

<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>		<b>Deadline 31 July 2012 18:00 CET</b>
Name of Company:	Mercer Ltd	
Disclosure of comments:	Please indicate if your comments should be treated as confidential:	Public
<p>Please follow the following instructions for filling in the template:</p> <ul style="list-style-type: none"> <li>⇒ Do <b>not</b> change the numbering in the column “reference”; <b>if you change numbering, your comment cannot be processed by our IT tool</b></li> <li>⇒ Leave the last column <u>empty</u>.</li> <li>⇒ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a paragraph or a cell, keep the row <u>empty</u>.</li> <li>⇒ Our IT tool does not allow processing of comments which do not refer to the specific numbers below.</li> </ul> <p><b>Please send the completed template, in Word Format, to CP-12-003@eiopa.europa.eu. Our IT tool does not allow processing of any other formats.</b></p> <p>The numbering of the paragraphs refers to Consultation Paper 12-003.</p>		
<b>Reference</b>	<b>Comment</b>	
General Comment	<p>Mercer Limited is a global leader for HR and related financial advice and services. Our client base includes employers providing occupational pension schemes to employees in all sectors of industry and the trustees and other entities responsible for managing those pension schemes.</p> <p>The consultation would have been far more useful had it set out the principles to follow and the justification and derivation of any formulae or assumptions to be used, rather than just asking whether what is being proposed is fit for purpose or not.. We are aware that a calibration document for QIS5 of Solvency II has been published but it would be useful for this new audience to have this background. In any case, it is not possible to consider whether the proposals are ‘fit for purpose’ since the purpose (that is, the regulatory impact of the calculation results) has not been discussed. Further, the objective set out in I.8.2 takes a balance sheet view on the world</p>	

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	<p>and ignores what is of most financial consequence to IORPs and their sponsors, i.e. the funding implications in respect of underfunded benefits accrued in the past and benefits that will be accrued in the future. For example, if the QIS identifies under its objective set out in I.8.1 and I.8.2 that at an aggregate national level the excess capital is similar or indeed greater than under the current regime, it is not at all obvious to us that the new regime is more affordable at the individual IORP level since we would anticipate considerable behavioural asymmetry between IORPs where there is a surplus and IORPs where there is a deficit.</p> <p>For many IORPs, the sponsor covenant effectively provides ‘solvency capital’. So we find it difficult to understand why such sections of the QIS have been given relatively little consideration when other areas, which relate risks likely to be immaterial in many cases, are presented in far greater detail. EIOPA should take into account the limited resources and budgets that individual IORPs will have to carry out the QIS and, with a view to optimizing the value of responses, ensure that priority is given to the most material considerations. Appropriate simplifications should be available to use where risks are unlikely to be material and where the size of the IORP indicates that greater detail would be likely to result in spurious accuracy.</p> <p>We do not believe that the QIS will meet its objectives, since its purpose seems to set out a narrow range of alternatives, with most of the material produced focussed on the one closest to Solvency II and with very little opportunity for qualitative observation.</p>	
Q1.	<p><b>Do stakeholders agree with the general set-up of the QIS exercise as put forward in the Introduction (Chapter 1)? What improvements do stakeholders suggest?</b></p> <p>We have specific practical and technical reservations over the methodology presented in the consultation document, which we address in subsequent questions. However, overall we have concerns over the way the review of the IORP Directive is being carried out and how the results of a QIS carried out in accordance with the proposals in the consultation document would contribute to an already dysfunctional process.</p>	

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	<p>It is, of course, important to understand the likely affects of regulatory policies as they are being developed and before they are implemented. However, it appears to us that the policy has already been developed and that the QIS effectively implements the policy, by setting out the general principles that it is intended should be followed. We are particularly concerned because:</p> <ul style="list-style-type: none"> <li>• The process set out is derived apparently without considering the consequences of the various measurements (in particular the financial strain, measured as a percentage of earnings or cash-flow that is caused on sponsors through the requirement to fund past and future service benefits), so that in fact it is not possible to determine what their quantitative impact would be;</li> <li>• Similarly, without knowing how actuarial information will be used, it is impossible to determine whether the approach determined for collecting that information is appropriate;</li> <li>• The approach and parameters have largely been drawn directly from QIS 5 for insurance companies, with very little regard given to the particular circumstances of occupational pension schemes and also apparently ignoring the continuing developments to Solvency II;</li> <li>• IORPs are not capital raising entities and this fundamental difference between them, and insurance companies, appears to have been ignored. In particular, it appears to us that very limited consideration has been given to the measurement of employer covenant and other security mechanisms available to IORPs;</li> <li>• Given the limited resources and budgets available to most IORPs, the QIS is likely to attract responses from larger institutions, such that a biased view is created.</li> <li>• Our understanding of the development of Solvency II is that there is no consensus that its quantitative aspects will result in the most desirable regulatory framework for the insurance industry. In view of this, it seems hasty to attempt to apply the same principles to IORPs, particularly when they have not been designed with the conditional and sometimes contingent nature of occupational pension scheme benefits in mind.</li> <li>• Further, no account is taken of the fact that insurance companies and pension funds are major providers of capital to the markets, and if all of these measures seek to harmonise</li> </ul>	

