	Comments Template on Discussion Paper on Sponsor Support Technical Specifications	Deadline 31 October 2013 18:00 CET
Name of Company:	Groupe Consultatif Actuariel Europeén	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
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Reference	**Comment**	
General Comment	We welcome this discussion paper as a constructive attempt to address the difficulties arising with the quantification of sponsor support for the QIS. We note that the contents of the paper should be considered as a work in progress and we would be pleased to assist EIOPA to develop further some of the unresolved issues. As noted in the paper, the document does not address how the calculated value of sponsor support will be used (if at all) for supervisory purposes: • what trigger points will lead to supervisory action, • duration of recovery plans, • tiering of assets etc	

	and it is difficult to give a full response to the questions posed without understanding the context. There are many references to a further QIS and whilst we agree that it would be helpful to assess the impact of the proposed approach and various sensitivities, we would be concerned that few IORPs would be willing to participate in a further QIS if this were too onerous. We believe that the vast majority of IORPs will look to adopt a simplified approach (both for any QIS exercise and if, in due course, the assessment of sponsor support became a regulatory requirement) and we think that EIOPA should focus on developing such approaches. The approach proposed in the paper is a good starting point but requires further research and development before it would be fit for purpose. In particular, IORPs should be given flexibility, based on expert judgement, to adjust the parameters to reflect the specificities of their scheme, provided that they can demonstrate that this is appropriate. In particular, we would ask EIOPA to recognise in setting default probabilities that it is generally believed that these are not static over time but that those for highly rated companies may be expected to regress to the mean. We also consider that further thought needs to be given to the appropriate level of recovery given default. We consider that limited conditional sponsor support has a value that should be recognised although further consideration needs to be given to how this can be done. We note that EIOPA has reiterated the objective of obtaining a market consistent value of sponsor support, and whilst we have sympathy with this objective, we consider that this will be very challenging, given the lack of any market for sponsor support, or any reliable proxy, and the need to use judgement and subjective inputs to generate a value.	
Q01.	It has to be kept in mind that stochastic valuations are very complex and costly. Even if more detailed guidance is provided, we do not believe that many IORPs will wish to undertake stochastic valuations if a more simplified approach is available. Those large well-resourced IORPs who consider that there may be added value in using internal models either have the expertise or can afford to buy it. In our view, EIOPA should continue to develop simpler methods for the small	

	and medium IORPs and offer them as default options to the larger IORPs. EIOPA (perhaps in association with others) could make available examples that illustrated the actual calculations that it might expect to be carried out if an IORP were to conduct a stochastic valuation. We think that there are likely to be many assumptions that need to go into such a valuation, many if not most of which will be similar to ones that would be needed with the non-stochastic alternative, so the illustrations should cover not just the mathematical mechanics but also assumption selection. The paper does not address the question as to whether it is intended that IORPs which develop their own internal models for assessing sponsor support would be required to get approval from the supervisor before they could be used (as with Solvency II).	
Q02.	The proposed simplifications should be kept in any further QIS. If the methods are workable and produce sensible results then they should be retained. Ideally, simplifications should be kept as simple and as standard as possible. So if Simplification 2 proves to be workable then we would recommend ultimately dropping Simplification 1. We would also recommend supplying spreadsheets that justify some of the calculations quoted in the paper, e.g. the ones underlying Tables 9 and 10.	
Q03.	In our view, the concept of maximum sponsor support was overemphasised in the previous technical specifications, and the logic of calculating it has not properly been explained. Unless it is defined in a legal sense it will simply serve to confuse: for example, if the maximum sponsor support is less than the covenant required then does it follow that the scheme's claim on the sponsor is limited to the maximum and the liability (and therefore benefits) should immediately be reduced to reflect the difference? The concept may still be relevant in some circumstances: (a) In many instances the maximum sponsor support will be substantially larger than the shortfall between the IORP assets and liabilities, so the market consistent value of the sponsor	

