



aba Response

to the EIOPA Discussion Paper

On Sponsor Support Technical Specifications

30 October 2013

The aba - Arbeitsgemeinschaft für betriebliche Altersversorgung e.V. - is the German industry association representing all matters concerning occupational pensions in the private and public sector. The aba has 1,300 members including corporate sponsors of pension schemes, IOPRs, actuaries and consulting firms, employer associations and unions, as well as insurance companies, banks and investment managers. According to our statutes, our mission is to represent existing schemes as well as to expand coverage of occupational pensions independent of vehicle.

General remarks

A Solvency II framework is not adequate for IORPs

The current discussion paper undertakes an attempt to improve on the shortcomings of the valuation of sponsor support in the IORP QIS performed in 2012. EIOPA has tried to address the major shortcomings of the previous methodology for sponsor support valuation but not resolved them in a sufficient way. We generally welcome EIOPA's attempt to address the weaknesses of the QIS, however the approach presented is again very complex. Most IORPs will face great difficulties when having to perform this kind of calculation.

Any HBS based solvency II framework is inadequate for IORPs. The model is not suitable for describing the reality of German IORPs. The results of the first IORP QIS in 2012 have convincingly evidenced that any Solvency II type capital requirements for IORPs will not strengthen the system of occupational retirement provisions in Europe but rather pose an existential threat to it. We therefore do not see the need to conduct further QIS work based on elements of Solvency II.

It is obvious therefore that even though further work on valuating sponsor support might improve some technical details of the HBS approach, it does not solve the problem that the HBS approach is in total an inadequate tool for supervisory purposes of IORPs. The HBS approach does not account for the social character of IORPs (as opposed to the commercial character of insurance companies) and is therefore not appropriate.

Every move towards a system that places heavy burdens on IORPs and their sponsoring undertakings must take into account that in times where most European societies undergo demographic change, occupational pension systems should be strengthened rather than weakened. Every increase in the costs of providing occupational pensions decreases an employer's willingness to provide this important social benefit. Moreover, we consider the market value based approach inadequate for liabilities with such long durations.

IORPs are deeply rooted in national labour law, and in a correspondingly developed national supervisory law. As both legal systems are very heterogeneous across the EU, every unifying set of regulatory rules will necessarily be too complex to be handled with reasonable effort. It should be taken into account that the resulting costs will be borne mostly by beneficiaries and members.

The acknowledgement of the importance of sponsor support is an attempt in the right direction

The approach proposed in the Discussion Paper borrows from credit checks in bank lending and is clear and comprehensible in its features. The modified approach has two main advantages. First, it allows IORPs with relatively large sponsors to balance their accounts, where before there would always remain a gap. Second, the problem that sponsors who do not have a credit rating get relatively poor default rating has been addressed. However, while EIOPA has attempted to address these issues, they have not all been *resolved*, some problems have not been addressed and others have emerged.

We understand that mechanistic reliance on ratings shall be reduced. However, we encourage EIOPA to carefully assess the quality of alternative methods before taking any conclusions. The alternative approach is only a small step in the right direction, because important and difficult questions have not been sufficiently addressed yet, in particular the complexity of the approach, situation of multi-employer and industry schemes and sponsors with several IORPs. Overall, we have four main concerns:

1. Generalisation: not really simpler and not adequate, particularly for MES

In the previous QIS, all IORPs where sponsors did not have their own credit rating had to use a relatively poor rating in their calculations – the current proposals attempt to address this problem by offering IORPs to do

their own calculations. However, the generalisation creates new problems. As any generalization, the suggested approach might make things easier for some IORPs, but it can also be expected that for a large number of individual cases it will not fit. The crucial question is still what is done with the results: within the HBS as well as the then derived economic consequences (see below). If the consequences for the IORP are significant, due diligence must be carried out. All parameters have to be questioned and analysed to determine which the better fit is rather than to accept standard suggestions. The result is the opposite of a simplification. In the case of multi-employer schemes (MES), industry schemes and sponsors who run a number of schemes (see e.g. Questions 2, 4, 7, 9, 10) additional problematic aspects emerge.

