

Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II		Deadline 31 July 2012 18:00 CET
Name of Company:	<p>aba Arbeitsgemeinschaft für betriebliche Altersversorgung e.V. Rohrbacher Strasse 12 69115 Heidelberg, Germany <i>Contacts:</i> <i>Klaus Stiefermann, klaus.stiefermann@aba-online.de, Tel: +49 6221 13717814</i> <i>Sabine Mahnert, sabine.mahnert@aba-online.de, Tel: +49 6221 13717823</i> <i>Dr. Cornelia Schmid, cornelia.schmid@aba-online.de, Tel: +49 6221 13717825</i></p> <p>The aba Arbeitsgemeinschaft für betriebliche Altersversorgung e.V. is the German industry association representing all matters concerning occupational pensions in the private and public sector. The aba has 1,400 members including corporate sponsors of pension schemes, IORPs, actuaries and consulting firms, employer associations and unions, as well as insurance companies, banks and investment managers. According to our statutes, our mission is to represent existing schemes as well as to expand coverage of occupational pensions independent of vehicle.</p>	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
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Reference	Comment	
General Comment	<p>We welcome the opportunity to comment on the Draft Technical Specifications for the EIOPA QIS. We note with regret that EIOPA was unable to provide the normal 3 month consultation period due to the “imposition of an external timetable”. We are concerned by the haste with which the IORP review is being carried out given the profound impact it will have on IORPs, their stakeholders and the wider economy. The timing of the actual QIS is also unfortunate as it will coincide with IORPs’ year end activities and, therefore, deter even more IORPs from participating.</p> <p>Contrary to the promises made by the Commission and EIOPA, the QIS is more or less a direct copy/paste from Solvency II with some modules added for sponsor support and pension protection schemes. No effort has been made to develop a solvency approach which reflects the true nature of IORPs, the benefits they provide and their role within society. In particular, capital requirements based on VAR, a one-year forecast period and market based parameters are completely inappropriate for institutions that have long-dated liabilities that cannot be called, have flexible funding backed by a sponsoring employer and are a critical provider of long-term capital both to the banking sector and to the real economy. Rather than copying regulation from the insurance sector, we would have expected EIOPA to seek inspiration from regulatory approaches in comparable pension systems (eg. USA, Switzerland etc.) Indeed, it is this playing field which is relevant for European corporate pension sponsors.</p> <p>Whilst we agree with the principle of risk-based supervision, where, in our view however, the definition of risk should be calibrated to the objectives of the individual IORP, we disagree with the notion of introducing risk-based capital requirements and attaining “a level of harmonization (of prudential regulation) where EU legislation does not need additional requirements at a national level”.</p> <p>The current economic environment lays bare the flawed approach of market-consistent valuation. European fixed income markets are dysfunctional, interbank lending is at a standstill and prices in sovereign debt markets are heavily distorted due to large scale</p>	

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	<p>political and central-bank intervention. Introducing volatile risk-based capital requirements for IORPs would increase uncertainty and further weaken confidence in the financial system.</p> <p>It is, therefore, not clear why the “base-scenario” in the draft technical specifications reflects the current stress environment we are facing with the so-called Euro crisis. Economically, it does not make sense for the “base case” to reflect a scenario of negative real interest rates as the rationale for retirement saving in this context ceases to exist.</p> <p>The Commission has declared that “any new supervisory system for IORPs should not undermine the supply or the cost-efficiency of occupational retirement provision in the EU.” It should be apparent that solvency II-like capital requirements based on December 2011 yield levels, if implemented, would drastically reduce the cost-efficiency and, therefore, supply of occupational retirement provision in the EU. To be clear, the proposed regulations, if implemented, would lead many corporates in Germany to review their continuing sponsorship of IORPs. Particularly the young, who are already shouldering a significant portion of the cost of 1st pillar provision, would be most affected.</p> <p>We, therefore, stress the importance of the questionnaire that EIOPA is currently developing (I.6.2) that will “give a first impression of the outcomes of the QIS and the potential policy reaction by the IORPs and other stakeholders if the holistic balance sheet approach were implemented.” We believe it would be useful to draft this questionnaire in the context of the five points that Commissioner Barnier outlined in his speech at the Public Hearing on the 2nd EIOPA consultation on 1 March 2012:</p> <ol style="list-style-type: none"> 1. Facilitation of cross-border schemes. <p>Will the proposed measures encourage and facilitate the creation of cross border IORPs?</p>	