	support will be driven largely by the likelihood of the sponsor running into (unexpected) difficulties and/or actually defaulting. (b) In many (all?) other situations the impact of sponsor support being capped can in principle be taken into account by some adjustment in the default probability. In the limit, a default probability of p = 100% at outset is equivalent an assumption that the maximum sponsor support is zero. Point (b) largely ties in with comments in paragraph 26 about how other major financial creditors assess the likelihood of repayment of credit and debt obligations. However, we think that it would be unwise to eliminate all reference to maximum sponsor support, since such creditors do consider asset cover in their internal rating systems and in their lending / investment criteria. An asset cover type measure is included in Table 4 and can only be calculated if it is possible to quantify somehow the net assets of the sponsor. Perhaps there should be a strong presumption that some asset cover type measure should included if at all possible.	
Q04.	If it is considered necessary to consider the maximum amount of sponsor support then, in general, we do not consider wage to be an appropriate measure for estimating this since capital intensity of production varies substantially by industry and from corporation to corporation and wage bills are not directly related to solvency of a sponsors. In some companies the wage bill of the current employees bears no reflection to the legacy liabilities in the pension schemes. Furthermore, some industries are intrinsically capital intensive whilst others may be intrinsically labour intensive. However, there may be employers in the latter category where wage is the only practical basis for assessing sponsor support.	
Q05.	This first attempt to define sponsor's strength is a good starting point but may have to be refined. Estimates of probabilities of default still rely a lot on credit ratings, which in turn rely on historical data with all their drawbacks (US data, big companies, high correlation with business cycle, default on bonds does not mean insolvency). On the other side, the approach proposed relies less on downgrading but more on financial statements. As reliable databases do not exist, significant basis risk remains.	

Q06.	Yes, although better still would be to identify or encourage the creation of industry-wide credit scores carried out in a consistent fashion and linked as per EIOPA proposals, as this is likely to reduce the inconsistencies that would otherwise arise from giving individual IORPs flexibility over what credit ratios to use and how to interpret them. The figures in such table would need to be carefully calibrated in order to provide a realistic picture of default probabilities where ratings are not available. The validity of the calibration should be assessed by comparing the estimated default probabilities with market implied default probabilities or by statistical analyses based on historical data. EIOPA may wish to consider what arrangements would need to be in place for reviewing, and potentially updating, the calibrations. A key point is that credit ratings are based on a much richer set of information compared to credit ratios. Therefore any derived measures based on ratings appear to be less volatile (and more reliable?) compared to measures based on credit ratios.	
Q07.	One suggestion would be for the creation of industry-wide credit scores and for EIOPA to identify ways in which they can be mapped to the risk of default as well as to the sponsor's appetite for investment risk and ability to support reasonable calls from the pension scheme. Market prices could give additional information to be included (e.g. credit default swaps for sponsor's debt where these are traded).	
Q08.	Yes because a strong and thriving employer is the best support for the pension scheme and therefore the IORP's demands on the sponsor should not be such as to put it into insolvency. "Back-end loading" of sponsor support, as permitted by the Pensions Regulator in the UK as a response to the financial crisis, should not be prohibited. However, we note that taking account of affordability risks reintroducing issues relating to maximum sponsor support noted above. If some guarantee of support being forthcoming exists (unless the sponsor defaults) because of regulatory requirements then it seems reasonable to adjust the timing accordingly. However, if it is merely a vague commitment then it seems less desirable to assume that shortfalls (versus Level A liabilities) will be paid quickly, see answer to	