2. Which consequences are tied to the results, where do the parameters for the calculations come from?

To choose one approach over another, in the first place IORPs need to know what the consequences of these calculations are. As with all generalizing procedures, the applicability is seriously hampered because it does not fit for many individual cases. Here again it matters what is done with the results – both within the HBS and in a wider context. Otherwise it is not possible to make an informed decision on which approach to follow.

The discussion paper does not address the general question whether and how sponsor support will be reflected in the balance sheet of a sponsor. Since accounting for sponsor support properly might be linked to significant financial consequences for the sponsoring undertaking, this point needs further elaboration and transparency.

Similarly, it is difficult to answer the questions in the discussion paper (see e.g. Questions 5, 6 and 16) without knowing what the consequences will be. It matters what role the sponsor support will play in the HBS, and what the overall economic consequences of the HBS will be. Without this information, we can only respond to EIOPA's questions tentatively.

In a similar vein it would also have been useful if more background information was provided. Often it is not clear how certain parameters are derived (for example Tables 4 and 6 of the Discussion Paper).

3. Data requirements: difficult, particularly for MES and industry-wide schemes

EIOPA should consider whether the data requirements are realistic. Particularly MES with a large number of small employers will struggle to get all the required information from their sponsoring employers. The fact that many industry wide schemes have often more than thousands financial independent and potentially very small sponsors is not treated in a sufficient manner.

4. Sponsor support and insolvency protection by a pension protection scheme

The purpose of the Discussion Paper is to propose a practical approach for calculating sponsor support. We consider it questionable whether this is necessary for IORPs which have in place two security mechanisms: sponsor support coupled with mandatory insolvency protection. Not only would an individual calculation of sponsor support be a highly complex, spuriously accurate and potentially costly exercise, it would also be unnecessary. Even worse, despite the double securing mechanism, the risk remains, that the sponsor would be required to disclose the value of its (questionably calculated) contingent commitment in its own financial statements. A more practical approach would be to reflect the nature of the employer support and insolvency protection, which enable a comprehensive level of protection across the Member State. The HBS should, in these cases, be regarded as balanced, thereby rendering obsolete additional spuriously accurate calculations. This can especially be assumed for a protection scheme with a proven quality such as the German PSVaG.

Conclusion

It is crucial that EIOPA bears in mind that their recent work could have a dramatic impact on the appetite of corporates to sponsor occupational pensions. Looking at the modified approach to calculating sponsor support in isolation, it is a small step in the right direction, but a number of issues (see above) are still questionable. This does not change anything in our fundamental position against a Solvency II framework for IORPs. As laid out in the introduction, we do not think that this is an adequate framework for supervising IORPs, and tinkering with concepts such as sponsor support does not make it more adequate.

EIOPA Questions

General valuation principles

Q1: Should IORPs be provided with additional guidance for conducting stochastic valuations of sponsor support?

The order needs to be changed: the deterministic approach should not be a “lower-quality” alternative, but a first choice in its own right. It has by the way not been proven that stochastic approaches are better in principle. Each IORP needs to be able to decide whether they use the stochastic or the simplified calculation. No IORP should be forced to use the stochastic model. Even if guidance was provided, the costs for IORPs will be high and we do not believe that many IORPs have enough resources to do stochastic valuations. EIOPA therefore should work on developing a deterministic approach which works for IORPs in terms of size, practicability and comprehensibility. Overall, we consider it best to leave it at the IORP’s discretion to decide whether the value added by stochastic or internal models justifies the resources dedicated to the development of such models. We therefore do not need any additional guidance for conducting stochastic valuations, most German IORPs are likely to use the deterministic model. Those who use the stochastic one can discuss any open questions with the supervisory authorities.

Q2: Should IORPs be provided with additional guidance for conducting valuations of sponsor support using either Simplification 1 or 2? Should either of these simplifications be removed or should any other simplification be developed?

