General valuation principles for sponsor support

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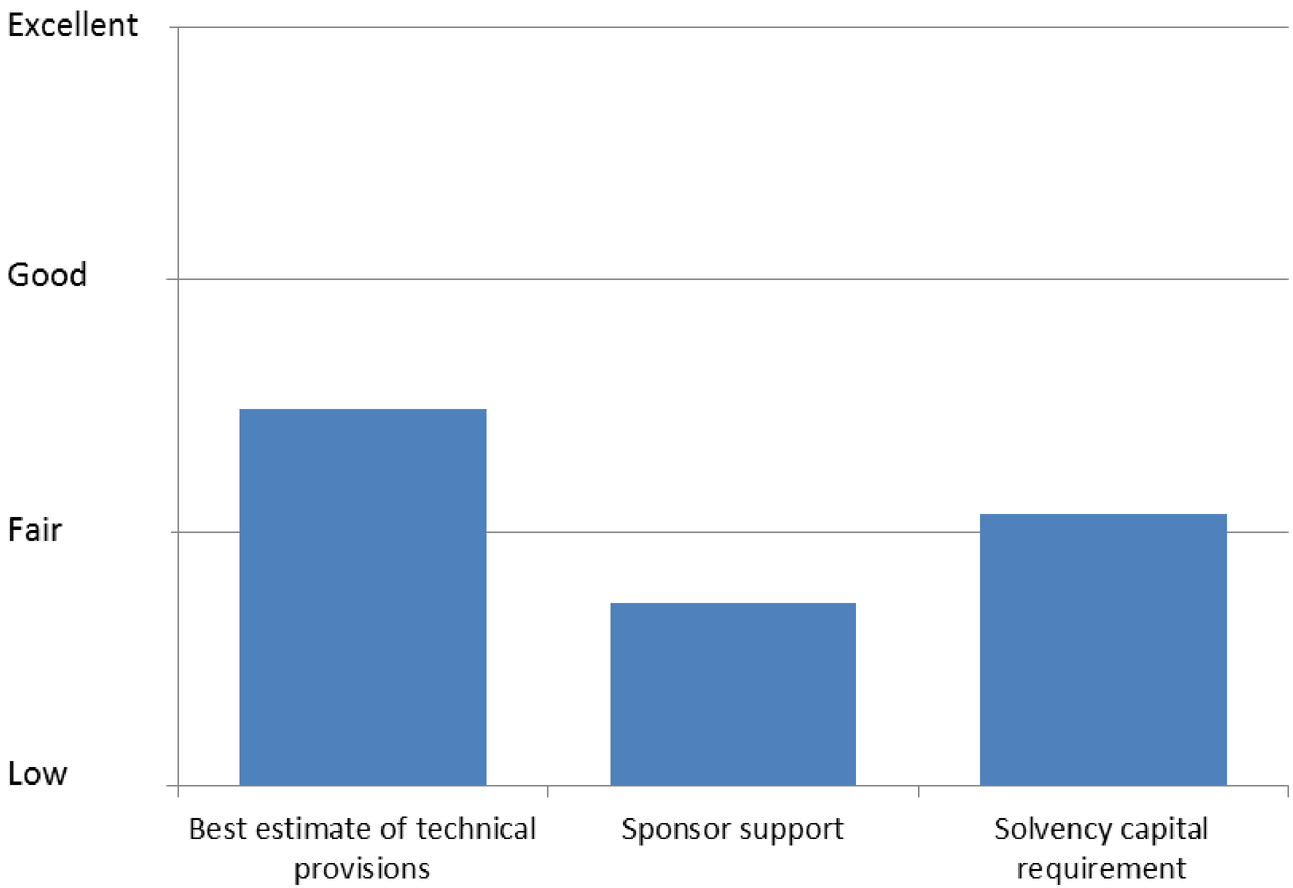
Background (I)

- Issues identified in a number of areas of the technical specifications during:
  - o Public consultation draft technical specifications: mid-June – end July 2012
  - o QIS exercise : mid-October – mid-December 2012
- Methodology for valuing sponsor support subject to considerable practical difficulties
- EIOPA stressed last year that further work “will include revised proposal for, and public consultation on, an improved methodology for the calculation of sponsor support, [..].”