	Q21.	
Q09.	Yes – we agree that limited conditional sponsor support should be valued, although determining the basis on which this should be done may require further research and guidance. Given the different nature of this support to "legally enforceable" sponsor support, we agree that it should be identified separately, although it would seem appropriate for it to be included in the holistic balance sheet. In practice, conditional sponsor support (e.g. a "best endeavours" commitment from the sponsor rather than a contractual or statutorily imposed guarantee) reflects a level of security or negotiating ability that the IORP and/or its members may have in the event of the sponsor trying to walk away from its implicit business commitments. For example, in the QIS exercise, no value was shown for sponsor support in the QIS calculations for Irish IORPs as this is not legally enforceable (at present) but in practice many employers (particularly subsidiaries of multinational companies) have met their commitments to date and may be expected to continue to meet funding shortfalls into the future. This suggests that making no allowance for conditional sponsor support would potentially result in misinformed policy-making.	
Q10.	Yes, and it would help to differentiate security behind this mechanism from others such as limited conditional support.	
Q11.	The proposed alternative approach is a worthy attempt to identify a valuation approach that is less dependent on complicated mathematics. However, it still involves lots of subjective inputs and would only be appropriate if schemes were allowed to use it flexibly and where appropriate supplemented by expert judgement. There are a number of references in the detail of the method to the making adjustments and the use of judgement in relation to particular aspects of the method (e.g. paragraph 59,62,76,84) which we welcome. Although we recognise that standard credit ratings are available to very few IORPs, they are often available to IORPs with large numbers of members and we believe that generally the credit ratio method seems less robust compared with the use of standard credit ratings (where these are available for the sponsoring company) as ratings are based on much more information and thus	

	supposedly provide a more reliable estimate for a sponsor's probability of default. It is not obvious how to deal with non-standard scenarios where a sponsor supports more than one IORP or where one IORP has several sponsors. Some aspects of the method need further explanation or elaboration or otherwise seem very arbitrary (e.g. tables 4 and 6). We note that the approach is substantially based on that used by banks (e.g. references in paragraphs 50, 55,58) to assess the ability of a (potential) borrower to service debt. We recognise that the assessment of the ability of an IORP sponsor to meet pension obligations will have some similarities to this, but equally there will be many differences e.g. in the nature and duration of the obligation.	
Q12.	Some of the concerns have been allayed but the approach proposed still involves lots of subjective elements that will need tightening down in order to come up with a practical solution for smaller IORPs. One of the concerns raised was the assessment of small unrated sponsors that might fall under the weak to very weak category under the current specifications and for which the value of sponsor support might be significantly reduced. We notice however a big jump in default probabilities for weak sponsors. If it is implicitly assumed that a very weak sponsor will default shortly with a high probability, combining a very weak sponsor support over at least 20 years is not sensible. We should have more granularity at the lower level than at the top: the difference in outcomes between the steps at the top end of the scale is likely to be quite small. The validity of this approach should be tested based on historical data (testing if values for sponsor support under standard rating based valuation and under the alternative method are comparable).	
Q13.	Yes. We think that the assumption that a currently very highly rated entity always remains very highly rated is incorrect: it is generally believed that default probabilities are not static but that those for highly rated companies may be expected to regress downwards towards the average	

	over time. This can be catered for relatively simply by building in a transition matrix between categories. There is some reference to this point later on in the consultation paper but it is relatively fuzzy. Also a two factor model may not be sufficiently representative of real life situations and the criteria for allocating to credit grades would not be the same across all industries in practice. Affordability does not mean that this is an effective payment with information on duration mismatch, ALM strategies. The consequences on risk management and SCR calculations should be further investigated (e.g. SCR int & SCR default,…)? Non standard cases have not sufficiently been addressed (see comment to Q32).	
Q14.	We think that if they are using the simplified approach, IORPs are unlikely to calculate a measure which is not required unless they perceive that it provides added information which may be useful. However, we can see that this might be used for ORSA type purposes or for negotiation purposes over how rapidly a shortfall might be made good, especially in cases where the maximum value of sponsor support is not clearly sufficient to make good the existing shortfall.	
Q15.	Yes, differentiation by industry or by other characteristics of companies: e.g.different business cycles, investment in production tools, innovative behavior. Sponsors with lots of cash are favoured but large companies also have to invest in research and development, production tools etc. The approach taken is too short-term. We think that asset cover might be defined more by reference to total assets versus total liabilities including pension shortfall rather than net assets versus pension shortfall in isolation, if the aim is to seek to mimic what lenders might typically consider. Table 3 is not very transparent about how the mapping of Financial Ratios into rating classes has been done. The same applies to Table 4. Maybe this could be clarified in an Appendix.	
Q16.	No it does not, among other things, have sufficient regard to other factors like industry characteristics or support available from other companies in the group or to factors like the outlook for the market in which the sponsor operates and its position in that market. See	

