A torch	Comments Template on Discussion Paper on Sponsor Support Technical Specifications	Deadline 31 October 2013 18:00 CET
Name of Company:	Gazelle Corporate Finance Limited	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
	Please follow the following instructions for filling in the template: ⇨ Do **not** change the numbering in the column "reference"; if you change numbering, your comment cannot be processed by our IT tool ⇨ Leave the last column empty. ⇨ Please fill in your comment in the relevant row. If you have no comment on a question, keep the row empty. ⇨ Our IT tool does not allow processing of comments which do not refer to the specific numbers below. **Please send the completed template, in Word Format, to DP-13-001@eiopa.europa.eu** **Our IT tool does not allow processing of any other formats.** The numbering of the questions refers to Discussion Paper on Sponsor Support.	
Reference	**Comment**	
General Comment	We have separately submitted our suggestions for an alternative approach using the Gazelle MT model for quantification of sponsor covenant risk and in this response we have therefore concentrated solely on the questions asked. As far as we are aware Gazelle is currently the only UK firm which has developed and has experience of actually using a stochastic model which quantifies covenant risk, incorporating affordability measures, sponsor default risk and scheme default risk. This modeling incorporates stochastic investment performance and correlation.	
Q01.	We agree that stochastic models are the best method of providing information about uncertain investment performance, uncertain employer contributions and uncertain longevity with an	

	economic scenario overlay. Without stochastic modeling an integrated approach to managing pension risk will not be feasible. However we do think EIOPA should not impose a one size fits all approach. In many other regulatory areas smaller entities representing minor risk exposures are not required to perform detailed calculations. If the intention is to introduce a centralized EIOPA stochastic model this is very unlikely to be able to deal with differences in individual country actuarial and regulatory approaches. In view of the radically different systems of occupational pension provision in different Member States we think it would be more appropriate at this stage to limit proposals to general principles, leaving each Member State to address the detailed implementation. After some experience with quantification of sponsor risk, best practice could be identified, which might then form the basis of a harmonised approach. Given that sponsor covenant risk measurement is in its infancy the attempt to specify detailed methodology in European legislation at this stage is unlikely to be successful and is not realistically achievable for the foreseeable future. Principles should include: • sponsor support should be quantified and taken into account; • covenant and investment risks should be modelled as occurring together not seperately; • qualitative assessment may be appropriate in addition to but not instead of quantitative; • regulatory action should be proportionate to the level of funding risk in each case - a simplified approach may be used for smaller schemes. In developing Gazelle's stochastic model to quantify covenant risk we have found that to achieve a satisfactory representation of the real world, as required by the UK Technical Actuarial Standard- Modelling, we have had to specifically make assumptions based on the specific UK pemsions and legal regulatory framework.	
Q02.	Simplification 1:	

	Our modelling of high, medium and low correlation coefficients of default risk with investment performance indicates that correlation can increase the impact of investment risk on expected scheme losses but is scheme specific. Using Gazelle's MT model, correlation has a bigger impact for sponsors with higher credit ratings than lower ones and it has a bigger impact for schemes with stronger funding levels than weaker ones. Given the paucity of relevant correlation data and studies we would advise that EIOPA proceeds with care in translating an insurance perspective into occupational pensions. This is an interesting subject requiring further research which we are planning to be involved with in the UK.	
Q03	The concept of Maximum Sponsor Support as a single value has in our view no meaning as evidenced by the failure of any participant to produce an acceptable and objective method to quantify it. We recommend EIOPA recast the concept as the reasonable expectation of a scheme achieving solvency funding. This expectation would be expressed as a confidence level. For example: below a certain confidence level- say 50%- regulatory intervention may be warranted, above a certain level say 75% regulatory examination is not warranted; between 50-75% regulatory review may be warranted. Regulatory intervention would be concerned with introducing measures to increase the scheme's probability of reaching solvency funding. This concept could be introduced through ORSAs which are part of Pillar 2.	
Q04.	As noted in our reponse to Q3, the concept of Maximum Sponsor Support as a single value has in our view no meaning. We recommend EIOPA recast the concept as the reasonable expectation of a scheme achieving solvency funding. This expectation would be expressed as a confidence level. This concept could be introduced through ORSAs which are part of Pillar 2.	

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Q05.	Rating agency default datasets at present provide the only empirically based evidence for default probabilities of sponsors. These datasets are backtested. No new method will be credible compared to 25 years of historical data with stringent testing. The criticisms being levelled at the use of credit ratings in the pension context are in our view largely misplaced and we find it unusual that this part of the discussion is being conducted without involvement of the rating agencies themselves, who are in the best position to defend and explain their data. The principal issue is therefore mapping "unrated" sponsors to equivalent ratings. There are existing commercial models to do this. We consider credit ratios alone have far less potence and accuracy as rating assessment tools but they might be suitable for smaller schemes which individually present minor risks.	
Q06.	As indicated above standard tables as suggested might be suitable for smaller schemes representing minor risks. Larger unrated schemes should use commercially available products to obtain a rating or be assessed by a qualified professional firm.	
Q07.	Reducing reliance on the only empirical basis for calculating default probabilities is misplaced.	
Q08.	An approach which does not incorporate the probability and impact of affordability constraints on scheme funding is unrealistic. Affordability constraints reduce funding, extending scheme default exposure and increase the loss on scheme default. Ignoring affordability considerations would be to ignore a material part of the risk impact of weaker sponsors.	
Q09.	Credit ratings already build in a defined level of conditional support from other group entities. This is a well accepted approach and methodology in banking and credit markets. If credit ratings or equivalent are used for default probabilities, these already reflecte a degree of conditional support which is consistent with that used in other markets.	
Q10.	In the UK employers can typically unilaterally close schemes to future accrual,and in many cases have already done so. Therefore assuming normal contributions as a contracted part of funding is mis-placed. There may be other examples where sponsor support is subject to discretionary withdrawal.	
Q11.	The alternative approach is focused on providing a low or nil cost simplified version which can be	

