

**Comments Template on EIOPA-CP-11/006  
Response to Call for Advice on the review of Directive 2003/41/EC: second consultation**

**Deadline  
02.01.2012  
18:00 CET**

Company name:

Balfour Beatty plc

Balfour Beatty has significant pension liabilities and runs several defined benefit pension schemes of various sizes in the UK, the largest of which has around 21,000 pensioners and 24,000 non-pensioners.

Disclosure of comments:

EIOPA will make all comments available on its website, except where respondents specifically request that their comments remain confidential.

Public

*Please indicate if your comments on this CP should be treated as confidential, by deleting the word **Public** in the column to the left and by inserting the word **Confidential**.*

The question numbers below correspond to Consultation Paper No. 06 (EIOPA-CP-11/006).

**Please follow the instructions for filling in the template:**

- ⇒ Do not change the numbering in column "Question".
- ⇒ Please fill in your comment in the relevant row. If you have no comment on a question, keep the row empty.
- ⇒ There are 96 questions for respondents. Please restrict responses in the row "General comment" only to material which is not covered by these 96 questions.
- ⇒ Our IT tool does not allow processing of comments which do not refer to the specific question numbers below.
  - If your comment refers to multiple questions, please insert your comment at the first relevant question and mention in your comment to which other questions this also applies.
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**Question**

**Comment**

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General comment

The timescales for responding to the consultation are extremely short and therefore we have been able to respond only on the issues which are of highest importance to us. Absence of a reply to any question should not be taken as signifying our agreement to that question.

Whilst we support the principle that members' benefits should be protected we are unsure in what ways the current regime fails to do this and therefore the necessity for significant (or any) change.

We fully support the recommendation of a full cost / benefit analysis of the proposals. We believe that this analysis should include both quantitative and qualitative impact assessment, and look at the impact not only on pension schemes but also the broader economy as we believe that some proposals could affect equity and bond markets and therefore have wide ranging implications. Given the possibly very significant implications, we strongly believe this analysis should take place before the Commission considers the options. We have carried out approximate calculations of the possible impact on one of our large pension schemes, which indicate that if Solvency II were applied to pension schemes the liabilities would increase from some Euro 3bn to Euro 5.8bn. This is a very significant increase in liabilities, and one we believe is consistent with the proportionate increase for many other UK pension schemes. Whilst employer covenant will fill a large part of the gap in our case we are still concerned at the level of the liabilities that could arise.

In addition to the increase in liabilities, any change in regulatory and funding requirements will result in potentially significant costs of advice to schemes and companies as trustees and sponsors take advice on what the changes mean for their scheme. Whilst this may settle down once any regime has been in place for a while any increase in costs of running pension schemes is likely to accelerate their closure.

We strongly disagree that pension schemes should be treated in similar ways to insurance companies, which are inherently very different entities. The fundamentally different nature of the two arrangements, insurance companies operating in a commercial environment and existing to make a profit compared with pension schemes which provide social benefits to individuals as a result of their employment mean that there should be separate regimes specifically designed for the two

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	<p>different arrangements.</p> <p>We note that in all but one of the options for the discount rate, future liabilities are discounted at (or near to) a risk-free rate. Even within that one option where a discount rate linked to the return on assets (the usual approach in the UK, with margins for prudence) is mooted, the risk-free rate is still used to determine the "big picture". The implicit assumption that a risk-free rate is appropriate has not been proven and should not be accepted without evidence.</p> <p>The Commission states that aims for pensions were adequacy, sustainability and safety. Whilst a strong solvency regime may meet, in the short term, the safety aim, the associated costs to sponsor we believe would accelerate the closure of DB pension schemes in the UK. This would therefore be unlikely to achieve the Commission's first two aims of adequacy and sustainability. This would also be expected to reduce, rather than increase, the number of DB cross-border pension schemes.</p> <p>Finally, we do not believe that now is the right time to be considering applying the Solvency II regime to pension schemes. The Solvency II Directive for insurers is not fully operational until January 2014. Any consideration as to whether pension schemes should be subject to a similar regime should await practical experience (perhaps of several years) of operating that new regime for insurers. There may well be unanticipated issues arising from Solvency II for insurers the application of which might prove detrimental to pension schemes, members' benefits and the broader economy and we therefore believe there is no compelling case for urgent (if any) action</p>	
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12.	<p><b><i>What is the view of the stakeholders on the holistic balance sheet proposal? Do stakeholders think that the distinction between Article 17(1) IORPs, 17(3) IORPs and sponsor-backed IORPs should be retained or removed?</i></b></p> <p>The concept of an holistic balance sheet only arises as a result of trying to make pensions fit into the Solvency II regime. As stated in the general points above we do not believe that it is appropriate to try and fit a regime designed for insurance companies to pension schemes which are fundamentally different.</p> <p>However, if such an approach is to be adopted then we strongly agree that account should be taken of the strength of the employer's covenant. We are concerned though as to the work that may be involved in assessing the strength of the covenant and also how consistency between employers would be achieved.</p> <p>Valuing the covenant could be an expensive process even for strong entities. As mentioned in the general points above, additional costs on sponsoring employers of IORPS (and in the UK such costs will fall to sponsoring employers either directly or through the funding requirements) should be avoided as pension benefits are already expensive to provide.</p>	
13.	<p><b><i>Do stakeholders agree that assets of IORPs should be valued on a market-consistent basis?</i></b></p> <p>Pension schemes are long-term investors and as such the market value of an asset may not be the most appropriate value to adopt. Allowance should be made for the value of expected future cashflows as well as the current market value of an asset.</p>	