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	<p>2. Impact on long-term investment</p> <p>Will the proposed measures facilitate economic growth and long-term sustainable wealth creation?</p> <p>3. Contribution to the sustainability of Member States’ public finances.</p> <p>Will the proposed measures reduce the reliance on state provided benefits? Will they be tax neutral, given that funding may have to increase?</p> <p>4. Take better account of specific characteristics of IORPs by using an approach based on economic substance rather than legal form.</p> <p>Do the proposed measures take the economic substance of IORPs adequately into account? What will be the impact on the sponsoring employer’s balance sheet?</p> <p>5. Maintain a level playing field for regulatory competition</p> <p>Will the proposed measures turn IORPs into insurance companies and, if so, will sponsoring employers be willing to underwrite insurance business or rather seek alternative forms of providing deferred compensation to employees? How will the proposed measures affect the competitive landscape of European corporates vis-à-vis their non-European counterparts.</p> <p>Finally, we hope that the Commission and EIOPA will recognize that this QIS can only be the first in a series of QIS on the way towards developing a workable model for prudential regulation of IORPs in Europe.</p>	
Q1.	No. The QIS is based on Solvency II with some modules added for sponsor support	

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	<p>and pension protection schemes. No effort has been made to develop a solvency approach which reflects the true nature of IORPs, the benefits they provide and their role within society. In particular, capital requirements based on VAR, a one-year forecast period and market based parameters are completely inappropriate for institutions that have long-dated liabilities that cannot be called, have flexible funding backed by a sponsoring employer and are a critical provider of long-term capital both to the banking sector and to the real economy.</p> <p>Notwithstanding this, the QIS will be inadequate for EIOPA to assess the impact of the proposed regulations on IORPs and their members without specifying or providing an idea of the possible regulatory actions of a shortfall in the holistic balance sheet. As these actions can have an impact on the benefits provided by IORPs, the valuation of liabilities may well contain a high degree of error.</p> <p>The complexity of the exercise will overwhelm many IORPs who will not have the staff nor the financial resources to undertake the study. For many IORPs, the exercise would not be feasible without using consultants at a significant cost. Many smaller IORPs, therefore, will not participate with the result that EIOPA will receive an biased sample of responses.</p> <p>We have identified 972 scenarios (for one confidence level) that IORPs will be expected to compute. Many IORPs will not have inputs in the appropriate format. Given that EIOPA will only be publishing 3 “typical scenarios”, the effort seems completely disproportionate.</p> <p>Given the similar complexity to Solvency II, we would expect the cost of the QIS and finally the implementation of an analogous IORP II regime would be very similar to the total Solvency II QIS/implementation cost for insurers. We, therefore, call on EIOPA to carry out a cost/benefit analysis prior to carrying out the QIS.</p>	
Q2.	<p>No. IORPs have available to them a range of adjustment mechanisms that are anchored in labour and collective bargaining law i.e. outside of prudential law. As some of these adjustment mechanisms can be scheme, industry and context specific,</p>	

