaic with some parameters in the formulae appearing to be arbitrary and/or subjective. There is no certainty that arbitrary elements used for the purpose of the QIS will be carried through to the final regime and so the results of the QIS appear likely to require subjective adjustment before they are appropriate for the purpose of making policy decisions.</p> <p>We are very concerned that the approximate methods that must inevitably be adopted for the QIS risk materially understating both the results and the resources required to provide results under the new regime as implied by the QIS specification. In relation to the SCR, significant resource will be needed to assess this yet, in the UK environment, the presence of the SCR appears to be of little practical benefit.</p> <p>Ultimately, and taking into account the situation of UK IORPs in particular, we question whether the benefits of a new solvency regime justify the huge costs and upheaval that the proposals would undoubtedly entail. We reiterate the point in our response to question 1, that EIOPA should obtain details of the costs involved in developing and implementing Solvency II for insurers, from which they can extrapolate the likely costs if the same regime were applied across the far more numerous IORPs in the EEA.</p>	
Q5.	<p><i>Do stakeholders believe that the draft technical specifications provide enough guidance on how to set up and value the holistic balance sheet as discussed in Chapter 2? If not, which parts could be improved upon and in what way?</i></p> <p>Our experience with helping insurers understand and implement the requirements of Solvency II suggests that setting up valuation systems to carry out stochastic calculations for discretionary benefits would be a substantial and costly exercise.</p> <p>We also repeat comments made earlier that</p> <ul style="list-style-type: none"> <li>• we doubt that the guidance is sufficiently detailed to result in consistent interpretations</li> </ul>	

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	<p>between IORPs and between Member States</p> <ul style="list-style-type: none"> <li>a series of increasingly sophisticated, QISs would be a much better approach.</li> </ul> <p>In HBS 4.12, in our view it should be clarified that 1. applies where the IORP <b>or the sponsor</b> has the possibility to adjust or end the future accrual of benefits, including in circumstances where the IORP is itself terminated.</p> <p>In HBS 7.39, the simplified formula appears to be missing.</p>	
Q6.	<p><i>Given the purpose of the QIS, do stakeholders consider the proposed simplifications for the valuation of the holistic balance sheet (for the risk margin in section 2.5, sponsor support and pension protection schemes in 2.6 and amounts recoverable from insurance in 2.7) adequate? Do you have suggestions for additional simplifications that would be appropriate?</i></p> <p>The background to the simplification to the Risk Margin calculation is unclear. Adopting a Solvency II approach might suggest a margin based on the duration of the liabilities. That said, we do not favour using a basis akin to Solvency II and consider that EIOPA’s options of either having an explicit provision for adverse deviation or no Risk Margin at all to be preferable.</p> <p>We question whether the ‘stochastic simplification’ of the valuation of sponsor support is stochastic at all, as the text provides a closed formula solution. We would also want to consider whether the proposed simplifications could go further, as the formulae appear complex yet are based on rather arbitrary assumptions. Some significant testing is needed to see whether appropriate simplifications can be made in order to avoid spurious accuracy.</p> <p>The distinction between the actual value of sponsor support and the maximum value of sponsor support seems artificial. One outcome is that, because the actual value of sponsor support (and pension protection schemes) is limited to the shortfall in the IORP relative to Level A technical provisions (plus risk margin), the HBS is very unlikely to balance. Furthermore, in the simplified approach to valuing sponsor support in HBS 6.50 and HBS 6.51, there is an inconsistency in the discount rates used to determine the cash flows <math>CF_t</math> (which uses the risk-free rate at duration <math>d</math></p>	