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In some cases, such as subordinated loans and certain insurance policies, a liquid market may not exist and here the managers/trustees of the pension scheme should be able to adopt a valuation basis that they consider appropriate.

14.

***What is the stakeholders' view on the two options regarding the starting principle for valuing liabilities? Do stakeholders agree that such a principle for IORPs should contain no reference to transfer value?***

Option 1 is to make no changes to the existing IORP directive. Technical provisions would then be calculated in a "prudent, reliable and objective" but not necessarily "market-consistent" manner. Option 2 would be to require technical provisions to be determined on a "market-consistent" basis. "market-consistent" is stated to mean risk-free replicating assets.

As stated above in response to Q13, we do not agree that assets should be valued on a "market consistent" basis in all cases. Option 1 is consistent with this. We are not concerned about the possibility for regulatory arbitrage. There has been no notable regulatory arbitrage in the past because pension provision is about far more than just the 'prudence' used in setting technical provisions.

Option 2 might be regarded as a reasonable approach if pension promises were of a contractual nature similar to insurance liabilities. However, this is not the case.

Of greater concern is the focus on risk-free assets that option 2 implies. Recent market events have shown that no assets are truly risk-free. However, attempting to define technical provisions by reference to available yields on particular assets will drive market behaviour. We believe a market-consistency requirement for IORPs based on risk-free assets would also emphasise pro-cyclical behaviour in markets.

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18.	<p><b><i>What is the stakeholders' view on the three options regarding the inclusion and calculation of a risk margin as introduced by Article 77?</i></b></p> <p>Option 1 is valid if no changes are made to the current IORP approach to valuing liabilities, whereas options 2/3 are valid if a market-consistent approach is adopted to valuing liabilities.</p> <p>This is essentially the same point as how liabilities should be valued. As stated above, we have serious concerns about any market-consistent valuation of liabilities.</p> <p>We expect that Option 2 would lead to a very significant increase in technical provisions (including the risk margin) for most UK IORPs. UK IORPs are not able to reduce members' benefits in the event of serious underfunding, nor can they raise capital independently of the sponsor. Any increase in the funding requirement placed on IORPs therefore directly impacts on the covenant of the sponsoring employer.</p> <p>Option 3 has the appeal of having a lower impact on IORPs' funding requirements, but seems to have little objective merit.</p> <p>In our opinion, it would be appropriate to set a long-term funding objective for IORPs based on a prudent assessment of the value of the liabilities, as is currently the case under the existing IORP directive. We therefore support option 1.</p>	
19.	<p><b><i>Do stakeholders agree with the proposed conditions defining in what cases IORPs should take into account future accruals or not when establishing technical provisions?</i></b></p>	

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	<p>We expect UK IORPs will only rarely be required to include future accruals in their technical provisions. This is because the sponsor usually meets the balance of cost over the members' contributions. Future contributions are agreed at each formal valuation and are usually fixed for three years, reviewed at the following valuation.</p> <p>Overall, we agree with the proposal for taking future accruals into account in technical provisions. However, careful drafting will be needed to ensure that only those cases where future accruals meet these conditions are captured by the new requirements.</p>	
20.		
21.	<p><b><i>What is the stakeholders' view on the two options presented regarding the interest rate used to establish technical provisions (including the positive and negative impacts)?</i></b></p> <p>Option 3 (two discount rates/levels of technical provisions) is the preferred option. This could be most similar to the current arrangements, with the level B technical provisions being determined in a similar way to currently, and would therefore be significantly less disruptive.</p> <p>We are concerned that the other approaches could result in trustees wishing to invest in a pro-cyclical manner, we think this is less likely under option 3.</p> <p>In the UK we are currently required to disclose the funding position of the scheme on a buy-out basis (perhaps similar to Level A technical provisions under option 3). Although volatile, there is no requirement to fund over the short-term towards this level and hence the impact on schemes is low. If it becomes a requirement in future to fund at Level A we are concerned at how the volatility will be managed and also how quickly schemes would be required to reach this funding level (though as stated previously, we do not believe that it is necessary or appropriate to fund to such a level).</p>	
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24.	<b><i>Do stakeholders agree with EIOPA's view of introducing Article 79 of Solvency II with</i></b>	

