**Selected issue 2: Background on analysing impact on sponsors and questions to stakeholders**

The IORPs Stress Test Report 2015 concluded that further work is needed to have a deeper understanding of the effects of adverse scenarios on the real economy and in particular of the consequences of the additional pressure put on sponsors to increase their future payments to secure benefits.[1]

A possible avenue for assessing the impact on sponsors is by relating sponsor support values on the (stressed) common framework's balance sheet and/or the underlying cash-flows to measures of sponsor strength, such as book value, market value and/or earnings. The quantitative analysis could be supplemented by some qualitative questions, asking participating IORPs for their assessment of the affordability for/impact on sponsoring companies.

Such an analysis would benefit from synergies with the valuation of sponsor support on the common framework's balance sheet. IORPs already have to make use of income and asset data of the sponsor to establish the value of sponsor support:

- The technical specifications for the 2015 QA/ST prescribed that IORPs have to establish the Maximum value of sponsor support to ensure that the value of sponsor support does not exceed an amount that the sponsor could reasonably afford.[2]
- The technical specifications included a condition for using the balancing item approach to valuing sponsor support based on the value of the sponsor, besides the condition based on the sponsor's probability of default.[3]
- The alternative simplified approach (ASA) to valuing sponsor support relied on financial reporting data of the sponsor relating to asset and income cover.[4]

Questions to stakeholders:

1) Do stakeholders agree with the above avenue for assessing the impact of the adverse scenario on sponsors? If not, please provide an alternative proposal.

Scope of the analysis

The scope of the analysis can be restricted to IORPs which recognise a value for sponsor support on the common framework's balance sheet. It is not meaningful to request sponsor data from IORPs that are not covered by some form of sponsor support or do not need to recognise sponsor support on the common balance sheet. In addition, it could be considered to reduce the scope even further to limit the burden on specific types of IORPs for which it would be very difficult to provide relevant sponsor data or for which the analysis would be less relevant. For example, IORPs with a (very) large number of sponsors or with sponsors in the public/not-for-profit sector (see also the section below on the "Request for relevant sponsor data" or IORPs which only dispose of non-legally enforceable sponsor support. Unlike countries with predominantly non-legally enforceable sponsor support, prudential frameworks in countries with a high incidence of legally enforceable, unlimited sponsor support are also more likely to already consider measures of sponsor strength.

[1] Page 8, paragraph 32.
[2] HBS.7.26-HBS.7.42.
[3] HBS.7.49-HBS.7.53.
[4] HBS.7.84-HBS7.100

Question to stakeholders:

2) What is the view of stakeholders on the scope of the analysis to assess the impact on sponsors?

Relevant measure of sponsor obligations

The technical specifications aim to ensure that the value of sponsor support recognised on the common framework's balance sheet (and underlying cash-flows) does not exceed the amount the sponsor is capable of paying. For IORPs that are not eligible to apply the balancing item approach, the value of sponsor support on the balance sheet already has to take into account scenarios in which the sponsor defaults and, consequently, will not able to (fully) cover its pension obligations. As a result, comparing sponsor support values with measures of sponsor strength may to some extent become a trivial exercise. These IORPs will already have applied a haircut to ensure that sponsor support is affordable, thereby limiting the impact on the sponsor. This suggests that it would be preferable in such cases to use a measure of sponsor support values/cash-flows which has not been adjusted for the sponsor's probability of default/maximum sponsor support. The disadvantage is that it would increase the data request and, hence, the burden on participants.

Question to stakeholders:

3) Do stakeholders agree that it would be preferable to use an unadjusted measure of sponsor support values/cash-flows for IORPs that are not eligible to apply the balancing item approach? Please explain.

Request for relevant sponsor data

In order to produce a sound and comprehensive analysis, it will be important to collect comparable sponsor data for the entire sample. It is difficult to draw conclusions from an analysis that is based on market values for part of the sample, book values for another part and net cash-flows for the remaining part. At the same time feedback from past consultations/exercises showed that not all IORPs dispose of the same information of their sponsor(s).

This is an important reason for the technical specifications to take a principle-based approach to the calculation of maximum sponsor support, enabling IORPs to use measures of sponsor strength that are most easily available. The qualitative questionnaire included in the QA requested IORPs to provide sponsor data (as far as possible) based on different definitions for net cash-flows (EBITDA, PBT, net income, other) and net asset values (shareholder funds, market value, unrestricted assets, other).[5]

Especially for multi-employer IORPs it may be challenging to provide the data as they may dispose of a large amount of sponsors. The technical specifications for the 2015 QA/ST put forward possible simplifications, allowing multi-employer IORPs to estimate sponsor data based on a sample of sponsors and, if representative, grossing them up to the level of all employers.[6] For not-for-profit institutions / public sector IORPs, the

[5] Question 60.
[6] HBS.7.56-HBS.7.58.

challenge will be to collect relevant data since concepts like market value/earnings are not well-defined for such sponsors.

The data requested from IORPs should first of all be guided by the question of which analysis using which sponsor information is most relevant to assess the impact on sponsors in the stress test. For example, the analysis could relate sponsor support values to the market value of sponsors and/or sponsor support cash-flows to the net cash-flows of sponsors. However, it also needs to be ensured that IORPs are able to fulfil the data request without imposing an undue burden on them. There is a trade-off between the accuracy/detail of the analysis and the costs of requesting more data. For example, adding the pension liabilities already reported in the sponsor's financial accounts to the book/market value of the sponsor may result in a purer measure for comparison with the value of sponsor support, but will also increase the size of the data request.

The overall response rate could be encouraged by asking IORPs to provide estimates if the information is not directly available. For example, an IORP sponsored by subsidiary of a listed company may not dispose of a market value, but may have earnings data available. The market value of the sponsor could be estimated using a discounted cash-flow approach or – less burdensome – by applying some relevant P/E-ratio observed in financial markets.

Questions to stakeholders:

4) What type of analysis using what kind of sponsor data is most relevant to assess the impact on sponsors, taking into account the availability of the required sponsor data? Do the pension obligations already reported in in the sponsors' accounts play a role in the analysis?

5) Does the proposed analysis depend on detailed definitions for net cash-flow and net asset data of the sponsor or are IORPs afforded some room for choosing the most appropriate definitions?

6) How do stakeholders propose to deal with data issues relating to multi-employer IORPs with a great number of sponsors or IORPs sponsored by not-for-profit institutions? What additional guidance should these type of IORPs be provided with?

7) Does the proposed analysis envisage asking IORPs to estimate sponsor data that are not directly available to them? If yes, what guidance should be provided to IORPs to prepare these estimates?

Qualitative questionnaire

The quantitative part of the analysis could be supplemented by a qualitative part by means of a questionnaire to be completed by participating IORPs. This qualitative part could address the quality of the data provided under the quantitative part as well as the IORP's assessment of the affordability of sponsor support for the sponsoring undertaking. With regard to the impact of the adverse market scenario on sponsors, the questionnaire could distinguish between the effects of the deteriorating economic and financial conditions on the sponsor's business environment in general and the effects of the increase in the sponsor's pension liabilities in particular. The impact of higher pension

obligations will also be related to the extent to which additional sponsor payments may be smoothed over time (and hence related to the selected issue 1 on cash flows).

Question to stakeholders:

8) Do stakeholders have (other) suggestions for topics and/or specific questions to be addressed in the qualitative questionnaire?

References:

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