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	<p>we do not believe it is possible to evaluate these factors using a market consistent approach with any degree of usefulness in the holistic balance sheet.</p> <p>Some multi-employer IORPs, for example, include a solidarity component which makes all sponsoring employers jointly liable. If necessary, benefit reductions can be negotiated between the social partners. Other schemes may apply different adjustment mechanisms which are not adequately reflected in the proposed model.</p> <p>It should be apparent that the QIS model for valuing sponsor support does not adequately reflect local practice. Moreover, it is heavily laden with assumptions and the outcomes are not robust. Small changes in the inputs result in large deviations in outcomes.</p> <p>Pension protection schemes are an important security mechanism for occupational pensions in Germany. In contrast to other security schemes in the financial industry which are potentially exposed to systemic risk, the German Pensions-Sicherungs-Verein (PSV) is backed by 91,700 employers i.e. the majority of listed companies in Germany as well as a significant portion of the Mittelstand.</p>	
Q3.	<p>No. The draft technical specifications are too complex and not sufficiently clear and understandable. As a result many IORPs will not take part in the QIS which will disproportionately affect multi-employer IORPs, small IORPs and those who largely outsource their operations with the result that EIOPA will receive a distorted picture of the quantitative impact of the proposed regulations.</p> <p>Most importantly, this QIS will not provide sufficient information because its approach is too narrow. The draft technical specifications are purely based on Solvency II models whilst other options are not taken into account. Hence, the study will not enable EIOPA to gain a truly holistic view of IORPs' economic position.</p> <p>The main driver of the quantitative impact of the proposed regulations will be the discount rate used to calculate the best estimate of liabilities. This is a calculation that is relatively straightforward, if applied in the context of the existing actuarial methodology, and could be undertaken by all IORPs. EIOPA should, therefore, focus</p>	

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	<p>on those variables that will explain the bulk of the impact.</p> <p>Unfortunately, the spreadsheets which EIOPA will be supplying were not part of the QIS draft technical specifications. As such, the QIS will be, at least for many IORPs, an exercise in which they enter data into a “black box”. It is unlikely that IORPs will have the necessary input data nor be able to perform adequate plausibility checks (on inputs and outputs) if they do not understand what the model is calculating, thereby leading to the “garbage-in garbage-out” phenomenon.</p> <p>We would have expected the Commission/EIOPA to respect the principle of proportionality and exempt smaller IORPs from the proposed regulations.</p>	
Q4.	<p>No. We believe that IORPs will not be able to perform the calculations proposed in the technical specifications within the proposed timeframe at a reasonable cost. The timing of the QIS which will coincide with year-end activities will further reduce the ability of IORPs to participate.</p> <p>In addition, the accuracy of the calculations will be questionable. The level of complexity of the technical specifications as well as the heavy reliance on assumptions will lead to model risk. The “errors” will be compounded further when the regulator grosses up the results of a biased sample to reflect the universe of entities subject to regulation. Finally, further error will enter the equation when EIOPA transposes these results to reflect the different confidence levels.</p> <p>Given the similar complexity to Solvency II, we would expect the cost of the QIS and finally the implementation of an analogous IORP II regime to be very similar to the total Solvency II QIS/implementation cost for insurers. We, therefore, call on EIOPA to carry out a cost/benefit analysis prior to carrying out the QIS.</p>	
Q5.	<p>No. The draft technical specifications do not sufficiently recognize the full variety of schemes that operate in the Member States. Participants will, therefore, interpret the specifications differently leading to figures that are not comparable.</p> <p>In particular the valuation of sponsor support is too complex and impractical and not</p>	

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	<p>suited to multi-employer IORPs, quasi-public institutions, non-listed and/or non-rated corporates, subsidiaries of foreign enterprises etc.</p> <p>We are concerned about the reliance on ratings in the computations. There was a clear commitment by representatives at the G20 summit to reduce the reliance on ratings in financial regulation. This point has been taken up by the OECD in redrafting the Core Principles for Occupational Pension Regulation and the European Commission in its draft revision of the Credit Ratings Regulation. It should be noted that the vast majority of employers who sponsor occupational pensions are not rated. These are especially to be found in the SME segment who often employ low income workers. By making the provision of pensions more expensive for this group of the workforce, EIOPA would be clearly acting against the aims of the European Commission as stated in its recent White Paper.</p>	
Q6.	<p>We reject the concept of a risk margin as inappropriate in occupational pension systems with sponsor support and PPS. In these systems the IORP is simply a delivery mechanism for the benefit promise given by the employer. In a going concern situation it is economically inefficient (both at the company level and at the whole economy level) to fund the IORP over and above the long-term value of liabilities.</p> <p>Even in the event of scheme closure, bulk transfers are rare, therefore, the transfer value rationale is not applicable. Should a shortfall in the IORP exist, scheme members have legal recourse to the sponsoring employer.</p> <p>Moreover the cost of capital concept is not relevant for IORPs as they do not have third-party shareholders and, hence, do not have to earn (equity-) capital costs, nor are pension liabilities traded in an active market.</p> <p>Therefore, applying both a risk margin and a capital requirement to IORPs is excessive and a misallocation of resources that could be employed more productively in the real economy. Corporate sponsors will be quick to recognize this and curtail their engagement in occupational pensions accordingly.</p> <p>Notwithstanding this, some valuation and calibration assumptions have built in risk</p>	