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	<p>(across the financial services) the incentives that inform this interaction, this serves to direct markets to behave in a particular way, which is likely to create instability. In other words, the QIS seeks to determine a first order effect without any consideration of second order effects that could be far more serious in terms of their implications for retirement provision.</p> <ul style="list-style-type: none"> <li>• Although the importance of sponsor covenant to some IORPs seems to have been recognized, no account seems to have been given to the very different structures that employers have. Many companies, for example, those that are privately owned, have no obligation to share information publicly or with the IORP they sponsor. This makes it impossible to require IORPs to follow out the processes described in the QIS, without interfering with the employer’s legal status.</li> <li>• Considering the effect of the QIS in aggregate is likely to be misleading, since it will hide the different behaviours of those IORPs who are relatively stronger funded compared to those that are weakly funded. In particular, the former might continue to demand additional funding due because it is affordable to the employer, whilst the latter might be unable to do so.</li> <li>• Affordability for the employer, and the constraints it imposes, has been ignored.</li> </ul> <p>Our view is that the QIS would have been improved by considering a wider range of possibilities, each with clear objectives and outcomes. It would also have been preferable in our view to invest less effort in detail at this stage, and more in the design of the different possible regulatory regimes such that the end result is to be roughly right rather than exactly wrong.</p>	
Q2.	<p><b>Do stakeholders believe that the adjustment (discretionary and conditional benefits, last resort benefit reductions) and security mechanisms (sponsor support, pension protection schemes) IORPs dispose of are taken into account adequately?</b></p> <p>The distinction made between ‘Type 1’ and ‘Type 2’ (4.12) schemes seems to us to be largely artificial. In any case, it seems excessive to require employers to finance liabilities that have not yet accrued.</p>	

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	<p>It is impossible to determine what is ‘adequate’ without understanding how the information provided via the measurement of, for example, conditional benefits, will be used. The likelihood is that the understanding of what is ‘conditional’ and ‘discretionary’, and the associated practices, will vary from country to country, and so the appropriate measure for technical provisions is also likely to vary. The result is that it will be difficult to get a consistent approach to determine the regulatory capital required to support these liabilities.</p> <p>Overall, though, the nature of conditional benefits is that they might not be paid and so the degree of security afforded to them could be less. It is postulated that these could be considered a loss absorbing mechanism, and so the additional reserves that could be necessary, might be less. But, for many employers, the amount of the technical provisions will be a key measure and should be less for schemes that are in other ways identical, but where one has conditional benefits.</p> <p>Similarly, in our view, there should be no need to include discretionary benefits in technical provisions.</p> <p>The sections regarding sponsor support seem to have been developed without much consideration as to the very different corporate structures that support IORPs. At the simplest level many, if not most, of these are likely to be unrated (in particular recognizing that the legal recourse available to an IORP may not be to the parent entity that carries the rating) and to treat these all as though their covenant is less than investment grade is sweeping and likely to provide unreliable information. In fact, a key reason why many sponsors are unrated is because they have no financial debt nor cause to raise it, and indeed in such cases the IORP is arguably more secure than when it is competing with other creditors.</p> <p>At a more detailed level, the approach adopted does not seem to reflect techniques used by analysts. For example:</p> <ul style="list-style-type: none"> <li>• The valuation of sponsor support seems largely cash flow based. This is a very narrow determinant of company strength and seems unlikely to reflect the criteria of market</li> </ul>	