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	<p>only) and then to discount these cash flows to arrive at <math>SS_{CF}</math> (which use risk-free rates for each year up to duration <math>d</math>). This inconsistency means that, even if the default probability were zero, the value of sponsor support would not be equal to the shortfall.</p> <p>In HBS.6.36, the definition of <math>EC_t</math> needs clarifying. In particular, we believe that the reference to discounting in (i) and (ii) is inappropriate because the formula in HBS.6.39 includes a discounting factor explicitly.</p> <p>Also in HBS.6.36, the reference to “duration of <math>d</math>” in the definition of <math>i^t</math> should be to “duration of <math>t</math>”.</p> <p>It should be clarified whether, in HBS.6.42 and HBS.6.48, TP is intended to include the risk margin. We believe this is implied by the draft technical provisions, but it should be confirmed explicitly so as to remove any scope for differing interpretations.</p>	
<p>Q7.</p>	<p><i>The best estimate of technical provisions should be based on the most recent mortality tables including the future trend in mortality rates (Section 2.4). Do stakeholders believe that IORPs will be able to take into account this trend in mortality rates? Can you explain?</i></p> <p>We consider the reference to the most recent tables to be ambiguous. If it is intended that “recent tables” refers to the most recent calibration of the IORP to standard tables, we are happy to support this principle. If, by contrast, it is intended to require IORPs to calibrate their mortality only by reference to the most recently published standard tables, we would consider this a retrograde step. IORPs should be permitted to use the standard tables that best fit their demographic profile even if that means calibrating to older tables.</p> <p>We consider “future trend” to be an unsatisfactory term, and in the context of HBS 4.2 note that no recently published mortality tables in the UK include a future trend. However we would support the principle of using mortality tables that included a “best estimate” projection of future mortality improvements.</p> <p>In our view the longevity ‘shock’ proposed is too crude in that a permanent 20% decrease in</p>	

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	mortality rates is a poor approximation to a 1 in 200 shock. A more realistic approach would include decreases in mortality rates that vary by age.	
Q8.	<p><i>Is it clear enough from the technical specifications what cash flows should be taken into account in the calculation of the best estimate (e.g. in relation to benefits (unconditional, pure conditional, pure discretionary, mixed), contributions, expenses, etc.) and how the projection of these cash flows should be made (Section 2.4)?</i></p> <p>The principles appear clear, but we reiterate our concerns that different IORPs and different Member States may interpret what constitute unconditional, conditional, discretionary and mixed benefits differently. Using a stochastic approach could be onerous; as could unbundling liabilities into the different categories (discretionary, unconditional etc..) and doing separate SCR calculations for each category.</p>	
Q9.	<p><i>EIOPA is considering to take into account in the QIS the possibility in some member states to reduce benefits in case of sponsor default (for example, when a pension protection scheme does not guarantee the full level of benefits) in the valuation of the best estimate of technical provisions (see Reduction of benefits in case of sponsor default in Section 2.4 and Pension protection schemes in Section 2.6). Do stakeholders agree and, if yes, should it only apply in case of sponsor support backed up by a pension protection scheme or to sponsor support in general?</i></p> <p>In terms of the best estimate of technical provisions, we think this should depend on the extent of (and evidence for) the contractual agreement between IORPs and their members regarding the circumstances in which benefits might be reduced. In general, where benefit reductions in the case of sponsor default only occur as a practical reality then we see no justification for making an allowance for such reductions in the best estimate calculation. On the contrary, one of the purposes of the solvency regime is to minimise the circumstances in which benefits need to be cut back due to default of the sponsor and this would be frustrated if the technical provisions made allowance for benefit reductions in the event of sponsor default.</p> <p>Having said this, we believe that there is a strong case for removing the requirement for additional capital in respect of sponsor support in the counter-party default risk module where</p>	