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	<p>buffers (eg. mortality assumptions). Adding an explicit risk margin would be double counting (adding an SCR would then be triple counting.)</p> <p>The valuation of sponsor support and pension protection schemes needs to be radically simplified. The draft technical specifications are unusable for:</p> <ul style="list-style-type: none"> • Multiemployer schemes, especially those without a small group of dominant employers • IORPs of quasi-public institutions (broadcasting, public utilities etc.) • IORPs of sponsors who do not publish EBTDA (sub-entities, foreign subsidiaries, non-listed entities that do not report under IFRS etc.) <p>In a system with unlimited sponsor support and a pension protection scheme that is backed by the Germany economy, their values should simply equate to the balancing item in the holistic balance sheet and represent the base case.</p>	
Q7.	<p>The best estimate of technical provisions should include a suitable trend in mortality rates.</p> <p>Mortality is country and sometimes sector/scheme specific. Therefore, mortality tables and assumptions for future mortality trends should be defined at a national level or even sector/scheme level.</p> <p>For those IORPs who currently use mortality tables without a trend, a simple adjustment should be acceptable for the QIS.</p>	
Q8.	<p>No. Projecting cash flows in respect of each individual member will be costly and time consuming for many members. Having to provide evidence that the grouping of entitlements is acceptable would almost require as much effort.</p> <p>Pensions plans in Germany typically provide defined death and disability benefits. The valuation of these is integrated with the valuation of retirement benefits, therefore, it is not feasible to value these as a separate plan.</p>	

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	<p>The exact distinction between unconditional, conditional and discretionary benefits is not sufficiently clear.</p> <p>Under the current wording of the technical specifications, the majority of German IORPs would fall under Type 1 schemes according to HBS 4.13, as these can be discontinued at any time. In this case, accrued benefits would be valued on an ABO basis. This means that conditional benefits arising from accrued entitlements (eg. bonus distributions in hybrid schemes) would not be included in the valuation. In any event, these are a function of the funded status of the scheme, which is influenced by the solvency requirements. To the extent that future solvency requirements are not yet known, it is not possible to make these projections.</p>	
Q9.	<p>Many IORPs have the ability to reduce benefits in the event that the sponsor discontinues supporting the scheme, independent of whether a PPS exists or not, therefore it does not seem consistent to differentiate here.</p> <p>In some instances sponsor default is not a necessary condition for benefit reductions. It is unclear how this would be taken in to account in the valuation. We, therefore, urge EIOPA to conduct further research on the various adjustment mechanisms that exist in practice as the current model does not seem to adequately take them into account.</p>	
Q10.	<p>No. We do not agree that security mechanisms should be valued on the basis of probability-weighted average discounted expected payments from the sponsor and the pension protection scheme. Firstly, this approach overlooks the fact that, in reality, the value of security mechanisms is digital, either they function or they don't. This means that a sponsor will continue to support a scheme up to the point where it is no longer financially feasible, at which point it will be closed and support will cease. Of course the deficit funding procedure, which is omitted from the technical specifications, will have an impact on this. Having to fund the entire deficit tomorrow with cash is a different proposition to having to increase the next x years of contributions by y%, even if the present value might be the same.</p>	