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	<p>consistency established in HBS6.9;</p> <ul style="list-style-type: none"> <li>• The calculation of maximum sponsor support assumes that companies are necessarily income generating, which is not the case. Corporate wealth can take different forms, and these will have to be recognized in the holistic balance sheet for EIOPA to understand the actual quantitative impact of its proposals. In practice, to remain viable, a sponsor needs to balance competing claims on its resources and a one size fits all approach does not appear to reflect reality.</li> <li>• In many cases where financial statements are not in the public domain (for example unlimited liability partnerships), it is inconceivable that the sponsor makes information on its financial position available to an IORP.</li> <li>• In many cases the legal recourse available to an IORP may be to a group company that is under no obligation to disclose its financial position.</li> <li>• In many jurisdictions, notably Ireland, the willingness of a sponsor to support a defined benefit IORP is at least as important as the financial capacity. The QIS offers no mechanism to incorporate qualitative views on the availability of sponsor support.</li> </ul>	
Q3.	<p><b>Do stakeholders believe that the draft technical specifications provide enough information and are sufficiently clear and understandable? Which parts could be improved upon?</b></p> <p>Clearly a lot of information has been provided in the QIS, to the extent that it should be possible to construct a tool to carry out the calculations. However, whilst the information provided is sufficient to establish a process to follow, we are concerned that the document setting out how the methodology has been established and how the assumptions have been derived was not made more easily available to those likely to be interested in the results of the QIS. In addition, although some parts of the Solvency II QIS 5 calibration document are generic to other financial sectors, for other parts it is less clear why the method and assumptions proposed are appropriate for calculations to be applied to occupational pension schemes.</p> <p>The approach set out in the consultation is quite narrowly defined, which makes it unlikely that it</p>	

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	<p>will be sufficiently flexible to meet its own objectives, in being market consistent in each member state. Most obviously, several assumptions are derived from yields that apply in the eurozone, which as well as not applying in specific eurozone member states, will not necessarily be appropriate for non-eurozone countries.</p> <p>In several cases, key determinants of liabilities and economic risks are not included in the QIS. We recognise the intent to provide an inflation risk module and would suggest that this is prioritised, as is the need to use market-based inflation assumptions (to the extent that liabilities are inflation linked and there is a deep and liquid market). In many geographies, it is common practice to set assumptions such as salary inflation and expected pension increases by reference to market based parameters such as inflation expectations and we would suggest that the QIS allow this flexibility.</p> <p>We would have preferred a principles based methodology, enabling local regulators to reflect how the pension ‘promise’ differs in different countries. Whilst this wouldn’t have resulted in consistent assumptions it might result in more consistent outcomes, which we consider would be more useful information.</p>	
Q4.	<p><b>Do stakeholders believe that the calculations proposed in the technical specifications are feasible at appropriate costs and with appropriate accuracy within the given timeframe of the QIS?</b></p> <p>We are not sure how to determine what an ‘appropriate cost’ for carrying out the QIS should be. For example, if there were greater certainty about the direction that European regulation is likely to take, then it would be worth member state regulators and IORPs investing the time and effort in developing their approaches to the proposed calculations and considering what generalisations or approximations might be appropriate for their particular circumstances. However, at this stage in the process, apart from political pressure at the European level we are not convinced that the case has been made for the quantitative principles underling Solvency II to be applied to IORPs quite as directly as has been proposed here.</p>	

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	<p>This is particularly the case whist there is still a debate surrounding Solvency II as it applies to insurance companies. Even in that market there appears to be no general consensus that the approach adopted is the most desirable. So it seems perverse to impose costs on IORPs and their regulators in relation to a system that has not yet agreed in relation to its target market, let alone been implemented in practice and proven to meet its objectives.</p> <p>Because of the uncertainty about the approach proposed, we think it is unlikely that the QIS will provide useful information without imposing costs that could be considered disproportionate.</p> <p>Quite apart from the costs of this QIS, we are also very aware of the costs incurred by the insurance industry in preparing for the implementation of Solvency II. Some individual companies have spent several million Euros (in aggregate, the estimated cost is 1.9 billion Euros per annum) engaging with their regulator and developing internal controls and systems. Such an expensive approach is unlikely to be appropriate for many IORPs and, in fact, would directly and materially contribute to a diminution in the security currently available to IORP members.</p>	
Q5.	<p><b>Do stakeholders believe that the draft technical specifications provide enough guidance on how to set up and value the holistic balance sheet as discussed in Chapter 2? If not, which parts could be improved upon and in what way?</b></p> <p>Although there appears to be sufficient information to carry out the proposed calculations, the results produced are not likely to be useful or representative in many cases. That is, the information provided results in too narrow approach and there is not sufficient flexibility given for those cases where the resulting measures do not produce useful outcomes.</p> <p>On the other hand, the approaches proposed are costly to implement and likely to impose disproportionate cost on many IORPs. Many have fairly straightforward benefit structures and investment strategies, and are unlikely to use stochastic models because they will provide very little additional useful information beyond what can be gleaned from deterministic measures and scenario testing.</p>	