Generally, we do not consider further QIS work necessary (see General Comments). However, should there be another QIS, the considered simplifications should be kept (in particular Simplification 2, Simplification 1 is less important to German IORPs). With any simplification it is crucial that it is viable for IORPs and that there are opening clauses so that special schemes do not have to follow the simplification. Regarding Simplification 1 and 2, for example industry-wide IORPs are often not able to assess the sponsor support data in an appropriate way. They need more simplifications like macro-economic data and / or pars-pro-toto calculations or sampling. Further simplifications should therefore be developed in order to reflect the heterogeneous nature of IORPs regarding available resources and know-how. However, “over engineering” of the simplification should be avoided. The applied assumptions must be stated more clearly. The simplifications according to HBS 6.36 of the technical specifications for the QIS should remain applicable. We therefore welcome that this consultation paper sets out on page 6 (last sentence of the second paragraph) that the simplifications of the QIS are not questioned.

Q3: In the stakeholders’ view what role should the concept of maximum sponsor support play in the general valuation principles for sponsor support?

As EIOPA states in the Discussion Paper, there are no “universally recognised standards” of calculating maximum sponsor support.¹ We agree, but still think that it could be a useful measure. However, so far it has not been used sensibly. We think that there could be alternatives how to use the maximum sponsor support in valuations. If EIOPA thinks the HBS should be developed further – contrary to our position – additional research could identify better ways of using the concept of maximum sponsor support.

¹ See Chapter 3.4 of the Discussion Paper, p. 14. (Point 21).

Q4: Is wage an appropriate additional measure for estimating the maximum amount of sponsor support? If so, please explain why? Are there any other measures which could be used to assess the maximum sponsor support?

Generally, wage is not an appropriate additional measure for estimating the maximum amount of sponsor support in Germany (maybe in contrast to countries where final pay schemes are still the typical defined benefit plans). However, there might be exceptions to this rule: For example for an industry-wide pension fund wage may be nonetheless the only measure for estimating sponsor support because no other data are available. We therefore suggest an opening clause if this idea was taken forward.

Q5: Are stakeholders comfortable with the concept of linking default probabilities, credit ratios and sponsor strength?

No, because it is unlikely that it is possible to specify something of general applicability / general validity which works on the level of the individual IORP. It therefore cannot be the only factor taken into account. For example for long-term assessments default probabilities must be used very carefully. Using market data / calculated ratings for a timeframe of e.g. 10 years and combining it with a fixed (high) probability for 10 years+ may merit further consideration. In general the concept is not sufficient, because it does not include mandatory insolvency protection and last man standing principles which support employers of many IORPs (see General Remarks on the complementary nature of sponsor support and insolvency protection).

For MES it is a concern that in practice linking default probabilities, credit ratios and sponsor strength can be a very challenging approach, since it is assumed the credit ratios are dependent on the industry sector. Again, the concept is by far not elaborated enough to support industry wide or multi-employer IORPs.

Finally, to answer this question properly it would be inevitable to know what consequences the results will have.

Q6: Do stakeholders agree with exploring the possibility of including a standard table in the technical specifications that links credit ratios with default probabilities?

This would be an intellectually interesting approach, but we do not think this is feasible in practice. The figures in such a table would need to be carefully calibrated in order to provide a realistic picture of default probabilities in case ratings are not available. The validity of the calibration would have to be assessed by comparing the estimated default probabilities with market implied default probabilities or by statistical analyses based on historical data.

The key problem appears to be that credit ratings are based on a much richer set of information compared to credit ratios. Therefore any derived measures based on ratings appear to be more reliable compared to measures based on credit ratios (average values for different sectors, cycles, etc.?). In practice this approach can also be challenging because of market volatility. In a nutshell, it will be difficult to achieve general validity with this approach (see Question 5).

Q7: Do stakeholders have other suggestions to derive default probabilities of the sponsor and to reduce reliance on credit ratings?

We do not have any suggestions for general applicability.

However, if there is only sector specific data easily available, industry-wide scheme should be able to use it. We would also like to stress the special character of industry-wide schemes and the importance of opening clauses in this context.

Q8: Do stakeholders agree that timing of sponsor support reflecting the affordability of making additional payments could be an improvement to the general principles for valuing sponsor support?

Yes, this would be more appropriate, but we do not see how this could work in practice. The application would be very complex and would create many uncertainties.

Q9: Do stakeholders think that limited conditional sponsor support should be valued and included on the holistic balance sheet? Should it be included separately?