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	<p>In addition, EIOPA should take into account that a prudent and sustainably acting sponsor company will financially support an IORP not only to the extent that liabilities are covered but also with respect to coverage of a capital requirement. Otherwise benefits would have to be reduced and given the subsidiary liability of the employer, these would simply land on the balance sheet of the sponsor.</p> <p>The valuation of sponsor support as proposed by EIOPA is not robust due to the number of assumptions that need to be made. Moreover, the input data required would mostly not be readily available. For example, EBTDA is a figure that is usually only published with respect to publicly listed and consolidated entities. Benefit promises, however, are made at the legal entity level and it is only the legal entity that is liable. Therefore, a consolidated EBTDA figure is irrelevant for the purposes of this calculation. Non-publicly listed entities are not required to prepare financial statements in accordance with IFRS and, therefore, would not publish an EBTDA value.</p> <p>To the extent that the value of sponsor support can only be estimated for a few large corporates, the question arises whether the proposed method represents discrimination of SMEs.</p>	
Q11.	No. We do not agree with the proposed methodology and altering the parameters would not make a difference to this.	
Q12.	<p>No. We do not agree with the proposed methodology and altering the parameters would not make a difference to this.</p> <p>As stated above, the valuation of sponsor support as proposed by EIOPA is not robust due to the number of assumptions that need to be made. Moreover, the input data required would mostly not be readily available. For example, EBTDA is a figure that is usually only published with respect to publicly listed and consolidated entities. Benefit promises, however, are made at the legal entity level and it is only the legal entity that is liable. Therefore, a consolidated EBTDA figure is irrelevant for the purposes of this calculation. Non-publicly listed entities are not required to prepare financial statements in accordance with IFRS and, therefore, would not publish an EBTDA</p>	

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	<p>value.</p> <p>It is not justifiable to use commercial ratings to estimate the default risk of sponsors especially in light of the fact that both the Commission and the European Parliament are committed to reducing the reliance on credit ratings in European legislation.</p>	
Q13.	<p>We endorse any counter cyclical measures in specifying solvency standards. These would be achieved by using valuation assumptions that are based on long-term equilibrium values and not short-term market rates. Shifting the yield curve by 50 bps is insufficient given the historical range of interest rates and does not adequately take into account the long-term nature of pension liabilities.</p>	
Q14.	<p>The level B discount rate seems to be a more appropriate rate to discount liabilities and should represent the base case. It's derivation, however, needs adjustment. The fixed income asset classes listed in HBS 8.18 are not representative of the asset allocation of German IORPs which have significant investments in covered bonds and registered bank bonds that may be rated lower than AA. In addition, many IORPs have significant issuance of mortgage loans to members which are not covered in HBS 8.18. Basing the fixed income portion of the level B discount rate on AAA and AA rated securities is unreasonable given the lack of depth of this market.</p> <p>Importantly, the level B discount rate should represent a long-term equilibrium return on the IORPs assets and not be based on today's yield levels. The fixed income yield should reflect a long-term historical average and the duration of liabilities.</p>	
Q15.	<p>We believe that all assumptions should be based on long-term equilibrium values.</p>	
Q16.	<p>The description of the SCR will not be sufficiently clear and understandable for smaller IORPs, who will not participate in the QIS as a result.</p> <p>It seems as if a significant part of the calculation will be done by a spreadsheet to be supplied by EIOPA. It is questionable whether IORPs will have the required input data let alone understand the output to the degree necessary to check plausibility and interpret the results.</p>	