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	<p>As mentioned in our response to Q3, often the key determinants of liabilities and economic risks are not included in the QIS. Most significantly, an inflation risk module based on market information should be provided. In many geographies, it is common practice to set assumptions such as salary inflation and expected pension increases by reference to market based parameters such as inflation expectations and we would suggest that the QIS allow this flexibility.</p> <p>We also find the interest rate stress section unsatisfactory, in particular the proposal that a stressed real yield curve is floored at zero percent (given that on December 2011 many real interest rates were negative). Our strong preference would be for separate treatment of nominal interest rates versus inflation.</p> <p>The suggestion that a spreadsheet is provided with the QIS is in our view welcome, in particular if it facilitates simplifications in situations where participants do not have sufficient detail to accurately carry out calculations.</p>	
Q6.	<p><b>Given the purpose of the QIS, do stakeholders consider the proposed simplifications for the valuation of the holistic balance sheet (for the risk margin in section 2.5, sponsor support and pension protection schemes in 2.6 and amounts recoverable from insurance in 2.7) adequate? Do you have suggestions for additional simplifications that would be appropriate?</b></p> <p>Risk margin – we cannot argue that the proposal for calculating a ‘risk margin’ is simple. However, we do not understand its purpose. Generally, IORPs are not bought and sold for commercial reasons by other IORPs, so the premise in HBS5.1 seems flawed. In addition, 8% seems entirely arbitrary particularly compared against the 6% margin required for insurers.</p> <p>The alternative – an explicit margin against the risk of adverse experience – seems (theoretically) more defensible although we are still not convinced that it is necessary or appropriate in the context of IORPs: in a framework that requires them to hold explicit margins for risk this seems like double counting.</p>	

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	Sponsor support and pension protection schemes – we understand that measuring these contingent sources of security is complicated and largely untested. As a consequence, the simplifications are not simple	
Q7.	<p><b>The best estimate of technical provisions should be based on the most recent mortality tables including the future trend in mortality rates (section 2.4). Do stakeholders believe that IORPs will be able to take into account this trend in mortality rates? Can you explain?</b></p> <p>The statement in paragraph HBS4.2 is unclear. There is no purpose in using the most recent mortality tables if these are not representative of the IORP'S experience.</p> <p>We also note that the use of 'future trends' is unclear. For example, although we believe EIOPA means that an allowance should be made for future improvements in mortality rates, scheme experience could also change because the nature of the membership has changed.</p> <p>Our experience is that allowance for future improvements in mortality rates varies considerably between different member states, in terms of the methods used and the allowance made. This is partly because the effect is more material in some countries than in others and also (perhaps not unrelated) because some countries have more information about the rate of improvement.</p>	
Q8.	<p><b>Is it clear from the technical specifications what cash flows should be taken into account in the calculation of the best estimate (e.g. in relation to benefits (unconditional, pure conditional, pure discretionary, mixed), contributions, expenses, etc.) and how the projection of these cash flows should be made (Section 2.4)?</b></p> <p>As in much of the document, the principles that have been adopted are relatively clear, but not necessarily appropriate. IORPs in different member states, and their regulators, are likely to characterise unconditional, conditional and discretionary benefits differently. In any case, in our view discretionary and mixed benefits should not be included in technical provisions calculated</p>	

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	<p>for regulatory purposes before the discretion has been exercised. One of the subjective tests for granting payment is likely to be the financial state of the IORP so their inclusion will be circular. In addition, the ability to exercise discretion was often provided for in IORP rules when there were no legislative requirements to ensure, for example, that benefits were increased or vested. Since legislation has formalised these requirements, IORPs generally have less need to, and generally do not, provide benefits on a discretionary basis.</p> <p>Also, the requirement to value unconditional, conditional and discretionary benefits separately for the QIS seems unduly onerous and unlikely to give rise to useful information as the way the benefits emerge is likely to be inextricably interlinked.</p> <p>We also disagree with the distinction being made between IORPs with the power to close to future accrual and those where there seems to be no possibility to do so. In practice, it is always likely for employers to be able to stop sponsoring a particular form of IORP (apart from some compulsory defined contribution schemes) although the required steps might be more laborious (for example, changing employment contracts).</p>	
Q9.	<p><b>EIOPA is considering to take into account in the QIS the possibility in some member states to reduce benefits in case of sponsor default (for example, when a pension protection scheme does not guarantee the full level of benefits) in the valuation of the best estimate of technical provisions (see Reduction of benefits in case of sponsor defaults in Section 2.4 and Pension protection schemes in Section 2.6). Do stakeholders agree and, if yes, should it only apply in case of sponsor support backed up by a pension protection scheme or to sponsor support in general?</b></p> <p>In our view, good plan management would require those responsible for benefit provision to target funding relative to the benefits they are expected to provide rather than those that might be provided were the sponsor or plan to default. So, although we agree that the existence of pension protection funds, which might provide for lower benefits than those intended under plan rules, should be taken into account as a contingent asset, we do not think they are relevant to the measurement of the liabilities.</p>	