For most German IORPs this is not relevant, but there are exceptions such as a well-known very large IORP run collectively by the social partners in the construction sector.

Q10: Should more detailed guidance be provided in future technical specifications to value sponsor support that is subject to discretionary decision making processes? If yes, please explain in what way. Could the suggested detailed guidance also be applied to benefit adjustment mechanisms that contain discretionary elements?

See the response to Question 9.

In addition it might be worth bearing in mind that reasonably acting sponsors will not only provide support for covering technical provisions but also to enable the IORPs to meet all their business needs, including solvency capital requirements.

Alternative approach in general**Q11: Please provide your general comments on the alternative approach.**

As stated in the General Comments, the alternative approach could be useful for the standard case with a medium sized sponsor with one IORP, and addresses the problems for unrated IORPs. Generally the credit ratio method seems less sound compared to standard credit ratings as ratings are based on much more information and thus supposedly provide a more reliable estimate for a sponsor's probability of default.

It is not obvious how to deal with nonstandard scenarios where a sponsor supports more than one IORP or where a single IORP has several sponsors. The suggested approach also still seems to be very complex, in particular for small IORPs.

We oppose the introduction of any new data requirements. However, if any new data requirements were to be introduced at all, this should only be done for the future, because in the past the necessary data was not collected. Some aspects of the method need further explanation or elaboration or otherwise seem very arbitrary (e.g. Tables 4 and 6). Large IORPs should also be allowed to use the simplified approach.

Q12: Does the alternative approach address the concerns raised during the previous consultation on the technical specifications?

The approach at most attempts to address some of the concerns but does not resolve them (see the General Comments for more detail). The presented approach bears the potential to become very complex and still does not deal with many special scenarios. For instance, the specific issues MES and single employers with several IORPs face have not been addressed adequately.

The comparability of the proposed approach should be tested and demonstrated by means of a validation study based on historical data (testing if values for Sponsor support under standard rating based valuation and under the alternative method are comparable).

Q13: Are there any areas that have not been addressed adequately enough?

Yes, there are number of areas which have not been addressed adequately. Our main concerns are (see the General Comments for more detail):

- Generalisation: not really simpler and not adequate, particularly for MES. The problem of unrated companies has been addressed, but other central problems have not been solved.
- Which consequences are tied to the results?
- Where do the parameters for the calculations come from?
- Data requirements: difficult, particularly for MES
- Sponsor support and insolvency protection

Q14: Are IORPs still likely to want to calculate a maximum value of sponsor support (even if not required under the alternative approach)? If so, for what purpose?

As EIOPA states in the Discussion Paper, there are no “universally recognised standards” of calculating maximum sponsor support.² We agree, but still think that it could be a useful measure. However, so far it has not been used sensibly. We think that there could be alternatives how to use the maximum sponsor support in valuations. If EIOPA thinks the HBS should be developed further – contrary to our position – additional research could identify better ways of using the concept of maximum sponsor support. (see Question 3).

Alternative approach – stage 1

Q15: Do stakeholders have other suggestions to adjust these ratios to cater for different sectors?

Q16: Does Stage 1 contain enough information and guidance for IORPs to calculate a credit strength that is proportionate for QIS purposes?

We are concerned about a number of points, including those raised in the General Comments. While the description of the sponsor still works, the picture of the future must be incomplete. In addition, it is unclear how the parameters presented in the tables were derived.

The generalisation poses problems for all IORPs. One important question for example is how to obtain and how to apply average estimations of the required ratios. Statistical sampling might answer that question, but sponsoring companies nowadays do not have a legal obligation to provide data for that sampling exercise and their willingness to provide these data on a voluntary basis might prove poor. As stated before, the consequences are not clear – in this specific case, what exactly is the “purpose”, or even more, the “impact”? In addition, the inputs are heterogeneous; firms could for example have used figures from national commercial law or according to IFRS in the IORP QIS. As an aside, national law accounting rules are not comparable among member states, and on the other hand, by far not all sponsors report under IFRS.

We still consider this approach far too complex for a QIS. We doubt this method will make more small and medium sized IORPs want to join a QIS effort and will later be able to execute such calculations.

