	Comments Template on Discussion Paper on Sponsor Support Technical Specifications	Deadline 31 October 2013 18:00 CET
Name of Company:	PricewaterhouseCoopers LLP	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
	Please follow the following instructions for filling in the template: ⇨ <u>Do **not** change the numbering</u> in the column “reference”; if you change numbering, your comment cannot be processed by our IT tool ⇨ Leave the last column <u>empty</u>. ⇨ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a question, keep the row <u>empty</u>. ⇨ Our IT tool does not allow processing of comments which do not refer to the specific numbers below. **Please send the completed template, <u>in Word Format</u>, 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 Dicussion Paper on Sponsor Support.	
Reference	**Comment**	
General Comment	We have provided comments below on some of the questions posed by EIOPA. However, we have major reservations which we have summarised here. Although our comments here are necessarily critical in nature we would wish to balance them by recording our appreciation of the work EIOPA has done which is helping to make risk management central to the effective management of IORPs. We firmly believe that finding an appropriate holistic way of balancing those risks is necessary and we will continue to engage constructively in that debate. In summary, we believe the Alternative Method is a helpful but flawed attempt to simplify the answer to a less important question.	

	EIOPA equates sponsor support with the contributions required to meet the IORP shortfall and the Alternative Method provides a simplistic method of valuing such a payment stream. The required support is devalued by default risk and (unsurprisingly) fails to meet the shortfall in almost all cases: the value of sponsor support will equal Level A shortfall only when a AAA/AA sponsor meets the shortfall in a one year period which appears an astonishingly high hurdle. In every other case the HBS will fail to balance. In the context of providing an overview of security for members this is a significant flaw. Also, and paradoxically, where a scheme is fully funded, and there is no shortfall, the Alternative Method would value sponsor support as zero. This is a surprising result for, in likelihood, the strongest possible sponsor. These counter-intuitive results point to a fundamental flaw in the HBS methodology. Funded pension schemes look to their investments as a significant source of meeting the liabilities and, unlike an insurer, can also look to their sponsor to underwrite the risk in those investments as well as other risks. By discounting liabilities at risk free rates and equating sponsor support with the ability to make immediate payment of the resulting shortfall stretches both the logic of funded schemes and economic reality. It is, if implemented, likely to lead to investment decisions with damaging consequences both for the security of member benefits, capital markets and the wider economy. In practice, and before turning to benefit reductions, it is necessary to understand the capacity of the sponsor to underwrite the scheme risks, including investment risk, and also to determine what levels of contributions are affordable without damaging the sponsor strength on which the scheme relies. This capacity is closer to expressing the Maximum value of sponsor support which seems to be sidelined by the Discussion Paper. In contrast, we believe that quantifying the Maximum available sponsor support is a more	

	appropriate and insightful measure. We also believe this can be done using market consistent business valuation principles which address the concerns expressed about the calculation of Maximum value of sponsor support laid out in the QIS. We set out these business valuation principles in our Research Report referenced in footnote 7 of the Discussion Paper.	
Q01.	Unless a principles based approach is adopted then more detailed guidance on stochastic modeling will be needed, although this shouldn't be constraining on organisations to use their own models when appropriate. In our view many UK IORPs will struggle to understand stochastic modeling or have access to the tools (such as economic scenario generators) to perform the relevant calculations. Recognising that small IORPs may well choose to use deterministic techniques, there are likely to be a large number of medium sized IORPs who will require support from professional advisers. The limitations of any model should also be considered and factored into the outcome.	
Q02.		
Q03.	We believe the concept of Maximum value of sponsor support is an insightful measure and should be a focus for EIOPA. In practice it is necessary to understand the capacity of the sponsor to underwrite the scheme risks, including investment risk, and also to determine what levels of contributions are affordable without damaging the sponsor strength on which the scheme relies. This capacity is closer to expressing the Maximum value of sponsor support. Despite the widespread criticism of the QIS's *calculation basis* for arriving at the Maximum value of sponsor support, we believe IORPs and/or their sponsors could perform the calculations using market consistent valuation principles as set out in our Research Report referenced in footnote 7 of the Discussion Paper. Judgement can be applied in using these principles to come to far more appropriate measures of the Maximum value of sponsor support than would have been derived using the QIS calculations.	

| | Below are responses to specific issues with valuing sponsors which were raised in Section 3 of the Discussion Paper.

Para 21 states that there are no "universally recognised standards for calculating the value of a sponsor".