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	<p>In any case, allowing for the possibility that benefits could be reduced in certain contingencies will increase the complexity of the measurement without producing much more useful information.</p> <p>However, if the regulatory standard is to measure IORPs against a discontinuance position, it might be more reasonable to allow for this deduction in benefits and IORPs should be allowed to regardless of the nature of their sponsor support.</p>	
Q10.	<p><b>The technical specifications propose that security mechanisms should be valued on a market consistent basis, i.e. by calculating the probability weighted average of (discounted) expected payments from the sponsor and the pension protection scheme (Section 2.6). Do stakeholders agree with the principles for the valuation of sponsor support and pension protection schemes? If not, what alternatives would you propose?</b></p> <p>For many reasons, we do not accept the principle of ‘market consistency’ laid out in this question, including:</p> <ul style="list-style-type: none"> <li>• a discounted cash flow calculation using some assumptions derived from a narrow range of market information and some more sweeping assumptions does not result in a ‘market consistent’ valuation; and</li> <li>• there is not a direct market in ‘sponsor support’ for IORPs, or in pension protection schemes.</li> </ul> <p>By mandating a particular approach and in particular specific assumptions, EIOPA risks undermining the usefulness of the QIS since any change to the approach or assumptions could mean that the QIS needs to be repeated to understand the outcome.</p> <p>Our response to Q2 raised commented on the inadequacy of the proposals in relation to employer covenant and we repeat some of the reservations here. Overall, the sections regarding sponsor support seem to have been developed without much consideration as to the very different corporate structures that support IORPs. At the simplest level many, if not most, of these are likely to be unrated (in particular recognizing that the legal recourse available to an IORP may not</p>	

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	<p>be to the parent entity that carries the rating) and to treat these all as though their covenant is less than investment grade is sweeping and likely to provide unreliable information. In fact, a key reason why many sponsors are unrated is because they have no financial debt nor cause to raise it, and indeed in such cases the IORP is arguably more secure than when it is competing with other creditors.</p> <p>At a more detailed level, the approach adopted does not seem to reflect techniques used by analysts. For example:</p> <ul style="list-style-type: none"> <li>• The valuation of sponsor support seems largely cash flow based. This is a very narrow determinant of company strength and seems unlikely to reflect the criteria of market consistency established in HBS6.9;</li> <li>• The calculation of maximum sponsor support assumes that companies are necessarily income generating, which is not the case. Corporate wealth can take different forms, and these will have to be recognized in the holistic balance sheet for EIOPA to understand the actual quantitative impact of its proposals. In practice, to remain viable, a sponsor needs to balance competing claims on its resources and a one size fits all approach does not appear to reflect reality.</li> <li>• In many cases where financial statements are not in the public domain (for example unlimited liability partnerships), it is inconceivable that the sponsor makes information on its financial position available to an IORP.</li> <li>• In many cases the legal recourse available to an IORP may be to a group company that is under no obligation to disclose its financial position.</li> </ul> <p>In many jurisdictions, notably Ireland, the willingness of a sponsor to support a defined benefit IORP is at least as important as the financial capacity. The QIS offers no mechanism to incorporate qualitative views on the availability of sponsor support.</p>	
Q11.	<p><b>Do stakeholders have suggestions for the parameters – such as the probability of default and the recovery rate in the event of default – used in the valuation of sponsor support and pension protection schemes (Section 2.6)?</b></p>	

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	<p>Our understanding is that probabilities of default and the likely recovery of a company that has entered insolvency, even amongst similarly rated companies, differs between member states, for example, because of local insolvency rules and different degrees of protectionism. Consequently, the proposed assumptions are unlikely to be appropriate for all IORPs. For example, in Ireland the pension Trustee has no legal claim on the resources of the sponsor on default.</p> <p>As set out in Q2, we also believe that the proposal to apply a punitive probability of default to unrated sponsors is faulty and would give rise to misleading results. Companies can be unrated for many reasons, and sometimes it could be because of a position of relative strength rather than weakness. We reiterate also the distinction between the capacity of a sponsor to pay and the willingness of a sponsor to pay and suggest that the use of prescriptive discount rates misses this important point.</p>	
Q12.	<p><b>Do stakeholders agree with the methodology set out to value the maximum value of sponsor support (Section 2.6)? Do stakeholders have suggestions for the parameters used in valuing the maximum amount of sponsor support? In particular, with regard to the proportions of future profits/EBTDA and the time period of the calculations.</b></p> <p>The method proposed seems narrow and likely to result in a measure that does not properly reflect the extent of sponsor support available to some IORPs. We consider that IORPs and member state regulators should be allowed to consider all the various measures that are available for measuring sponsor support, taking local considerations into account. It is likely that more work needs to be done to fully understand those measures: sponsor covenant is a developing area and mandating a narrow and possibly uninformative measure might discourage IORPs from taking steps to consider better ways to assess covenant. For these reasons, we would suggest that rather than mandating such a narrow approach, a principles based approach could result in more useful outcomes.</p> <p>See also our responses to Q2 and Q11.</p>	