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	<p>benefit reductions are possible in the event of sponsor default, or where there is a pension protection scheme in place.</p> <p>We also believe that the capital requirement in respect of sponsor support in the counter-party default risk module needs to be re-examined as we are concerned that there could be an element of double-counting.</p>	
Q10.	<p><i>The technical specifications propose that security mechanisms should be valued on a market consistent basis, i.e. by calculating the probability-weighted average of (discounted) expected payments from the sponsor and the pension protection scheme (Section 2.6). Do stakeholders agree with the principles for the valuation of sponsor support and pension protection schemes? If not, what alternatives would you propose?</i></p> <p>Our concerns raised earlier remain: a number of the central parameters provided seem arbitrary (perhaps by necessity) and that this is likely to compromise the objective of market consistency. In addition, there is room for very different interpretations of the parameters, such as the expected future profits, which seems to be inconsistent with the principle of market consistency. We also reiterate the point that the complexity of the arrangements and corporate inter-relationships through which sponsor support is provided to IORPs militate against a formulaic approach to the assessment of sponsor support.</p> <p>We consider that EIOPA should look at other options for taking account of sponsor support and pension protection schemes, focusing on an assessment of the maximum value of these items that could be applied to the IORP. Please see the proposal Towers Watson in our letter to Commissioner Barnier on 11 June 2012 put forward in this context.</p>	
Q11.	<p><i>Do stakeholders have suggestions for the parameters- such as the probability of default and the recovery rate in the event of default - used in the valuation of sponsor support and pension protection schemes (Section 2.6)?</i></p> <p>We understand that the ECON has recently advised in its statement of 19 June 2012 that “no EU law would</p>	

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	<p><i>be permitted to refer to credit rating for regulatory purposes</i>, and regulated financial institutions would not be permitted to sell assets automatically in the event of a downgrade” – so it seems likely that EIOPA will need to amend this aspect of its advice.</p> <p>From a purely technical view, there may be different ratings given to a sponsor by different rating agencies. In particular, there may be some rating agencies whose ratings of the sponsor are out-dated or non-existent. Furthermore, credit ratings are not necessarily a reliable guide to the probability of default on a sponsor’s pension obligations.</p> <p>The issue discussed in response to question 2 above, regarding treatment of sponsors within a group of associated undertakings and with links to cross-border and non-EEA entities, also applies here. It seems reasonable when assessing the strength of sponsor support to consider the position in the event that that sponsor becomes insolvent. However, it is evident that a lot more thought is needed as to how to go about this – on the basis that use of credit ratings is inappropriate. Looking at the issue of groups of undertakings and cross-jurisdictional issues, it is evident that to take this into account in a formulaic but fair way will be complex and hence both time-consuming and expensive . For example, past experience suggests that the value of sponsor support can alter significantly over relatively short timescales and due to factors that may not be quantifiable until after the event.</p> <p>We believe that the above points are grounds for considering alternative approaches, and we draw EIOPA’s attention once again to Towers Watson’s letter of 11<sup>th</sup> June 2012 to Commissioner Barnier.</p>	
Q12.	<p><i>Do stakeholders agree with the methodology set out to value the maximum value of sponsor support (Section 2.6)? Do stakeholders have suggestions for the parameters used in valuing the maximum amount of sponsor support? In particular, with regard to the proportions of future profits / EBTDA and the time period of the calculations.</i></p> <p>Our responses to questions 10 and 11 apply here (repeated at the end of this section). We believe that EIOPA should consider alternative approaches to the assessment of sponsor support and pension protection schemes. As identified above, however, we believe that developing a quantitative methodology that caters for all circumstances is considerably more complicated than the consultation document implies. We would be happy to work with EIOPA and others to identify suitable alternative approaches but more time will be required than the consultation allows.</p>	