While it is true that there are no globally adopted valuation standards in the same way as there are, for example, financial reporting standards, there are generally accepted and widely used methods for performing business (including non-commercial entity valuations. These methods (valuation multiples, discounted cash flows) are used regularly by sponsors in areas such as mergers and acquisitions and financial reporting. Sponsors are generally familiar with such approaches and IORPS are likely to be no less familiar with such approaches than they are with the proposed Alternative Method.

Clearly different assumptions used in valuation will lead to different answers, but the Alternative Method is not immune to this either and typical business valuation approaches do have the flexibility to deal with multiple employers, not-for-profit organisations and subsidiaries. They can also be conducted deterministically or stochastically.

The challenge posed by potential lack of access to information needs to be considered in the context of whose responsibility preparation of a valuation of sponsor support should be. The discussion to date, and representative feedback from corporate sponsors, would suggest that sponsors are better placed to undertake the assessments as well as being interested parties who, although the implications of the HBS are currently unknown, must be regarded as major stakeholders in the process. In our view sponsors are best placed to undertake this element of the calculations for the following reasons:

• They have access to crucial information such as sponsor forecasts
• They are accustomed to performing this type of analysis for financial reporting and merger and aquisition purposes | |

	• They are more likely to have resource with the necessary skills available to perform the analysis **Para 26 states that "other major financial creditors, such as commercial banks, also do not try to calculate a maximum level of sponsor (corporate) support for credit and debt obligations"** We disagree. Banks and bondholders will invariably ask for a borrower's business plan/forecasts and will want to understand what proportion of total business value will be accounted for by their loans. Understanding the total business value (Maximum value of sponsor support) is also important for lenders to understand their likely recovery in default. In summary, we believe that the Maximum value of sponsor support is as important for typical lenders as it is for the IORP.	
Q04.	We found this explanation confusing. The concept of wage being used to measure the value of a business is not something we have come across, nor do we think there is any sound theoretical basis for it. Wage is a cost input for most businesses and does not explain the sponsor's ability to generate cash flows which will ultimately be used to fund the scheme. Other measures which could be used to assess the Maximum value of sponsor support are those outlined in our Research Report referenced in footnote 7 of the Discussion Paper. These valuation methods are generally accepted and widely used methods for performing business valuations and are used regularly by sponsors in areas such as mergers and acquisitions and financial reporting. Sponsors and IORPs would be generally familiar with such approaches.They also do not suffer from the shortfalls of the calculation basis described in the QIS.	
Q05.	To the extent that EIOPA and the QIS treat sponsor support as a payment obligation, in principle we are comfortable with linking default probabilities and credit ratios. This is best practice in the Financial Services industry, but the key caveat is that a suite of credit rating models and calibrations should be employed. A single set of ratios doesn't provide sufficient risk differentiation for sponsors of different size, sector and nature.	
Q06.	Partially. Credit ratios are typically used as inputs to credit rating models, which produce a score, this score is then calibrated to a probability of default for different homogenous risk types, e.g.	

	large corporates, mid corporates, small businesses, financial institutions, etc. The key to a successful risk framework is the segmentation that is applied to the portfolio of target obligors.	
Q07.		
Q08.	Yes. Affordability is a key criteria in assessing sponsor support.	
Q09.	Yes. It should be included and shown separately. For many IORPs such support is an important element of sponsor support, and although judgemental, it should be possible to demonstrate a reasonable thought process based on a matrix of factors.	
Q10.	Yes. EIOPA could provide guidance and an example explaining: • What factors IORPS should consider • How such factors could be weighted • How that weighting translates into an adjustment mechanism	
Q11.	**Para 51 states that "the advantage of using credit ratios is that they are based on readily available financial information".** While this is clearly an advantage in terms of the practical application of the Alternative Method, unless the judgments allowed for by paragraph 62 are applied, it could also be a significant limitation for the analysis. Synthetic credit rating analysis as described in the Discussion Paper would appear to be based on historic financials at a point in time. Historic ratios derived from historic financials do not reflect forecast sponsor or industry trends which are key inputs and considerations for any valuation. Valuation is a forward looking concept which ultimately depends on expectations about forecast future cash flows, so an analysis which only looks at historic ratios has significant limitations and could give misleading results for sponsors who are experiencing significant changes in their businesses or the wider sector of which they are a part. **Para 51 states that "….this alternative approach is similar to that used by bank lenders."** While institutional lenders would certainly analyse credit strength of the borrower through ratio	

analysis, a very important part of that assessment would involve analysis of a sponsor's forecasts and business plans. They would want to know how credit risk evolves over the term of the debt (i.e. forward looking). They would also want to understand the Maximum value of sponsor support to see how many times their debt was covered now and in the future and to determine potential recoveries in default (when the starting point of any analysis would be the Maximum value of sponsor support, albeit in distress).