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	<p><b><i>appropriate amendments into a revised IORP Directive regarding allowances for financial guarantees and contractual options when establishing technical provisions?</i></b></p> <p>Options should be included on a proportionate basis, and distinction should be made between contractual options and conditional or discretionary ones. For example, most UK IORPs contain an option for members to take their pension early, subject to a reduction, but the option is often subject to the agreement of the IORP trustees and/or the sponsor. The terms are usually reviewable at trustee (and perhaps sponsor) discretion.</p> <p>We can see that it could be difficult to establish whether such an option were conditional or not and thus such matters must be left to national regulators (who have more access to scheme specific information) to supervise.</p>	
25.		
26.	<p><b><i>What is the view of stakeholders on the two options regarding recoverables from reinsurance contracts and special purpose vehicles as introduced by Article 81 of Solvency II?</i></b></p> <p>Special Purpose Vehicles are little used by UK pension schemes (reinsurance, if this includes buy-in policies used by trustees, is more common) and therefore we do not think that it is necessary or proportionate to introduce further detailed requirements regarding their valuation.</p> <p>In both cases, as they are assets of the IORP, they would be subject to the normal asset valuation requirements (which we expect would take into account the nature and the timing of the expected recoveries from such vehicles, and associated risks such as counter-party default risk).</p> <p>We therefore prefer option 1.</p>	
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30.	<p><b><i>Do stakeholders agree that it would be useful to introduce Article 85 of Solvency II with appropriate amendments into a revised IORP Directive regarding powers of the supervisor to require IORPs to raise the amount of technical provisions corresponding to supervisory law?</i></b></p> <p>Where an IORP's technical provisions do not meet the requirements of the Directive, this seems appropriate. However, it may well be unclear whether the technical provisions meet these requirements, and IORPs must have a right of appeal against decisions of the supervisory authority.</p>	
31.	<p><b><i>Do stakeholders agree that a new IORP Directive should allow for the Commission to adopt level 2 implementing measures regarding the calculation of technical provisions as introduced by Article 86 of Solvency II?</i></b></p> <p>As mentioned previously, IORPs and insurance companies are fundamentally different. In particular, unlike insurers, UK IORPs are also entirely dependent on their sponsors as a source of capital. The impact of any new regime on IORPs is therefore inextricably linked with the impact on their sponsors.</p> <p>We therefore believe that most implementing measures should be in the hands of national regulators, who can apply detailed knowledge of the circumstances of IORPs. If it is necessary to adopt implementing measures at EU level, these should be the highest-level principles only, and subject to consultation and impact assessment before adoption.</p> <p>Any implementing measures for IORPs should not be considered until sufficient experience has been obtained from implementing the corresponding measures for insurance companies.</p>	
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33.	<p><b><i>What is the stakeholders' view on the analysis regarding sponsor support? Do stakeholders agree with EIOPA that IORPs should value all forms of sponsor support as an asset and take account of their risk-mitigating effect in the calculation of the solvency</i></b></p>	

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	<p><b><i>capital requirement?</i></b></p> <p>Given that the objective of pension supervision is to ensure the security of members' rights it must be correct to take into account all known factors. Therefore employer support should be taken into account. It could be argued that this item should be valued differently according to whether the purpose is ongoing or termination of the company and scheme.</p> <p>In the UK, support from the Pensions Protection Fund (PPF) is also relevant but only in the context of a company becoming insolvent. Therefore the pragmatic way to allow for these two items is as follows:</p> <ul style="list-style-type: none"> <li>• for the Holistic Balance Sheet value sponsor covenant based on what may realistically be expected to be obtained from the employer given its current strength. A practical broad-brush approach should be taken to assess the value of the sponsor covenant, to avoid an unnecessarily extremely expensive and time-consuming process.</li> <li>• When considering insolvency the PPF should determine the minimum level of total asset value (as the PPF can be relied on). Sponsor covenant should have additional value only if the amount recoverable from the company in insolvency is anticipated to produce a higher value overall when added to the assets.</li> <li>• Financial assets should be required only to cover the best estimate liabilities as long as ongoing sponsor covenant provides sufficient cover above this.</li> </ul>	
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36.	<p><b><i>What is the stakeholders' view on the analysis whether to introduce or not a uniform security level for IORPs across Europe? Do the stakeholders agree with EIOPA's decision not to recommend a specific probability? If not, what specific probability should be imposed upon IORPs?</i></b></p> <p>Whilst we can see the rationale for a consistent level of security for pension promises, we do not</p>	