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Q13.	<p><b>The draft technical specifications propose performing an upward shift in the basic risk-free interest rate curve to approximate the so-called counter cyclical premium or to allow IORPs – under conditions –to apply the so called matching premium (Section 2.8). Do stakeholders agree with this approach to take into account the long term nature of pension liabilities?</b></p> <p>First we consider reference to a ‘risk-free’ interest rate to be misleading and would prefer the use of ‘least risk’. Particularly given the recent and ongoing market turmoil, the known inadequacy of market processes and market pricing, and the importance of the language used in communications and regulatory statements, EIOPA should reflect on the degree to which it is possible to have ‘risk free’ financial markets.</p> <p>We observe, in particular, the contradiction between proposing a so-called ‘risk free’ rate and the requirement to deduct 10bp from that rate to allow for credit risk.</p> <p>The proposal to apply a 50bp adjustment at all points of the yield curve and in all member states is unlikely to provide useful information, since the adjustment is arbitrary, unlikely to reflect the ‘nature of pension liabilities’ in every member state and is clearly irrelevant when considering the transfer price of the liability to a third party. In addition, market illiquidity including potential stress caused by current market conditions, is likely to vary between member states (and in particular across currencies). Further, the impact on liabilities depending on whether this 50 basis points is driven by an increase in inflation expectations or an increase in real interest rates could vary enormously, and this distinction is of immense importance to many defined benefit schemes.</p> <p>We are also concerned by the comment in HBS8.14 that issues relevant to this section are being considered in the context of insurance companies and the results of these discussions will be reflected in the final QIS. This reflects a lot of our concern about the approach to the revisions of the IORP Directive, which appears to be to apply regulatory principles developed for the insurance market to IORPs. Even in those cases where IORPs look very much like insurance companies, there are fundamental differences, particularly in the nature of the contract between the IORP and</p>	

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	scheme members and the different ways IORPs access financial support.	
Q14.	<p><b>Do stakeholders agree that the proposed way to derive the level B discount rate adequately reflect the expected return on assets of IORPs (Section 2.8)? If not, what alternative would you propose?</b></p> <p>We are pleased that the ‘Level B’ measure of technical provisions is reflected in the QIS. However, although we would like to see less complexity elsewhere, the approach adopted here is very simplistic and unlikely to reflect the variety of investment strategies adopted by IORPs, or the different returns available from different investment products in different member states.</p> <p>If it genuinely is the case that no decisions have been made regarding the application of the quantitative measures of Solvency II to IORPs, then we do not understand why such little regard has been given to the measurement of level B technical provisions, compared to level A. In particular, rather than imposing an arbitrary ‘investment related’ discount rate, it would seem more appropriate for the Level B measure to be set using the existing principles and rules that apply in each member state. These are likely to have been set in the context of the market, social and economic conditions that apply in each member state and such an approach would ensure that local knowledge and experience in each member state is developed appropriately, rather than lost. In particular, it seems unlikely to us that IORPs or local regulators would concede to a funding level that was based on weaker principles than those that applied currently.</p>	
Q15.	<p><b>Do stakeholders agree that the draft technical specifications specify a fixed yearly percentage of respectively 2% and 3% for the expected inflation rate and salary growth? Or should IORPs also be allowed to expected inflation implied by financial markets? Could you explain?</b></p> <p>Assuming a fixed assumption for inflation and salary growth that is not related to market pricing will result (for those schemes with inflation and/or salary linked benefits) in a measure for technical provisions that is meaningless. Whilst we doubt whether it is possible to achieve ‘market consistent’ measures for many aspects of the holistic balance sheet, we do agree with the</p>	



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	<p>principle of starting with market prices for determining the assumptions to use. Although in many member states this might not be possible in relation to inflation, there is information in the UK and the Euro zone that should be taken into account.</p> <p>We recognise (and appeal to EIOPA to recognise) that market pricing is an imperfect measure in general and currently will be compromised by behaviours driven by the Euro zone crisis. However, although it is important to recognise these imperfections, it seems perverse to ignore the information entirely, particularly in an approach that is attempting to achieve ‘market consistency’.</p> <p>We have a similar concern in relation to the salary growth assumption. The rates of salary growth likely to be experienced over the short term will vary considerably between member states but, in particular, in many industries throughout the European Community are likely to be less than inflation. No information is provided about the derivation of the 3% figure (nor the 2% inflation assumption), but a more considered approach is needed for the QIS to provide useful information.</p> <p>More generally, we do not believe it is appropriate to include a salary growth assumption for the type A liabilities, since salary growth will only necessarily be granted if the scheme remains open, which presupposes a solvency employer. However, we would agree that they should be included for the Type B calculation.</p> <p>Finally, changes in inflation expectations are a real economic risk for schemes and should have a specific risk module or, at a minimum, be incorporated in the interest rate module.</p>	
Q16.	<p><b>Do stakeholders believe that the description of the SCR in Chapter 3 is sufficiently clear and understandable to enable participants in the QIS to perform the necessary calculations?</b></p> <p>The requirements in Chapter 3 draw heavily on those set out in the QIS5 Technical Specifications used for insurance companies apparently ignoring many fundamental differences between IORPs and insurance companies. Although it will be possible to perform the calculations, the detail</p>	