	especially comment to Q13. We still consider this approach too complex for a QIS. We doubt this method will make more IORPS (particularly small and medium sized IORPs) want to participate in a future QIS.	
Q17.	It is difficult to see how they would come to that conclusion without the limitations of the method being made clear and further information being made available in order to help them to understand the significance of the limitations. It would be helpful to have some worked examples.	
Q18.	Yes, they are sensible starting points but need to be left flexible to accommodate other refinements such as allowance for non-discretionary expenditure and/or other factors introduced where they would make a material difference. Presumably credit scoring providers will be familiar situations where such ratios do not work well, so EIOPA could seek input from them about how to deal with such cases. Some concerns should be addressed: • Income Cover is defined as EBITDA rather than net cashflow. EBITDA refers to operating activities whereas net cashflow also covers investing and financing activities and would be more representative of what is available for IORPs .EIOPA may wish to consider the extent, if any, to which the income cover for this purpose should reflect actual pension contributions or hypothetical contributions calculated by reference to the Level A deficit. • Asset Cover is the surplus in the audited accounting statements but if those are under Local GAAP, this value is far from market consistent and cannot be compared with IORP shortfall. • There might be an important time lag between the audited accounting figures and the calculation date of the sponsor support (e.g. about 6 months), requiring some adjustment in case of any significant event	

	We suggest that a study be undertaken to investigate which credit ratio indicators do best in predicting sponsor default based on a historical sample of corporate time series data.	
Q19.	We are unable to comment in the absence of a rationale for those parameters. If the parameters have been chosen to mimic what happens in credit rating assessments then we would question whether they are fit for IORPs e.g. risk appetite of pension trustees cannot be assumed to be the same as risk appetite of banks. Income cover is only related to sponsoring company and does not reflect the potential shortfall of an IORP. It is therefore surprising that sponsors with high income cover (but low asset cover) can be classified as 'strong sponsors' even though they might not be able to meet the shortfall of a large IORP. We suggest that either income cover should also be related to an IORP's service costs or the weight of asset cover in the determination of sponsor strength should be increased. As noted in Q18, EIOPA may wish to consider the extent, if any, to which the income cover for this purpose should reflect actual pension contributions or hypothetical contributions calculated by reference to the Level A deficit.	
Q20.	Definitions for public sector are not clear. We do not have any solution for public institutions which do not issue bonds directly.	
Q21.	No. We are not convinced by the argument apparently being pursued here that strong sponsors will top up shortfalls more rapidly than weak sponsors in situations where the sponsor has no regulatory or legal obligation to do so. It is well known that sponsors view pension deficits as a cheap form of finance. Economic theory would seem to imply that paying down the shortfall sooner than needed should reapportion value between stakeholders of the combined firm and IORP. For example, such payments should presumably improve the position of IORP members at the expense of more direct creditors of the firm as the asset cover in relation to the debt of such creditors is reduced. To put it another way, a shortfall in the IORP arguably corresponds to a loan to the firm on favourable terms from the IORP relative to the position where the IORP is fully funded. Perhaps this cost of capital disincentive to top up the shortfall weakens for stronger sponsors	

	whilst other human resources and reputational angles strengthen, resulting in some linkage. However, the extent of divergence in payment periods (10 fold or more) between very strong and very weak sponsors set out in Table 6 seems excessive to us, especially bearing in mind the regression to the average referred to in our answer to Q13. It is worth bearing in mind the reduction in value arising from allowing for non-zero likelihood of the sponsor default is, to first order, proportional to the annual likelihood of default times the length of time over which loss might occur. So if each falls substantially for stronger sponsors then the end answer will become extremely geared to the credit strength assigned to the sponsor. We are also not convinced about the recovery plan lengths suggested – what is the rationale for the particular periods suggested? Our preference would be for the IORP to decide based on its own circumstances. There are major differences depending on whether assets are tangible or intangible. In cases where strong sponsors rely on intangible assets (but are characterized by low income cover) it is not obvious how IORP shortfalls could be covered in a short time.	
Q22.	They should reflect the obligation but with flexibility within reason to take account of affordability in the short term. See answer to Q8.	
Q23.	We do not know of any such cases.	
Q24.	No. It is not clear how probabilities are derived. They should be time dependent taking account of regression to the average described earlier. It is important to recognise that this methodology for deriving default probabilities and, consequently, the discount rates applied to contributions, is not market-consistent and that this is incompatible with the general valuation principles stated in section 3.1 (first paragraph of 4). A market-consistent valuation methodology would need use default probabilities / discount rates that are calibrated to relevant observable market prices of bearing sponsor default risk.	