² See Chapter 3.4 of the Discussion Paper, p. 14. (Point 21).

Q17: Does Stage 1 contain enough guidance for IORPs to do their own calculations if they believe this is appropriate for them to do so?

The idea is clear. We do not think that more guidance would be adequate, because it would mean convergence on the lowest common denominator, which would make the model less suitable for a large number of IORPs.

Q18: Are Income Cover and Asset Cover suitable credit ratios to use for Stage 1?

Generally yes (description of the balance sheet and the strength of the sponsor can be used for calculating sponsor support), but it cannot be everything that is considered. In many cases it will be difficult to collect the corresponding data.

The final results will depend on the application of Table 4 (see Question 19). It might be difficult to find a generally valid factor (see the problem of general validity in Questions 5 and 6).

In addition it would be important that the Standard&Poors data in Table 3 really represents the actual sponsors of the IORPs (e.g. countries, sectors) and that it is valid und transparent. The used data in Table 3 seems to include a global set of companies, that non-essential are suitable (Data for the Middle East and Africa?). The involved industry-sectors and the distribution of the sectors are not clear. In addition the dataset only covers the period 2009 to 2011. Such a short period is very much influenced by actual market cycles.

Q19: Are the parameters used to determine sponsor strength in Table 4 appropriate?

It is not clear how the presented relation is derived, i.e. how the calibration is executed, more detailed reasoning is required. The data in the table should be checked in regard to the distribution and variation across sectors and countries; the extreme values in the table are not symmetric and the validity of the values should be considered – are the given relative figures appropriate? This is all hard to judge on from outside. Even the starting point, the Standard&Poors data is questionable with respect to its applicability in this context (see question 18).

For industry wide schemes these parameters are impossible to acquire and therefore not appropriate.

Q20: What other definitions of earnings or net assets could be used in sectors where the standard definitions are not appropriate?

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Alternative approach – stage 2**Q21: Are the periods shown in Stage 2 appropriate (bearing in mind this is for QIS work only, and not to determine a policy response)?**

Again it is not clear how payment periods are derived (short/medium/long; very strong/strong etc.). For a proper discussion about whether this calibration is adequate, it would again be necessary to know what the implications of the results are.

Q22: Do you agree that time periods for contributions for the QIS calculations for sponsor support should be based on affordability or should they be based on willingness/obligation to pay?

In Germany the sponsoring employer is obliged by labour law to ensure that the pension promise is met. The timing of sponsor support is defined by supervision/prudential law or on an individual basis by the Bundesanstalt für Finanzdienstleistungsaufsicht.

Q23: To what extent are there any IORPs whereby sponsor contributions cannot exceed certain limits (even if contributions are affordable)?

No, there are no general contribution limits in Germany.

However, in Germany tax exemptions for employer contributions are limited, which influences the attractiveness of contributions for employers and their employees. Still, taxed contributions could be made beyond this limit, even though they would not be efficient neither for sponsor nor for employees.

Q24: Are the annual probabilities of default appropriate for future QIS purposes? If not, why not?

The figures presented in Table 7 have to be subject to the same conditions mentioned in the answer to question 18.

Alternative approach – stage 3**Q25: Do stakeholders have any comments on stage 3?**

Again it is not clear where the parameters come from: what does short/middle/long stand for, especially with respect to the consequences and how does this fit into the overall model? In addition, the differentiation of Table 10 seems over-engineered when taking into account the rough figures one started with.

Alternative approach – stage 4**Q26: Is it reasonable to not allow for any recoveries from sponsor defaults? Please provide examples where this could increase the calculated value of sponsor support.**

The probability of recovery varies by sector and type of vehicle. For German IORPs it is likely to be much higher than 5% (recovery rate of bonds stand at around 40% - where do the 5% come from?). The use of 5% is therefore not adequate. In Germany sponsoring employers of Pensionsfonds are legally obliged to pay into the national insolvency protection system (Pensions-Sicherungs-Verein), which would lead to a probability of recovery of 100% (see also General Comments for the relation of sponsor support and insolvency protection).

For industry-wide schemes applying a de facto Last Man Standing principle recovery rates are irrelevant. Outstanding contributions pose the only problem of this scheme.