Background (II)

Assessment by IORPs of reliability of QIS outcomes



Discussion paper

- Nature of discussion paper:
    - gather feedback from stakeholders on possible directions and preliminary proposals
    - work in progress and all views expressed are preliminary
    - commonalities and interdependencies exist with other areas of further work
- Structure of discussion paper:

    I. **Exploring directions for improving the general principles for valuing sponsor support**

    II. Proposing alternative, simplified approach to calculate sponsor support

General valuation principles (I)

Sponsor support should be valued on:

- Market consistent basis

Standard stochastic approach:

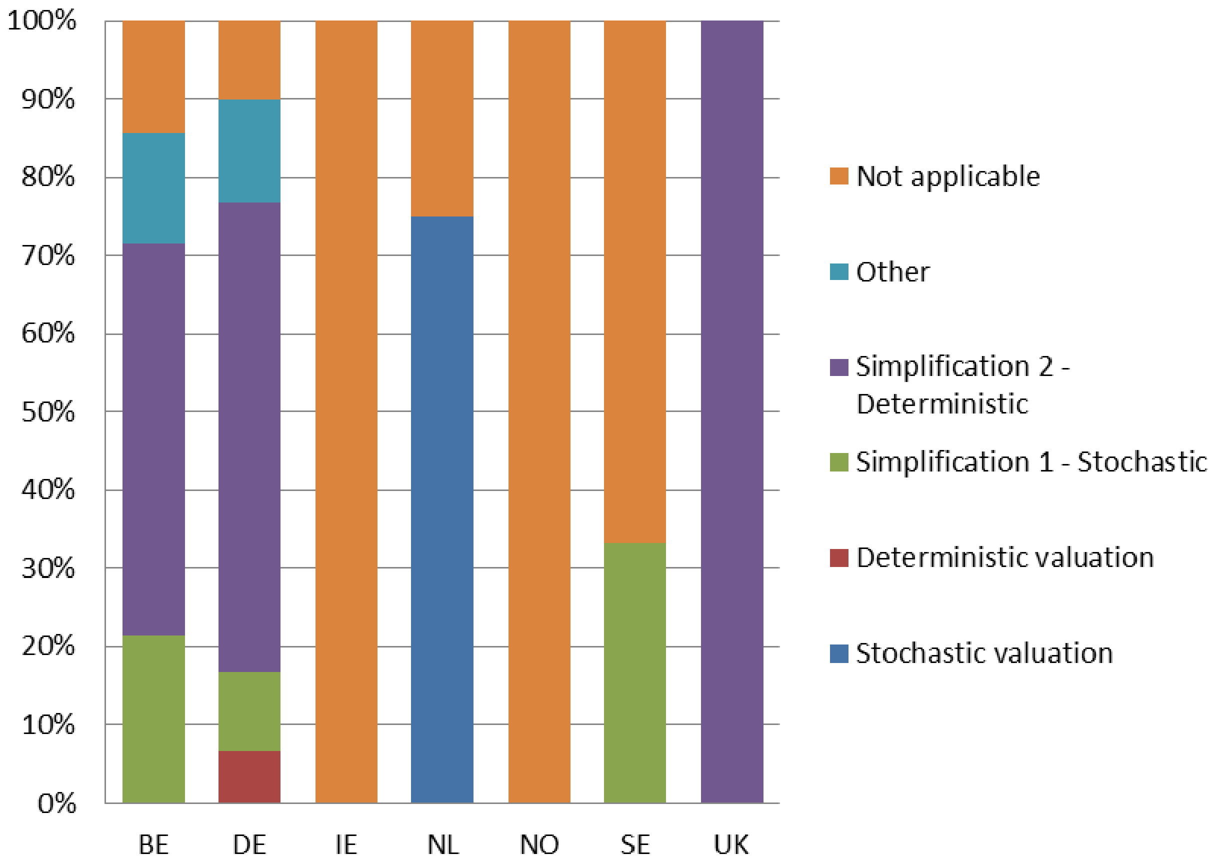
- Probability weighted average of the discounted value of cash flows in future scenarios using the risk-free interest rate
  - o Simulation model to generate future scenarios for economic/financial market parameters
  - o Assume that the expected return on all assets equals the risk-free interest rate