	The Groupe is supportive of the market consistency principle but recognises that an element of pragmatism may be needed in order to come up with a workable and proportionate approach which may be used by all IORPs.	
Q25.	See Q21. The resulting net discount rates shown in Table 9 seem to penalise very weak sponsors very substantially (and this is before any SCR effects). This may be because the overall methodology proposed in Stages 1 – 3 contains elements that in combination create too much sensitivity to sponsor strength or it may indicate that some modification of the sponsor strength classification system could be desirable or more flexibility introduced in other ways. The valuation of sponsor support generally appears to neglect the positive feedback effects of recovery plans. If an IORP falls short on its obligations and a sponsor is forced to make substantial contributions to a financially distressed IORP, it will affect the solvency of the sponsor and thus its credit rating. This in turn will lower the value of sponsor support in the IORP's holistic balance sheet, which further increases required sponsor contributions. These self-reinforcing effects should be considered further.	
Q26.	This approach may be viewed as very prudent or, alternatively, over pessimistic. Local legislation should be taken into account. Some pension obligations can be more secured, insolvency might be due to illiquidity issues during a limited period of time only. We do not understand the reference to providing examples but it seems self-evident that where the expectation is that there would be some reasonable level of recovery on sponsor default, this should increase the value placed ab initio on sponsor support.	
Q27.	Yes if sufficient information is available and suitable methods can be derived. If sponsor support must be calculated for each sponsoring undertaking, the calculation will become very complex for IORPs with many sponsors.	
Q28.	Yes on suitable methods of apportioning support where multiple schemes are involved.	
Q29.	The accessibility of the covenant by the IORP when needed, especially problems of enforceability	

	in jurisdictions outside the EU.	
Q30.	More guidance on how to apply the loss-absorbing capacity should be provided. The approach presented seems very complicated and time consuming since the calculation in stages 1-6 must be done in every single stress scenario.	
Q31.	Yes, on the significance of the numerous model assumptions discussed in the answers to the earlier questions. However, if the intention is to undertake a further QIS, care should be taken not to make this too onerous and so discourage participation of IORPs. In particular, a sensitivity analysis on recovery rate should be added.	
Q32.	We doubt that the approach presented to cater for IORPs with charity sponsors, multi employer IORPs or IORPs with public sponsors will make those IORPs want to take part in the next QIS (should there be one). The ideas presented for “other types of sponsors” seem very vague. If it has not already done so then we would recommend that EIOPA approach the UK supervisor and/or its Pension Protection Fund to explore how these sorts of issues have typically been handled by the industry-wide credit scoring provider used by its PPS.	
Q33.	We think that EIOPA should carry out further work to identify ways of gaining economies of scale to limit the burden that such requirements might introduce to (especially smaller) IORPs.	
Q34.	We think that EIOPA should carry out further work to identify ways of gaining economies of scale to limit the burden that such requirements might introduce to (especially smaller) IORPs.	
Q35.	It seems to require extensive reliance on expert judgement, which is likely to be expensive and unless carefully managed and reviewed by supervisors could lead to inconsistencies. Even the simpler approach still reads more like a set of possible guidelines for an ORSA (i.e. Pillar 2) than a practical and reproducible standardised Pillar 1 style capital requirement computation. If this is what EIOPA are targeting then it would be helpful if EIOPA could at the same time provide guidance on what else regulators and supervisors might expect the IORP to include in their ORSA thinking.	

| | The suggested methodology for other types of sponsors (charity, public sector etc.) seems very vague. | |
| Q36. | No comment, other than by referring to some (relatively objective) cross-industry analysis, which brings us back to credit scores and/or credit ratings. | |