	practically applied across a large number of small schemes. As indicated above, in nearly every other regulatory area, small entities representing minor risks are offered a much lower compliance hurdle. In this case the cart appears to be driving the horse and the potential merits of a quantitative approach are being sacrified on account of a large number of minor schemes. As indicated above the credit ratios approach may be fine for smaller risk exposures but it falls far short in terms of efficacy of using credit ratings. In practice, an approach based on covenant risk rather than covenant value may be more helpful, certainly in a UK context. There is an important distinction, which the Discussion Paper fails to make, between: (i) *Covenant Risk:* which tries to quantify the IORPs exposure to loss i.e. unrecovered S75 debt in the UK context; and (ii) *Covenant Support:* which tries to quantify the reasonable expectation of the sponsor being able to fund additional contributions, investment underperformance and/ or future increases in liabilities. We have addresssed this general point in our specific answers to the questions asked and in our separate submission referred to under General.	
Q12.	The alternative approach largely ignores Maximum Sponsor Support which is ultimately the means of meeting any funding gap. There have been many participants questioning the whole purpose of the HBS approach in the UK in the absence of clarity over how it would in practice be used to drive regulatory or supervisory consequences. As indicated in Q3 above, a potential solution to these issues is for EIOPA to recast the concept of Maximum Sponsor Support as the reasonable expectation of a scheme achieving solvency funding. This expectation would be expressed as a confidence level.	

Q13.	As noted under Q3, we recommend EIOPA recast the concept of Maximum Sponsor Ssupport as the reasonable expectation of a scheme achieving solvency funding. This expectation would be expressed as a confidence level. This concept could be introduced through ORSAs which are part of Pillar 2.	
Q14.	Some concept of Maximum Sponsor Support would still need to be calculated for ORSAs. A key objective of this would be to relate regulatory intervention directly to the probability of a scheme achieving solvency levels of funding. With the growing maturioty of many closed UK schemes this would be consistent with implementing a transition towards solvency funding as schemes head towards maturity and eventual “run-off”. The major risk being addressed in the UK is that a large number of schemes run out of assets before meeting their pension obligations to members.	
Q15.	We do not consider that credit ratios are an acceptable alternative to credit rating assessment other than for smaller schemes that represent minor risks.	
Q16.		
Q17.		
Q18.	These credit ratios represent a low or nil cost alternative for smaller schemes that represent minor risks.	
Q19.	It is akin to an arbitrary scoring system and does not embody a quantitative approach with a consistent objective methodology backing it up.	
Q20.	Whatever the methodology, allowance needs to be made to accomodate the distinctive features in terme os sponsor strength of a number of different types of organisation and entity which cannot fit a single standardised approach eg banks, utilities, property companies as well as not for profit organisations. .	
Q21.	EIOPA should not discard accepted credit rating methodology. Attempting to develop an alternative approach is akin to reinventing the wheel and is unnecessary and dangerous.	

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Q22.	Quantitative modelling can only provide information on the ability to pay. It is for pension regulators to deal with unwilligness to pay.	
Q23.	A possible example of limits on sponsor contributions might be utilities where the consumer fraction is fixed by another economic regulator.	
Q24.	The approach of using average annual default rates over extended periods is incorrect. There is considerable evidence built up by the ratings agencies to show that probability of defaul ttypically inceases over time. To ignore this is likely tp produce misleading conclusions.	
Q25.	Using this approach to determine the design of recovery plans is well beyond the brief.	
Q26.	In the UK recovery of S75 debt on default is an important element in covenant strength for many sponsors with strong asset bases and low leverage. Gazelle's modelling and experience in quantifying sponsor covenant risk indicates that it is very often a major sensitivity. Leaving it out of the equation is therefore wholly unrealistic.	
Q27.	Where there is a legal obligation on other group companies to support the IORP, this should be reflected in the valuation of the covenant. As noted in our reponse to Q9, indirect support should be reflected through the credit rating methodology. Credit ratings already build in a defined level of conditional support from other group entities. This is a well accepted approach and methodology in banking and credit markets. If credit ratings or equivalent are used for default probabilities, these already reflecte a degree of conditional support which is consistent with that used in other markets.	
Q28.	The guidance should be that indirect support can be reflected through standard credit rating methodology consistent with banking and credit market practises.	
Q29.	This should be driven entirely by the legal position in the Member State and by the circumstances of the scheme.	
Q30.	It is standard covenant assessment practise to consider the commercial and financial importance of a sponsor to a wider group it may be part of. This would determine whether loss-absorbing capacity has any relevance.	
Q31.	Stochastic modelling enables a full range of sensitivities to be examined in relation to employer	

	and actuarial inputs. The approach outlined will not identify key sensitivities.	
Q32.		
Q33.	Our experience of applying quantitative covenant risk modelling to utilities and banks indicates that these regulated sectors require important alterations to the modelling methodology.	
Q34.	.	
Q35.	The benefits of the suggested approach are unclear. As discussed above, it appears to us to be arbitrary and of little value to scheme members, sponsors or regulators. What do EIOPA think are the benefits of the approach? We have suggested a different approach based around the reasonable expectation of achieving solvency funding which we think is much clearer, more practical and more beneficial.	
Q36.	This question has never been adequately resolved by equity or debt analysts so it is unrealistic to expect the pension sector to find a solution.	