Paras 62 and 63 talk about the use of judgement in deriving credit ratios.

The Alternative Method is right to highlight the point that judgement needs to be applied, but this is also an acknowledgement that the approach is overly simplistic when applied to individual IORPs and their sponsors.

For example, one criticism of the previous approach was that cash flow as a measure of the future wealth of the sponsor was not defined and could be interpreted in different ways. In many ways cash is a cleaner measure than the income based measures suggested in the Alternative Method. EBITDA for example could be calculated in different ways by IORPs depending on the judgemental treatment of things like exceptional items as well as differences derived from inconsistent accounting policies between countries. The desire for consistency and comparability between IORPs relies on common accounting policies and interpretation of those policies, which does not exist. EIOPA should provide more detailed guidance and examples of the calculation of both numerators and denominators in the ratio calculations, which illustrate areas where appropriate judgments should be applied.

Para 58 states that "….the asset cover ratio measures the amount of value that is left in the business after all other creditors (except the IORP) have been repaid. This is a measure of how much "cushion" supports the IORP deficit and the numerator could be stress tested for a downside scenario."

For most sponsors the net asset number on the balance sheet bears very little relation to the

	value of the sponsor. Many balance sheet items are held at cost rather than fair value and other items, which in today's world make up a considerable and increasing proportion of sponsor value, are not even disclosed on the sponsor balance sheet (e.g. internally generated brands, customer relationships, goodwill etc). Net assets are not typically a good measure of how much "cushion" supports the IORP deficit, whereas the maximum value of sponsor support would be. The Alternative Method falls down in situations of sponsor distress when historic balance sheet and P&L ratios may be changing so rapidly that they become meaningless.	
Q12.		
Q13.		
Q14.	In the context of the HBS many IORPs will want to calculate the Maximum value of sponsor support to see what the available headroom is and to give the HBS a chance of balancing. It is also consistent with much of the current practice of looking at sponsor valuation as one aspect of an assessment of support.	
Q15.	The general principle when producing a generic rating tool is to use a diverse set of rating metrics in order to increase the robustness of outputs. Table 3 on page 23 is a diverse set of rating metrics, but it should be noted that S&P / Moody's have stated that their own rating tools produce ratings that are within two notches of the final allocated rating on only 65% of occasions. In addition for these tools there are often additional elements taken into consideration particularly around the investment grade / sub investment grade cut off. Publicly available information from Moody's shows that in the SME space for their RiskCalc model they consider the following types of financial ratios: • Activity: Creditors/Turnover, Change in Accounts Receivable/Turnover • Profitability: Net P&L/Turnover, Change in Return on Assets • Leverage: Liabilities/Assets • Debt Coverage: Cash Flow/Interest Expense • Growth: Sales Growth • Liquidity: Current Assets/Current Liabilities	

Q16.	Yes	
Q17.	Yes	
Q18.	Interest cover and asset cover are two important ratios, but as per our response to Q15, a model with a larger number of ratios focused on particular risk classifications would be an improvement.	
Q19.		
Q20.	Financial services often use Turnover as a metric of size to compensate the issue of low asset base high turnover companies, management consultancies being a classic example of this scenario	
Q21.	Yes. Broadly appropriate.	
Q22.	Time periods should be based on affordability.	
Q23.		
Q24.	The approach is reasonable as the probabilities of default are indicative of relative risk concentrations. However the approach taken to determining annual probabilities of default smooths the exponential profile of the default rate curve. The Discussion Paper recognises the short comings of the approach taken, particularly in the 'B' rating class and could be seen as being overly conservative.	
Q25.		
Q26.	No. We do not believe this is a reasonable assumption. In many businesses there would be value realised for unsecured creditors in insolvency. With an assumption of no value, EIOPA risks a potenitally material underestimation of sponsor support.	
Q27.	Yes. For some IORPs support from other group companies makes up a significant element of the covenant, even if not legally enforceable. Performing the calculations of the value of this support separately would allow such support to be distinguished if different treatments or presentations were felt to be appropriate.	
Q28.	Yes. It be helpful to include a list of features/circumstances of a sponsor’s relationship with the wider group which would guide IORPs as to the level of reliance or probability they could attach to that wider sponsor support. Some of these factors were discussed in our Research Report referenced in footnote 7 of the Discussion Paper.	
Q29.		

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Q30.		
Q31.		
Q32.		
Q33.		
Q34.		
Q35.		
Q36.		