

PensionsEurope Position Paper on appropriate IORP stress testing methodology and EIOPA IORP Stress Test 2017

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About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace pensions. Some members operate purely individual pension schemes. PensionsEurope Members are large institutional investors representing the **buy-side** on the financial markets.

PensionsEurope has **23 member associations** in 18 EU Member States and 3 other European countries with significant – in size and relevance – supplementary pension systems¹.

PensionsEurope member organisations cover different types of workplace pensions for over **110 million people.** Through its Member Associations PensionsEurope represents more than € **4 trillion of assets** managed for future pension payments. In addition, many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has **25 Corporate and Supporter Members** which are various service providers and stakeholders that work with IORPs.

PensionsEurope has established a **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

PensionsEurope has established a **Multinational Advisory Group (MAG)** which delivers advice on pension issues to PensionsEurope. It provides a collective voice and information sharing for the expertise and opinions of multinationals.

What PensionsEurope stands for

- A regulatory environment encouraging workplace pension membership;
- Ensure that more and more Europeans can benefit from an adequate income in retirement;
- Policies which will enable sufficient contributions and good returns;

Our Members offer

- Economies of scale in governance, administration and asset management;
- Risk pooling and often intergenerational risk-sharing;
- Often "not-for-profit" and some/all of the costs are borne by the employer;
- Members of workplace pension schemes often benefit from a contribution paid by the employer;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
- Good governance and alignment of interest due to participation of the main stakeholders.

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¹ EU Member States: Austria, Belgium, Bulgaria, Croatia, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Lithuania, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Iceland, Norway, Switzerland.

1. Summary and key messages

- The cash flow analysis (CFA) in EIOPA's 2017 IORP Stress Test Report was interesting and useful, and EIOPA could have focused more on it in its Report;
- Many of the practical and methodological problems related to the Common Balance Sheet (CBS) could be avoided by developing the CFA further and by replacing the CBS by it;
- PensionsEurope is ready and willing to work together with EIOPA on developing the CFA as alternative stress testing methodology. For that reason, we have conducted a mapping exercise on developing the CFA further (including 3 possible scenarios) and on the usage of ALM studies in various Member States. We are willing to share our expertise, experience, and the results of our mapping exercise with EIOPA to continue developing an appropriate stress testing methodology;
- PensionsEurope finds assessing financial stability and the resilience of IORPs very important;
- The results of the Stress Test 2017 confirm IORPs' countercyclical behaviour and their important role in stabilising financial markets. It is important that legislation continues to allow IORPs' countercyclical behaviour;
- EIOPA's conclusions in its press release were not fully consistent and were on certain issues stronger than the conclusions in its 2017 IORP Stress Test Report, in particular they overemphasised the impact of a possible adverse scenario on sponsors and younger generations;
- One should be careful when drawing any conclusions from the CBS, as it is not an appropriate stress testing methodology on IORPs.

2. Introduction

In 2017, EIOPA performed a second Europe-wide stress test on IORPs². Its main objectives were to (i) assess the resilience of IORPs to an adverse market scenario, and (ii) analyse the transmission mechanisms of IORPs towards the real economy and financial markets ('second round' effects). This position paper contains our feedback on the methodology EIOPA used (its stress testing methodology and alternative methodologies) and on the results of EIOPA's stress test. With the feedback, we intend to contribute to improve the relevance of future IORP stress tests for beneficiaries/members. We look forward to continuing exchanging views and sharing our ideas on an alternative methodology with EIOPA.

In general, PensionsEurope welcomes that:

 EIOPA took into account some concerns raised in the past by PensionsEurope and other stakeholders by trying to make IORP Stress Test 2017 less burdensome and costly than the first Stress Test 2015 for IORPs³;

² See <u>EIOPA IORP stress test 2017 on EIOPA websites</u>.

³ EIOPA used less scenarios in 2017 and did not require calculations for of a solvency capital requirement or a standardised risk assessment.

- EIOPA put in place a questions-and-answer procedure (Q&A) for the stress test specifications, including technical specifications for the valuation of the CBS (however, the CBS was still burdensome)⁴;
- EIOPA has started considering alternative stress testing methodologies, i.e. a CFA.