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	<p>On a specific aspect, we do not understand why the parameter for the proportion of shareholder funds available for the IORP should be limited to 50% in determining the maximum value of sponsor support. Furthermore, it is unclear whether the maximum value of sponsor support is intended to change in stress scenarios, for example under the interest rate risk sub-module of the SCR. If so, then the implication is that the maximum value of sponsor support will increase with a downward shock in interest rates. We would question whether this is appropriate. We believe that the maximum value of sponsor support is more likely to be equity-like than bond-like (as the current proposal implies) in its behaviour.</p> <p><b>Answer given to question 10:</b></p> <p>Our concerns raised earlier remain: a number of the central parameters provided seem arbitrary (perhaps by necessity) and that this is likely to compromise the objective of market consistency. In addition, there is room for very different interpretations of the parameters, such as the expected future profits, which seems to be inconsistent with the principle of market consistency. We also reiterate the point that the complexity of the arrangements and corporate inter-relationships through which sponsor support is provided to IORPs militate against a formulaic approach to the assessment of sponsor support.</p> <p>We consider that EIOPA should look at other options for taking account of sponsor support and pension protection schemes, focusing on an assessment of the maximum value of these items that could be applied to the IORP. Please see the proposal Towers Watson in our letter to Commissioner Barnier on 11 June 2012 put forward in this context.</p> <p><b>Answer given to question 11:</b></p> <p>We understand that the ECON has recently advised in its statement of 19 June 2012 that “no EU law would be permitted to refer to credit rating for regulatory purposes, and regulated financial institutions would not be permitted to sell assets automatically in the event of a downgrade” – so it seems likely that EIOPA will need to amend this aspect of its advice.</p>	

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	<p>From a purely technical view, there may be different ratings given to a sponsor by different rating agencies. In particular, there may be some rating agencies whose ratings of the sponsor are out-dated or non-existent. Furthermore, credit ratings are not necessarily a reliable guide to the probability of default on a sponsor’s pension obligations.</p> <p>The issue discussed in response to question 2 above, regarding treatment of sponsors within a group of associated undertakings and with links to cross-border and non-EEA entities, also applies here. It seems reasonable when assessing the strength of sponsor support to consider the position in the event that that sponsor becomes insolvent. However, it is evident that a lot more thought is needed as to how to go about this – on the basis that use of credit ratings is inappropriate. Looking at the issue of groups of undertakings and cross-jurisdictional issues, it is evident that to take this into account in a formulaic but fair way will be complex and hence both time-consuming and expensive . For example, past experience suggests that the value of sponsor support can alter significantly over relatively short timescales and due to factors that may not be quantifiable until after the event.</p> <p>We believe that the above points are grounds for considering alternative approaches, and we draw EIOPA’s attention once again to Towers Watson’s letter of 11<sup>th</sup> June 2012 to Commissioner Barnier.</p>	
Q13.	<p><i>The draft technical specifications propose performing an upward shift in the basic risk-free interest rate curve to approximate the so-called counter cyclical premium or to allow IORPs – under conditions – to apply the so- called matching premium (Section 2.8). Do stakeholders agree with this approach to take into account the long-term nature of pension liabilities?</i></p> <p>We consider that EIOPA should assess all the options for taking into account the long-term nature of pension liabilities. We would be happy to work with EIOPA to identify these but more time will be required than the consultation allows.</p>	

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	<p>However, our immediate observations are:</p> <p><b>Counter-cyclical premium</b></p> <p>The proposal/option seems to suggest a uniform adjustment (50bp) across all Member States. We wonder whether this should vary from Member State to Member State to take account of different yields on Member States' sovereign bonds.</p> <p><b>Matching premium</b></p> <p>We are disappointed that the draft QIS specifications have been imported from Solvency II with minimal adjustment. We note from paragraph I.5.6 that EIOPA will update them as Solvency II evolves but our particular concern is that the circumstances in which a matching premium may be used will be more onerous for IORPs to meet than insurers, so that a level playing field will not be created..</p>	
Q14.	<p><i>Do stakeholders agree that the proposed way to derive the level B discount rate adequately reflect the expected return on assets of IORPs (Section 2.8)? If not, what alternative would you propose?</i></p> <p>We commend the principle of including this approach for determining the discount rate. Indeed we think this component of the technical specification is strangely short on detail relative to other sections and would very much like to see it developed so that it can become the primary method for determining the technical provisions. By doing so, IORPs will be encouraged to continue to develop a more diversified investment strategy, thereby reducing systemic risk in investment markets. We consider that IORPs are well placed to be able to invest in assets that support economic growth, business investment and jobs (including infra-structure projects and European 'project bonds'), in line with the 2020 Growth Strategy .</p> <p>We would suggest that the proposed approach to derive the level B discount rates should be refined to take account of the range of investment strategies available to IORPs.</p>	