Alternative approach – stage 5**Q27: Is it appropriate to do separate calculations to allow for sponsor support from other group companies (both for legally enforceable and not legally enforceable support by group companies)?**

No, this is not appropriate because it is too complex and the necessary data is often not readily available. If sponsor support must be calculated for each sponsoring undertaking, the calculation will become very complex for many sponsors organised in larger groups.

Q28: Should any other guidance be included on how to allow for sponsor support from other group companies?

The concept needs further evaluation especially for industry-wide schemes, multinationals and holdings with companies ranging from minority shareholders to 100% shareholders. However, fitting the model to a wider variety of schemes will inevitably lead to more complexity. Ever more complexity will make it less and less feasible for IORPs to carry out the calculations.

Q29: What could be other valid reasons why the IORP should or should not take the financial position of the wider sponsor group into account when assessing the sponsor's financial position?

It should be considered what is adequate according to the structure of the liability. It is not always clear how the liability is structured in corporate groups / enterprises, in particular if mergers took place more than a decade ago.

For MES, the whole group has to be considered - financial strength and support of all subsidiaries should feed into the group holding. Necessary financial data are available often only at holding level. If there is a corresponding liability / domination of the holding company, an approach of 100% should be possible.

Alternative approach – stage 6**Q30: Is the approach to determining the loss absorbing capacity appropriate?**

The approach is consistent within the concept chosen by EIOPA which is inadequate from our point of view. Its applicability is unclear and complex. The main question then is what is done with the results. E.g. is it sensible to give a sponsoring employer a lower rating because of a potentially exaggerated own capital requirement from its IORP?

Alternative approach – stage 7**Q31: Should any other sensitivity analysis be considered?**

No, there are already too many parameters to be included in the calculations, in particular in conjunction with the different QIS scenarios - the calculations carried out for the QIS were already very complex.

Alternative approach – Types of sponsors

We assume that the questions 32 through 36 relate to the special types of sponsors in sect. 4.9 only.

Q32: Are there any other types of sponsors that should be included?

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Q33: What additional work should be carried out if this methodology was to be used for determining sponsor support in a regulatory or supervisory environment?

We do not believe there is a one size fits all methodology for valuating Sponsor support. In particular the needs of MES and employers who have several IORPs need to be considered in more depth.

As we have stressed throughout, the sponsors of industry wide schemes or generally the multi-employer situation is not treated in a sufficient manner. This is acknowledged in the Discussion Paper, "In cases where the schemes are organised in a "last man standing" manner, it may be appropriate to base the sponsor support on average financial strength across the industry. Further analysis is needed on how to determine such average financial strength."³

If this was to be taken forward, we would have to find an acceptable way to calculate the required credit ratios for multi-employer / industry wide schemes. It seems to be clear that there will never be exact calculations (it is questionable to what extent it is possible to rely on sampling). So there is a need to accept certain approximations.

³ EIOPA Discussion Paper, p. 38.

Q34: What other improvements could be made to the suggested approach?

Q35: Are there any aspects of the suggested approach which are unclear?

Yes. Key questions are still open and problems not solved, for example how employers with several IORPs were treated in the QIS, or the problems with industry specific analysis (see below). The suggested methodology for other types of sponsors (charity, public sector etc.) seems vague.

For industry-wide schemes applying a de facto Last Man Standing principle the concept is not applicable. Partly due to data requirements and calculation efforts, partly due to an inappropriate concept that cannot take into account the legal structure and obligations of the sponsors within the scheme the sponsor support calculations would lead to a cost and time consuming process without information value. Number 106 of the EIOPA Discussion Paper does not provide a solution for MES.

Q36: How could the average financial strength of an industry be determined?

This is problematic because only the IORPs – but not the employers – have a duty to comply with the demands of the supervisory authorities. Therefore it could be difficult for IORPs to get all the required data to determine the average financial strength of the industry.

The approaches for sponsors who have multiple IORPs⁴ need further guidance, currently they are not clear and in particular sub-points 1 to 4 of Number 103 seem difficult to implement. The argument is circular.

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⁴ EIOPA Discussion Paper, p. 37.