3. PensionsEurope is ready to work on alternative stress testing methodology

We find the CFA in EIOPA's report interesting and useful, and we think that EIOPA should have focused more on it in the report. As mentioned above already, the CBS is inappropriate for assessing the resilience of IORPs and developing other methods would make EIOPA's IORP stress test more relevant. PensionsEurope believes that by developing the CFA further and by using alternative approaches many of the practical and methodological problems related to the CBS can be avoided.

PensionsEurope encourages EIOPA to use a more open and principle-based common framework instead of the CBS. Developing the CFA further would be preferable, and EIOPA could learn from the current practices and experiences (including Asset and Liability Management (ALM)) in many countries how such an approach can be developed further. Assessing the impact of stress scenarios on the contributions and the pensionable income of beneficiaries would be more useful than assessing the impact on the IORP itself, especially since in many pension arrangements the members and beneficiaries are the ultimate bearers of the risks.

Cash flow analysis should be developed further

PensionsEurope welcomes that EIOPA considers using the CFA as a new way to stress test IORPs. The advantage is that – especially in its current form – the method is easy to perform. If the CFA replaces the CBS in future stress tests, one of the main advantages would be that the problems with the complex, unreliable and volatile mark-to-market valuation, especially the problem of choosing the "right" valuation parameters, could be avoided. Furthermore, several effects (such as the expected development on member benefits and the expected impact on the real economy) would be more (adequately) visible in the CFA.

EIOPA needs to decide upon one methodology for EIOPA IORP stress tests, as it is not fit for purpose to conduct stress tests using two methodologies (CBS and CFA) in parallel on a continuing basis. PensionsEurope stresses that the framework of the CFA proposed by EIOPA for the Stress Test 2017 is not thorough enough, if it is to replace the current inappropriate CBS in the future Stress Tests. Now, after the EIOPA IORP Stress Test 2017, PensionsEurope proposes EIOPA to do a mapping exercise of different national practices, including the following questions: What kind of CFA various countries are already using and what kind of information they look for? Furthermore, EIOPA could have an internal separate working group on CFA to develop it further.

⁴ In some cases, the Q&A did not function properly.

PensionsEurope has already conducted a mapping exercise to develop CFA further

Recently, PensionsEurope has, via its members, conducted a mapping exercise on developing the CFA further (including 3 possible scenarios) and on the usage of ALM studies in various Member States. We are willing to share our expertise, experience, and the results of our mapping exercise with EIOPA to continue developing an appropriate stress testing methodology. We would like to propose to organise a roundtable of experts to discuss these topics.

Based on our experience and according to the results of our mapping exercises, IORPs should be allowed to specify management scenarios (e.g. the future asset allocation) in CFA. There should also be a discussion about the assumed returns in the scenarios. Furthermore, the number of relevant indicators should be as limited as possible and be aligned with existing practices. For example, splitting benefits into various subcategories would only slightly increase the insights of the analysis and would substantially increase the burden of the exercise.

PensionsEurope stresses that EIOPA should not focus on single cash flow events, but the goal of the CFA should be to compare a situation with regard to cash flows in a stress scenario with the cash flow pattern of a basic scenario. Any valuations - if they are needed to be used at all - should be based on national rules because national legislation determines the contributions, benefit adjustments etc.

4. General remarks on EIOPA stress tests

Common Balance Sheet not appropriate for stress testing IORPs

The 2017 Stress Test for IORPs reconfirms the inherent limitations of the concept of the CBS. As outlined in our earlier position papers⁵, the CBS is not an appropriate instrument to cover the wide range of diversity of IORPs in Europe as it has many shortcomings. The CBS is e.g. too complex, market consistent valuations in the CBS are unreliable and too dependent on arbitrary assumptions and approximations/simplifications, contains the misconception that option values (e.g. of benefit reductions) should be considered as expected values, and its execution is too expensive. Stress testing should focus on whether promises made by IORPs in the past are likely to be met. In our view the CBS approach is not a suitable tool to achieve this goal. The CBS only looks at (an approximation of) market values and does not take into account future developments indicating the likelihood, timing and severeness of events. In various Members States there are already packages of information to regulators, such as ALM studies⁶, that provide more relevant information than EIOPA stress tests).