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	<p>provided is too prescriptive and so unlikely to result in information that reflects the different structures and risk characteristics of IORPs. In particular, our view is that a principles based approach, that could potentially incorporate existing risk measurement infrastructure, could be employed.</p> <p>As outlined earlier, we find the interest rate stress section unsatisfactory, in particular the proposal that a stressed real yield curve is floored at zero percent (given that on December 2011 many real interest rates were negative). Our strong preference would be for separate treatment of nominal interest rates versus inflation. It would be helpful if as part of the documentation provided with the QIS (as was the case with the insurance QIS5), a set of interest rate and stressed interest rate curves is provided.</p> <p>Particular elements of the QIS that we think are likely to make the cost of performing the calculations disproportionate, compared to the value of the information provided, include:</p> <ul style="list-style-type: none"> <li>• the requirement to look through into the investments held by managed funds;</li> <li>• the expectation that capital requirements in respect of interest rate can be usefully separated into eight different measures;</li> <li>• the detailed measurement of, for example, spread risk and counterparty risk.</li> <li>• the requirement in the case of the interest rate stress to have a full set of liability cash flows.</li> </ul>	
Q17.	<p><b>Do stakeholders believe that the risks IORPS are facing are adequately reflected in the calculation of the SCR and MCR (Chapters 3 and 4)? Are there in the stakeholders' view any risks being considered that are not material and could be excluded from the technical specifications? Are there other risks that should be considered in the calculation of the SCR?</b></p> <p>We agree that Chapter 3 seems to identify most of the risks faced by IORPs, but we cannot say whether the proposed approach is 'adequate' since there is no information about how the results produced will be used by IORPs or by regulators. Clearly, as noted earlier, changing inflation</p>	

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	<p>expectations is a key risk faced by many defined benefit schemes but this is largely ignored in the proposed approach.</p> <p>Because IORPs’ benefit and legal structures vary, in many cases we expect that many of the risks being captured are unlikely to be material, although in other cases they might be. It is because of these fundamental differences that we consider a more principles based approach would be more appropriate.</p> <p>On some of the detailed aspects:</p> <ul style="list-style-type: none"> <li>• without commenting on the appropriateness of the measure chosen, in closed schemes, we expect the mortality ‘shock’ will be increasingly likely to overstate the relative size of the risk as the population ages;</li> <li>• we do not believe that the altered term structure created using the table in SCR5.21 is necessarily appropriate for pension scheme liabilities which are illiquid and long term.</li> <li>• a blanket stress applied to an asset class may not reflect underlying reality. For example some property and alternative asset classes may have very stable returns and low volatility while others may have precisely the opposite characteristics</li> <li>• we are uncertain about the derivation of the equity adjustments</li> <li>• inflation risk, which appears to have been ignored or described as a work in progress, is likely to be material in many schemes but has not been given proper consideration;</li> <li>• many IORPs give fiduciaries the power to wind up the IORP, which in jurisdictions like the UK could trigger an immediate financial requirement on the sponsor.</li> </ul>	
Q18.	<p><b>Do stakeholders believe that the way the loss-absorbing capacity of adjustment mechanisms and security mechanisms is taken into account in the calculation of the SCR (Section 3.2) is adequate?</b></p> <p>The calculation appears to result in three calculations of the SCR – one gross of security mechanisms, one net, and a third adjusted. In the time available we have not been able to</p>	