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	<p>When considering these two aspects, we believe that the technical, market-consistent approach upon which the EIOPA (and ultimately Commission) proposals are founded, are anti-growth, anti-investment and anti-jobs. The interaction of the calculation of sponsor support and the SCR will militate in favour of investment in sovereign debt rather than the growth-fuelling asset classes such as equities and infrastructure. We consider that this would be undesirable, increasing systemic risk. Moreover, it discourages employers from providing supplementary (Pillar II) occupational pension arrangements that are anything other than ‘pure DC’. This, in turn, places greater reliance on Member States’ Pillar I arrangements, which are already recognised as placing an unacceptable burden on national budgets.</p>	
Q15.	<p><i>Do stakeholders agree that the draft technical specifications specify a fixed yearly percentage of respectively 2% and 3% for the expected inflation rate and salary growth? Or should IORPs also be allowed to expected inflation implied by financial markets? Could you explain?</i></p> <p>The fixing of these variables is in stark contrast to the highly-detailed approach adopted in other areas of the specification in the name of achieving market consistency. We note that EIOPA is “considering including an inflation risk module” and this appears to us to be necessary if IORPs are to be required to set their inflation assumption in a market-consistent way.</p> <p>In doing so, it needs to be clear what inflation linkage is under consideration. UK IORPs typically apply inflationary adjustments based on two different inflation measures, RPI and CPI. In addition, further changes under consideration could result in a third (or more) inflation measures. The assumptions adopted should, as far as possible, be market-consistent relative to the inflation measure used. It would not be appropriate to use the same assumption for CPI and RPI.</p> <p>We are also strongly of the view that salary growth should only be allowed for to the extent that future salary-linkage is guaranteed (and cannot be limited or terminated by the IORP or sponsor).</p>	
Q16.	<p><i>Do stakeholders believe that the description of the SCR in Chapter 3 is sufficiently clear and understandable to enable participants in the QIS to perform the necessary calculations?</i></p> <p><b>It should not be inferred from the <i>technical</i> points that we make about the SCR that we support</b></p>	

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	<p><b>its application; we are opposed to its use</b></p> <p>Although we recognise that a formulaic approach to all intricate details of the SCR is difficult, we consider that a rather less detailed approach would be more appropriate, in particular, focusing on the simplifications. Based on our experience in helping insurers understand and implement the requirements of Solvency II and in carrying out QIS calculations for a sample of IORPs, we believe that the level of asset information is too detailed – for example the provision of asset data on a security-by-security basis, the requirement to apply a ‘look-through’ approach, exposures aggregated by issuer name, bond information by term and credit rating etc.</p> <p>We also believe that worthwhile simplifications could be made in other areas, for example by combining the mortality and longevity risk modules. There is also a need to simplify the counterparty default risk module to ensure that it can be applied in a practical and cost-effective way.</p>	
Q17.	<p><i>Do stakeholders believe that the risks IORPs are facing are adequately reflected in the calculation of the SCR and MCR (Chapter 3 and 4)? Are there in the stakeholders’ view any risks being considered that are not material and could be excluded from the technical specifications? Are there other risks that should be considered in the calculation of the SCR?</i></p> <p>As mentioned in our general comments at outset (and repeated at the end of this section), we consider calculating the SCR to have no benefit (and significant cost) for the vast majority of UK IORPs. The remainder of our comments, therefore, are on technical aspects. They are, in no way, intended to intimate that we consider calculation of an SCR to be appropriate.</p> <p>If an SCR calculation is to be required, we consider that it might be appropriate to include an additional shock relating to inflation risk (although, within the UK, many IORPs’ exposure to inflation risks are ‘capped’)</p> <p>In our response to question 9, we highlighted the need to re-examine the impact of the counterparty default risk module in relation to sponsor support. This is to ensure there is no ‘double counting’ of risks, taking into account the way in which sponsor support is valued in the HBS.</p>	