EIOPA formats deviate from national standards

The format of the assets that EIOPA uses in its stress test deviates from the representation used by the National Supervisory Authorities (NSAs) in their national reporting standards. This leads to extra costs

⁵ See <u>PensionsEurope Position Paper on EIOPA's IORP Stress Test 2015</u> and <u>PensionsEurope Position Paper on</u> EIOPA's IORP Quantitative Assessment 2015 and EIOPA's opinion for Risk Assessment and Transparency for IORPs.

⁶ For instance, the Prognoserechnung performed by German IORPs gives a much better insight into the situation of the IORP than the EIOPA stress test since it is mainly based on a 5-year projection of the national balance sheets / statements of income.

in performing the stress test. It could also lead to (slightly) different conclusions by EIOPA (compared if and when a national approach would have been used).

The accounting rules in the EIOPA stress test differ from the upcoming ECB Regulation on statistical reporting requirements for pension funds⁷, which underlines that the accounting rules are laid down in the relevant national laws implementing the IORP Directive (or in any other national or international standards that apply to pension funds based on instructions provided by National Central Banks). Furthermore, the valuation standards in the EIOPA Stress Test differ from EIOPA's upcoming regular information requests towards National Competent Authorities (NCAs) regarding provision of occupational pensions information⁸, which will require that liabilities and all monetary data points other than assets should be valued based on national accounting or valuation standards or national prudential requirements. These data will be based on national data available at the NCAs, and will deviate from stress test date, possibly leading to (slightly) different conclusions and confusion.

Large heterogeneity across European IORPs: NSA's should lead in micro-prudential supervision

PensionsEurope welcomes EIOPA's acknowledgement of the heterogeneity of European IORPs, their different practices (such as asset allocation and pay-out-methods), and their respective financial assessment frameworks and steering mechanisms. Given this heterogeneity, proportionality and subsidiarity are important principles to consider when dealing with pensions in Europe. IORPs are subject to national social and labour law. As a consequence, the supervisory frameworks of IORPs across Europe vary from country to country including capital requirements and steering mechanisms. There are major differences between second pillar pensions in the Member States. The lead of micro-prudential supervision is at the NSAs, whereas EIOPA should have a more important role to play in macro-prudential supervision from the perspective of financial stability. The impact of stress on financial stability should be explored by EIOPA or NCAs themselves based on aggregated regularly reported data.

National supervisors and IORPs already use various methods to assess the resilience and risks of IORPs

Based on their national supervisory frameworks (which e.g. include ALM studies and sustainability and resilience testing), IORPs monitor their resilience and risks on a regular basis. In addition, due to the way they are organised and given the long recovery periods, IORPs effectively mitigate financial shocks and do not transmit these to other financial institutions. In its report, EIOPA recognises the impact can be limited given current national approaches with recovery plans with long horizons.

⁷ See <u>the ECB Draft Regulation on statistical reporting requirements for pension funds</u> and <u>PensionsEurope</u> <u>answer</u> to it.

⁸ See <u>EIOPA Consultation paper on EIOPA's regular information requests towards NCAs regarding provision of</u> <u>occupational pensions information</u> and <u>PensionsEurope answer</u> to it.

5. Remarks on the results of IORP stress test 2017

EIOPA's press conclusions were too strong

In general, PensionsEurope finds that EIOPA's press conclusions from the results of the stress test were too strong and deviated from its Report on certain issues. The wording of EIOPA's press release was much stronger and less balanced than the report itself. What is more, the stress test result showed that DB/hybrid schemes were almost fully funded⁹ and the (national) funding ratio was slightly better than in the previous stress test (the average deficit was -3.5% compared with -5.4% in first stress test). Also for DC schemes, the results were better than in the previous stress test: the accumulated assets and replacement rates of DC schemes in the baseline scenario exceeded the projections of the 2015 IORP stress test.