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	<p>consider how this would work, but it seems an extremely laborious process unlikely to produce useful information at a proportionate cost.</p> <p>However, it is not possible to answer this question usefully because we do not know how the calculation is to be used and so we cannot say whether it is 'adequate'.</p>	
Q19.	<p><b>Do stakeholders believe that the calculation of SCR in the Operational risk module (Section 3.3) is adequate for IORPs?</b></p> <p>There is a slight difference between this and the insurance industry QIS 5 approach, but no explanation for it, except that it is likely to result in a lower operational risk reserve for IORPs than an insurance company would require which, all else being equal, seems reasonable.</p> <p>It is not possible to answer this question usefully because we do not know how the calculation is to be used and so we cannot say whether it is 'adequate'.</p>	
Q20.	<p><b>Do stakeholders believe that the simplifications provided for the calculation of the SCR (for spread risk on bonds in section 3.5, value of collateral in section 3.6 and mortality , longevity, benefit option and catastrophe risk in section 3.7) are adequate? Do stakeholders have any concrete suggestions for additional simplifications?</b></p> <p>A principles based approach would likely result in better outcomes.</p> <p>Spread risk and collateral – these areas are particularly complicated , we expect to the extent of spurious accuracy, since because of the necessary simplifications (for example, having to class bonds by credit rating, which results in cliff edge effects) and the unavoidable approximation (for example, the base insolvency probabilities and the spread risk factors). We would also point out that in many cases, the granular information needed to calculate this stress may not be available to IORP managers.</p>	

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	<p>Mortality – heavier mortality is normally a small part of an IORPs risk portfolio that is often reinsured out. In that case, it could be possibly to ignore this aspect of the calculation entirely.</p> <p>Longevity – improvements in mortality rates are difficult to predict, particularly for younger members. In a closed, or very mature, scheme where most of the liabilities are pensioners, the proposed stress is likely to over state the risk; for ‘younger’ schemes, it might understate it. Certainly, a fixed stress applied to all schemes is unlikely to give useful information.</p> <p>Benefit option – the principles here have been copied from the insurance industry QIS5 lapse risk module. We consider the risk of exercising an option to be different from those of lapsing a policy, partly because there is no subsequent loss to the IORP (for example, if an insurance policy is lapsed, the loss of premium income can affect the emergence of profit).</p> <p>We also observe that many options are only infrequently exercised, so it is hard to determine reliable assumptions. Hence, the amount of detail apparently required seems excessive for a calculation that will be at best a rough approximation.</p> <p>Catastrophe risk – This module requires further thought.</p>	
Q21.	<p><b>Do stakeholders believe that the treatment of sponsor default risk in the counterparty default risk k module of the SCR calculation (Section 3.6) is appropriate? If not, what improvements would stakeholders suggest?</b></p> <p>For many IORPs, the sponsor effectively provides ‘solvency capital’. So we find it difficult to understand why the sections of the QIS have been given such little consideration when other areas, which relate to risks likely to be immaterial in many cases, are presented in excessive detail.</p> <p>In particular, there are many different ways of assessing company covenant, which manifests itself in different ways and is both a risk to the IORP as well as a risk mitigating factor: 50% of</p>	

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	<p>SponsorSupport seems totally arbitrary and likely to result in misleading outcomes.</p> <p>Our overall view is that the treatment of sponsor default in this module is of spurious accuracy, given the wide range of potential outcomes across member states on such a default.</p>	
Q22.	<p><b>Do stakeholders believe that the calculation of SCR in the Benefit option risk sub-module (Section 3.7) is adequate for IORPs?</b></p> <p>As mentioned in our answer to question 20, we think it unlikely that a valuation method derived using insurance company statistics and to apply to the insurance industry is likely to be appropriate for IORPs. Rates at which options are exercised will vary considerably between schemes, and between IORPs, and this one size fits all approach could prove misleading.</p> <p>In addition, requiring the calculation to be carried out on a member by member basis seems unduly onerous.</p>	
Q23.	<p><b>Do stakeholders believe that the descriptions of financial and insurance risk mitigation (Section 3.9 and 3.10) are sufficiently clear and understandable to enable participants in the QIS to perform the necessary calculations?</b></p> <p>Although the principles for valuating the solvency capital required to be held due to financial risk mitigation products are clear, we expect that implementing them will not be simple (and this has been the experience in the insurance industry). Once again, it is clear that the principles in QIS5 have been copied across to IORPs without any consideration as to their relevance. In section 3.9 there are at least two requirements that do not seem to copy over so well:</p> <ul style="list-style-type: none"> <li>• the restriction on the use of rolling and/or dynamic hedging. IORPs' liabilities alter from year to year as experience differs from that expected, so it is impossible to have a single opportunity to find assets to hedge liabilities. Frequently, hedging strategies will be regularly reviewed to ensure they continue to meet their objectives.</li> <li>• There is prohibition on recognizing counterparties with credit ratings lower than BBB. But,</li> </ul>	

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	<p>if the sponsoring employer has a weaker credit rating than the counterparty, this could result in a lower risk position for the IORP.</p>	
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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	<b>Comments Template on CP-12-003 – Draft Technical Specifications QIS IORP II</b>	<b>Deadline 31 July 2012 18:00 CET</b>
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