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	<p>As suggested in our response to question 6, we question whether there should be an explicit Risk Margin or whether it should be incorporated within the SCR. If the option is chosen of a Risk Margin based on explicit provision for adverse deviation, then the existence of this margin should be taken into account when determining the stresses within the SCR.</p> <p>We do not believe that the pension revision risk sub-module is generally appropriate for UK IORPs.</p> <p><b>Comments on (non) relevance of the SCR to UK IORPs</b></p> <p>We cite the SCR as a particular example of an area of the proposals that does not recognise the current situation of UK IORPs. The majority of UK IORPs are ‘closed’ to new entrants and ‘on a journey’ to settlement – through the final discharge of their remaining liabilities by buying out with one or more insurers. Unlike insurance companies, UK IORPs do not exist to transact business for profit. As soon as they reach the level of funding at which they could pass their liabilities to the insurance market, they will do so. Sponsors are, in general, funding the shortfalls in their pension plans as quickly as they can reasonably afford. We question, therefore, whether the SCR has more than a theoretical relevance and therefore whether producing the figures required to construct it would be cost-effective.</p>	
Q18.	<p><i>Do stakeholders believe that the way the loss-absorbing capacity of adjustment mechanisms and security mechanisms is taken into account in the calculation of the SCR (Section 3.2) is adequate?</i></p> <p><b>It should not be inferred from the <i>technical</i> points that we make about the SCR that we support its application; we are opposed to its use</b></p> <p>Experience from implementing Solvency II for insurers leads us to conclude that the modular approach which requires three different SCR calculations (see response to question 1 above) is complex and expensive.</p>	

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	<p>Our calculations of actual QIS numbers lead us to consider that this is an aspect that can make a substantial difference to the SCR – in one example different interpretations of the sponsor support calculations coupled with use of the maximum available PPS support to cover the loss-absorbing capacity of sponsor support (SCR.2.21) led to an SCR that could be as low as 5% of the Level A best estimate liabilities plus risk margin, or as high as 22%. In this instance a difference of several €billions.</p> <p>As mentioned in our response to question 12 (reproduced below), we have a particular concern about the application of the interest rate stress to the maximum value of sponsor support and urge EIOPA to give this careful thought.</p> <p><b>Extract from response to question 12:</b></p> <p>Furthermore, it is unclear whether the maximum value of sponsor support is intended to change in stress scenarios, for example under the interest rate risk sub-module of the SCR. If so, then the implication is that the maximum value of sponsor support will increase with a downward shock in interest rates. We would question whether this is appropriate. We believe that the maximum value of sponsor support is more likely to be equity-like than bond-like (as the current proposal implies) in its behaviour.</p>	
Q19.	<p><i>Do stakeholders believe that the calculation of SCR in the Operational risk module (Section 3.3) is adequate for IORPs?</i></p> <p><b>It should not be inferred from the <i>technical</i> points that we make about the SCR that we support its application; we are opposed to its use</b></p> <p>From a purely technical point of view it is desirable to have greater transparency as to how the parameters have been arrived at. If this detail is made available, it seems to us to be appropriate to consult on the basis for deciding those parameters. We would be interested in seeing data as to what additional losses IORPs have incurred in the past due to operational risks before these parameters are reconsidered. The options available to IORPs to recover such losses by actions</p>	