The CBS gives only a snap-shot picture of liabilities and values them based on market rates. Pension funds invest in the real economy and realise attractive returns on their assets (in the short and long term much better returns than what risk free interest rates provide). On a forward-looking basis, based on a concept like the (further developed) CFA, one could have a more thorough assessment whether IORPs are able to fulfil their liabilities. Our understanding is that there is a very high likelihood that IORPs are able to deliver as promised, and this means that their ability to manage their liabilities is much better than concluded by EIOPA.

Most IORPs are relatively well funded and limited impact expected from underfunding

According to the national balance sheets, the assets of the European IORPs providing DB/hybrid schemes exceed liabilities in most countries. For instance, Belgium, Luxembourg and Sweden stand out with aggregate assets ranging from 139% to 153% of liabilities.

According to the aggregated results, the funding ratio of all IORPs included in the sample amounts to 97% (EUR -49 bn). This deficit is not a serious European problem and it does not contain serious spillover risks into the real economy, as IORPs that do not meet the national funding requirement usually have to draw up a recovery plan to be approved by the NSA and in some countries the effects can be spread over a longer period. As the actual funding problems of IORPs are not severe, the recovery mechanisms are able to cope with them.

Impact on sponsors relatively modest

EIOPA itself also recognises its limitations to draw conclusions on the impact on sponsors based on the limited stress test sample (EIOPA did not target the representativeness of sponsors) and based on the limited received answers. The aggregated data on sponsors show that the values of the liability towards the IORP are rather small and barely visible. The indirect impact of the adverse scenario on the average sponsor is relatively modest. National law often allows sponsor support and benefit reductions to be distributed over considerable time frames. Distributing sponsor support and

⁹ Excluding the UK, the assets were almost the same as the liabilities. IORPs that do not meet the national funding requirement in the UK have to draw up a recovery plan to be approved by the National Supervisory Authority.

benefit reductions over time means that they are not impacting instantaneously to the full extent on sponsors and members/beneficiaries, but that the impact is smoothed over a longer period of time. Therefore, the impact is not as direct, and in particular smaller in a given period of time, as would otherwise be the case.

IORPs' policies are stabilising and countercyclical

EIOPA concluded in the 2015 stress test report that IORPs' investment behaviour was on aggregate and on average counter-cyclical. This time EIOPA e.g. noted that many IORPs follow a buy-and-hold strategy, and consequently alleviate selling pressure during stressed market conditions.

The results confirm IORPs' countercyclical behaviour and their important role in stabilising financial markets. As long-term investors, IORPs are able to mitigate financial shocks and work as stabilising factor for the financial sector. IORPs' long-term investment horizon and their ability to follow contrarian investment strategies support the proposition that IORPs can act as shock absorbers in the economy by providing liquidity and by not being forced to sell assets when asset prices are squeezed. The results confirm that the investment strategies of IORPs are very stable, including to a certain extent buy-and-hold-strategies. It is important that legislation continues to allow IORPs' countercyclical behaviour.

Some parameters in the stress test simulated extreme negative market conditions which seem to be less frequent in practice. If acted upon, such assumptions might prevent IORPs from long-term investments into sustainable real assets, which seems to counter to the aims of the Capital Markets Union as envisaged by the European Commission.

Results of the DC stress test were unsurprising and a tool non-transparent

The tool for the DC stress test was not transparent, making it difficult to verify the outcomes and check their validity (the user could not see the formulas used). In addition, the differences in outcomes of the stress tests between DC plans using projections and DB and hybrid plans based on balance sheets (both the national balance sheet and the CBS) are difficult to explain.

The results of the DC stress test are not surprising: shocks affect more members who are closer to retirement and whose assets are largely invested in equities, as they do not have enough time to recover from a loss. Second, as the report by itself indirectly confirms, whether the forecasted reduction in pension income affects the real economy in the short run depends on the current behaviour of the members. However, based on the findings of economics behaviour literature, in general members far from retirement are not focusing on pension issues. We question whether this lack of interest should be considered as a supervisory issue or, more correctly, a political issue.

6. Going forward

We would be happy to work with EIOPA to develop a more appropriate stress test methodology.