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	<p>It is not clear how EIOPA will infer other security levels from the calculations on a 99.5% level given that the results will be non-linear.</p> <p>It is not clear which assets would fall under the definition of “intangible assets”.</p>	
<p>Q17.</p>	<p>We do not agree with a market consistent valuation of assets and liabilities as we do not believe short-term changes in market prices should drive the management of institutions that cover long-term liabilities and follow long-term investment strategies. Given that members cannot call their benefits before they are due (unlike customers of banks and insurance companies), market risk is a secondary risk to IORPs. The primary risk of changing asset prices is the effect on the portfolio return of reinvestments. This only changes gradually over time, however, due to the long duration of the assets in the portfolio. An SCR computed on the basis of a shock in asset prices is therefore completely inappropriate for IORPs.</p> <p>The same applies to interest rate risk. Interest rate risk – insofar as it does not represent the reinvestment risk of the portfolio resulting from changes in market interest rates - is only present because the QIS requires assets to be marked to market and liabilities to be discounted with a “market consistent” discount rate. In a sense, EIOPA is introducing pseudo-risks to IORPs. It is the absolute level of interest rates or market returns over time which matter, not intertemporal changes to these variables.</p> <p>Pension longevity risk: There is an element of double counting in the requirement to assume a 20% decrease in mortality rates as the best estimate used in calculation of the technical provisions already allows for future improvements in longevity.</p> <p>Pension disability-morbidity risk: The capital charge for pension disability-morbidity risk could be lower compared to insurers, since IORPs do not have the disadvantage of adverse selection (due to mandatory participation).</p> <p>Sponsor default risk: We are not sure why this is included in SCR as it seems to be</p>	

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	<p>double counted.</p> <p>Catastrophe risk: Not relevant for IORPs.</p> <p>Lapse risk: Not relevant for IORPs</p> <p>Spread risk: Too difficult for IORPs to calculate.</p> <p>Benefit option risk: Immaterial or does not cause strain on the fund.</p> <p>The calculation of the different risks for the SCR rely very much on the credit rating. This is remarkable given that the European Commission is reviewing the Credit Ratings Directive which will reduce the reliance on ratings in financial regulation. Relying heavily on credit ratings will introduce procyclicality into the solvency assessment of IORPs thereby amplifying risk.</p> <p>The objective of an MCR in a system with sponsor support and pension protection scheme is unclear. In our opinion, an MCR is not relevant for IORPs.</p>	
Q18.	<p>In principle, the loss absorbing capacity of adjustment mechanisms should be taken into account in assessing the solvency position of an IORP. We believe that EIOPA needs to investigate the various adjustment mechanisms available to IORPs in more detail as the proposed technical specifications are too vague and insufficient. In particular, smaller IORPs will be unable to handle these computations.</p>	
Q19.	<p>No. Should an IORP incur losses due to operational reasons, these are usually covered by the sponsoring employer. In Germany, it is the employer who chooses the funding vehicle for pensions, therefore, the employer is also responsible for its operational efficiency. Imposing a capital charge for operational risk is, therefore, inefficient and superfluous.</p> <p>In addition, the cost of operational failure may be met by outsourced service providers meaning that the IORP would not suffer any financial impact from the operational</p>	

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	failure.	
Q20.	No. The above risks are either non-existent or immaterial for IORPs. Leaving these out of the QIS would not alter the results significantly.	
Q21.	No. We do not understand the purpose of calculating the sponsor default risk as part of the SCR.	
Q22.	<p>No. Benefit options, where they exist, are usually calibrated so that they do not cause a strain on the fund. Therefore, the risk is immaterial and can be ignored in the QIS.</p> <p>Lapse risk is an insurance concept and not relevant for IORPs. It should be noted that upon a member's termination of service, his/her accrued entitlements often remain in the scheme. The present value of the termination benefit in most instances is equal to the actuarial reserve so that there is no strain on the fund. The same is true for transfers to another scheme.</p>	
Q23.	<p>No. These sections will not be understandable for smaller IORPs who will be deterred from participating in the QIS.</p> <p>The instruments outlined in this section may reduce risk as defined in the draft technical specifications, however, they do not necessarily reduce the liability of IORPs with respect to their members. In particular, schemes which offer profit participation are legally required to calculate these profits according to historical cost accounting standards. Financial instruments designed to hedge intertemporal changes in asset prices do not alter the benefit that is promised to the employee and, therefore, do not contribute to risk mitigation in a real sense.</p>	
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