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	<p>against third-party advisers and insurers should also be taken into account.</p> <p>We have a strong concern that an operational risk capital requirement determined in a formulaic way disincentivises IORPs to improve operational risk management.</p> <p>That said, in the overall SCR the operational risk module is a comparatively small element. There is a risk that this could be ‘over-engineered’ affording spurious accuracy at the cost of further complication.</p>	
Q20.	<p><i>Do stakeholders believe that the simplifications provided for the calculation of the SCR (for spread risk on bonds in section 3.5, value of collateral in section 3.6 and mortality, longevity, benefit option and catastrophe risk in section 3.7) are adequate? Do stakeholders have any concrete suggestions for additional simplifications?</i></p> <p><b>It should not be inferred from the <i>technical</i> points that we make about the SCR that we support its application; we are opposed to its use</b></p> <p>We believe that the mortality and longevity sub-modules could be combined for IORPs. At the very least, IORPs should only be required to apply the sub-module that produces the larger capital requirement, which will normally be the longevity sub-module.</p> <p>The proposed simplification for the longevity risk calculation in SCR.7.33 does not appear to be an accurate reflection of the change in liability due to a longevity shock. We would suggest a suitable alternative would be to use model point annuity factors.</p> <p>In our view, the application of the benefit option risk sub-module needs to be clarified for IORPs. In particular, it is not clear how benefit options such as commutation of pension for a cash sum at retirement, or early retirement take-up rates are to be taken into account. The lack of clarity arises because the wording used has been drafted in an insurance, rather than an IORP, context.</p>	
Q21.	<p><i>Do stakeholders believe that the treatment of sponsor default risk in the counterparty default risk module of the SCR calculation (Section 3.6) is appropriate? If not, what improvements would stakeholders suggest?</i></p>	

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	<p><b>It should not be inferred from the <i>technical</i> points that we make about the SCR that we support its application; we are opposed to its use</b></p> <p>No. In particular we consider that:</p> <p align="center">Loss-given default = 50% Sponsor Support</p> <p>is profoundly arbitrary and thus unsatisfactory in that it fails to capture the multi-dimensional nature of sponsor support and therefore risks substantially mis-stating the impact of the advice. Also, as mentioned in our responses to questions 9 and 17 (repeated at the end of this section), we believe that the interaction of this calculation with the valuation of sponsor support in the HBS (which already recognises the risk of sponsor default) needs further examination in order to ensure there is no double-counting of risk.</p> <p>Given the arbitrary assumptions about the loss given default, and the highly subjective nature of the probability of default, the complexity of the calculation of the counter-party default risk could be regarded as spurious.</p> <p><b>Response to question 9</b></p> <p>In terms of the best estimate of technical provisions, we think this should depend on the extent of (and evidence for) the contractual agreement between IORPs and their members regarding the circumstances in which benefits might be reduced. In general, where benefit reductions in the case of sponsor default only occur as a practical reality then we see no justification for making an allowance for such reductions in the best estimate calculation. On the contrary, one of the purposes of the solvency regime is to minimise the circumstances in which benefits need to be cut back due to default of the sponsor and this would be frustrated if the technical provisions made allowance for benefit reductions in the event of sponsor default.</p> <p>Having said this, we believe that there is a strong case for removing the requirement for additional capital in respect of sponsor support in the counter-party default risk module where</p>	

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	<p>benefit reductions are possible in the event of sponsor default, or where there is a pension protection scheme in place.</p> <p>We also believe that the capital requirement in respect of sponsor support in the counter-party default risk module needs to be re-examined as we are concerned that there could be an element of double-counting.</p> <p><b>Response to question 17</b></p> <p>As mentioned in our general comments at outset (and repeated at the end of this section), we consider calculating the SCR to have no benefit (and significant cost) for the vast majority of UK IORPs. The remainder of our comments, therefore, are on technical aspects. They are, in no way, intended to intimate that we consider calculation of an SCR to be appropriate.</p> <p>If an SCR calculation is to be required, we consider that it might be appropriate to include an additional shock relating to inflation risk (although, within the UK, many IORPs' exposure to inflation risks are 'capped')</p> <p>In our response to question 9, we highlighted the need to re-examine the impact of the counterparty default risk module in relation to sponsor support. This is to ensure there is no 'double counting' of risks, taking into account the way in which sponsor support is valued in the HBS.</p> <p>As suggested in our response to question 6, we question whether there should be an explicit Risk Margin or whether it should be incorporated within the SCR. If the option is chosen of a Risk Margin based on explicit provision for adverse deviation, then the existence of this margin should be taken into account when determining the stresses within the SCR.</p> <p>We do not believe that the pension revision risk sub-module is generally appropriate for UK IORPs.</p>	