General valuation principles (II)

- Simplifications may be used if proportionate to the nature, scale and complexity of underlying risk
  - o Embedded options in sponsor support arrangement?
    - Asymmetric cash flows, e.g. payments to recover shortfalls, but no restitution of surpluses
    - Limited sponsor support, i.e. acting as contribution cap
  - o Management actions and member/sponsor behaviour?
  - o Are all risks material?
- Simplifications:
  - o IORP’s own simplified method
  - o Simplification provided by technical specifications

General valuation principles (III)

Valuation methods used in QIS exercise



General valuation principles (IV)

Technical specifications	Issues
Guidance stochastic valuations	Lacking resulting in different assumptions
Definition cash flows: - only in excess of costs new accruals - contributions by employers and employees - include possible restitutions	Many questions during QIS exercise
Maximum sponsor support	Practical difficulties for multi-employer schemes, not-for-profit, subsidiaries
Sponsor default probability	Rating-based approach not suitable for most sponsors
Timing of sponsor support	No supervisory responses
Limited conditional support	Inconsistent application
Simplifications	-

Stochastic valuation sponsor support

- Main areas where technical guidance is missing
  - Incorporation of UFR-adjusted interest rate swap curve
  - Assumptions if market information is missing (long-term volatilities, wage inflation)
- Principles for stochastic valuation best estimate
  - Calibration economic scenario generator
  - Assumptions behaviour sponsors and plan members
  - Assumptions IORP management actions
  - Use of expert judgement
  - Time horizon for valuation
- What additional guidance?

Maximum sponsor support (I)

- Technical specifications maximum sponsor support
  - o Standard calculation method
    - current wealth available for the IORP, i.e. shareholders' funds
    - future wealth, i.e. future cash flows
  - o Own calculation method
  - o Simplification setting maximum support equal to value technical provisions
- Practical difficulties encountered by
  - o Multi-employer schemes
  - o Not-for-profit institutions
  - o Subsidiaries
- Not a concept commonly used

Maximum sponsor support (II)

- Different measures to calculate maximum sponsor support
- What percentage of the company's value is the sponsor capable of affording?

Examples maximum sponsor support					
	Sponsor (A)	Maximum support 1		Maximum support 2	
	EUR	% A	EUR	% A	EUR
Value	100	50%	50	20%	20
Capital income	10	50%	5	20%	2
Wages	20	25%	5	10%	2

Maximum sponsor support (III)

Options for taking into account maximum sponsor support:

- Standard method
- Own risk and solvency assessment (ORSA)
  - IORPs will have to assess whether sponsor can afford calculated value of sponsor support
  - If not, make adjustment
- Voluntary

Sponsor default probability (I)

- Technical specifications probability of default
  - Default probability linked to ratings / credit quality steps
  - Default probability of unrated sponsors equals 4.175%
  - If appropriate, IORPs may use different probability for unrated sponsors
- Issues with current approach
  - Only 1,500 European companies with credit rating
  - Multi-employers schemes and not-for-profit sponsors
  - EU aims to reduce reliance of IORPs on credit ratings
    - Directive 2013/14/EU of 21 May 2013 amending IORP Directive 2003/41/EC

Sponsor default probability (II)

Alternatives for establishing sponsor default probabilities:

- Default probabilities implied by financial markets
  - Credit default swaps, corporate bonds
  - Market-consistent
- Link credit ratios to sponsor default probabilities
  - IORPs have to assess sponsor strength using measures for asset cover and income cover
  - Practical application discussed in Session 2.
- Link credit ratios to default probabilities implied by financial markets

Limited conditional sponsor support

- Technical specifications prescribed that value of "limited conditional" sponsor support should be zero
  - o EIOPA's advice recommends that sponsor support should be legally enforceable
- Issues
  - o Not consistent with market-consistency principle
    - discretionary/voluntary support will have positive option value
  - o Different interpretations in the QIS exercise
  - o Valuation of discretionary decision-making processes
    - 40-100% disregarded future management actions that may have had a material impact

Thank you

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