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	<p>believe that consistent has to mean 'the same'. In particular, a flexible approach would be needed to reflect the different nature of pension promises in Member States. Furthermore, security in different Member States is provided in part by a range of mechanisms (such as the UK's Pension Protection Fund and various IORP-specific contingent funding arrangements). Such mechanisms are in many cases hard to place a value on. A wide-ranging discretion would need to be available to national regulators to decide how such mechanisms should be taken into account in assessing security.</p> <p>If a specific probability were to be prescribed for IORPs, then what this probability represents would need to be clearly explained in order to avoid misunderstanding by other parties, including IORP members and beneficiaries. In the consultation document, probability is discussed in the context of the confidence level used to determine the solvency capital requirement. However, we believe a more sensible definition of solvency would be the probability that the IORP is able to pay members' benefits over the long-term.</p>	
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38.	<p><b><i>What is the stakeholders' view on applying the Solvency II-rules for calculating the solvency capital requirement (SCR) to IORPs, taking into account their specific security and benefit adjustment mechanisms?</i></b></p> <p>We do not believe that an SCR is necessary for UK IORPS. The SCR would take the funding position of the scheme above that on a buy-out basis. However, once a scheme reaches buy-out funding we would expect the benefits to be bought out, thereby negating any need to hold an SCR.</p> <p>We also believe that the SCR would effectively require UK schemes to pay twice to "insure" the same risk – once through the SCR and a second time through the levies paid to the UK's Pension Protection Fund.</p> <p>Finally the calculations required to assess the SCR are not insignificant and we have serious concerns about the costs on schemes (and hence their sponsoring companies) of carrying out such calculations.</p>	

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42.	<p><b><i>Do stakeholders agree that capital requirements for operational risk should be applied to DC schemes where investment risk is borne by plan members? Should these capital requirements be uniform or tailored to the actual risk profile? Do stakeholders find it sensible to distinguish between DC and other schemes in the area of operational risk?</i></b></p> <p>Operational risk for both DC IORPs and contract-based arrangements is generally covered by the employer covenant. Good governance practices minimise operational risk to sponsors.</p> <p>Any capital requirements for operational risk would be either paid from members' pots or the employers would reduce contributions so that their total cost remained unchanged. In both scenarios members' benefits would be lower.</p> <p>We also believe that it is important that both DC IORPs and contract-based schemes that employers contribute to are treated in the same way. We therefore do not agree that there should be any capital requirements for operational risk, any such risk should be managed through governance and supervisory measures.</p>	
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44.	<p><b><i>What is the stakeholders' view on the analysis regarding the submission of recovery plans and the length of recovery periods as introduced by Articles 138 and 139 of Solvency II? Should the recovery periods – with regard to the SCR and possibly the MCR – for IORPs be flexible, fixed or a combination of both? What would be the reasons – if any – to allow IORPs longer recovery periods than prescribed by Solvency II?</i></b></p> <p>We agree with EIOPA that recovery plans for IORPs should be, and indeed must be, flexible. Most UK</p>	

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02.01.2012  
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	<p>IORPs are already trying to rectify their current underfunding over as short a period as the sponsor can reasonably afford. Too high a funding requirement for the pension scheme may simply result in sponsors ceasing to trade. Generally, members are best served by ensuring that the sponsor continues in business providing covenant backing for its IORP. National regulators are best placed to address the right balance between funding a deficit and protecting the sponsor's covenant.</p> <p>As we do not believe the SCR (and hence also the MCR) is appropriate for IORPs, then the distinction between Articles 138 and 139 is unnecessary.</p>	
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**Comments Template on EIOPA-CP-11/006  
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**Deadline  
02.01.2012  
18:00 CET**

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**Comments Template on EIOPA-CP-11/006  
Response to Call for Advice on the review of Directive 2003/41/EC: second consultation**

**Deadline  
02.01.2012  
18:00 CET**

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