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	<p><b>Comments on (non) relevance of the SCR to UK IORPs</b></p> <p>We cite the SCR as a particular example of an area of the proposals that does not recognise the current situation of UK IORPs. The majority of UK IORPs are ‘closed’ to new entrants and ‘on a journey’ to settlement – through the final discharge of their remaining liabilities by buying out with one or more insurers. Unlike insurance companies, UK IORPs do not exist to transact business for profit. As soon as they reach the level of funding at which they could pass their liabilities to the insurance market, they will do so. Sponsors are, in general, funding the shortfalls in their pension plans as quickly as they can reasonably afford. We question, therefore, whether the SCR has more than a theoretical relevance and therefore whether producing the figures required to construct it would be cost-effective.</p>	
Q22.	<p><i>Do stakeholders believe that the calculation of SCR in the Benefit option risk sub-module (Section 3.7) is adequate for IORPs?</i></p> <p><b>It should not be inferred from the <i>technical</i> points that we make about the SCR that we support its application; we are opposed to its use</b></p> <p>From our experience of working on Solvency II, we note that the benefit option risk sub-module (or ‘lapse rate’) is calibrated on insurance data and does not reflect actual/potential benefit option take-up within the IORP.</p> <p>We also consider that the member-by-member approach is very onerous and whilst the simplification (of a homogeneous risk group) appears attractive, we are unclear as to how to prove that the results will not be materially different from the member-by-member basis without doing those calculations anyway.</p> <p>As implied in our response to question 20 (repeated below), we believe it would be beneficial if this sub-module were re-drafted so that it is directly applicable to the benefit option risks of IORPs.</p>	

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	<p><b>Response to question 20</b></p> <p>We believe that the mortality and longevity sub-modules could be combined for IORPs. At the very least, IORPs should only be required to apply the sub-module that produces the larger capital requirement, which will normally be the longevity sub-module.</p> <p>The proposed simplification for the longevity risk calculation in SCR 7.33 does not appear to be an accurate reflection of the change in liability due to a longevity shock. We would suggest a suitable alternative would be to use model point annuity factors.</p> <p>In our view, the application of the benefit option risk sub-module needs to be clarified for IORPs. In particular, it is not clear how benefit options such as commutation of pension for a cash sum at retirement or early-retirement take-up rates are to be taken into account. The lack of clarity arises because the wording used has been drafted in an insurance, rather than an IORP, context.</p>	
Q23.	<p><i>Do stakeholders believe that the descriptions of financial and insurance risk mitigation (Section 3.9 and 3.10) are sufficiently clear and understandable to enable participants in the QIS to perform the necessary calculations?</i></p> <p><b>It should not be inferred from the <i>technical</i> points that we make about the SCR that we support its application; we are opposed to its use</b></p> <p>Our experience with implementing Solvency II leads us to conclude that the ‘basis risk’ requirements are very onerous. We also consider that the consultation document fails to recognise dynamic hedging as a valid risk management technique.</p> <p>Again this is an area that bears longer consideration and scrutiny than the consultation affords.</p>	
HBS 3.1	<p>In this context, we find the term “best estimate” unfortunate, It is a term that is widely used with a very different meaning in the UK. Bearing in mind that those responsible for running UK IORPs</p>	

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	<p>are mostly laymen rather than expert professionals, it is important that the jargon employed is not counter-intuitive.</p> <p>In our view, it would be better to refer to Level A Technical Provisions and Level B Technical Provisions as appropriate.</p>	
PRO 1.1	<p>In our view, it is necessary but not sufficient to consider the risks when judging proportionality : it is necessary also to consider the resources available, the value added and the implications for future benefit provision. Our concern is that a focus purely on risk will result in regime that fails to balance security with adequacy and sustainability.</p>	