PensionsEurope answer to the European Commission's Capital Markets Union mid-term review

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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 **24 member associations** in 19 EU Member States and 3 other European countries with significant – in size and relevance – workplace pension systems[1].

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.

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

PensionsEurope´s answer to the European Commission's Capital Markets Union mid-term review

Introduction

In the below answer to the European Commission public consultation on the Capital Markets Union (CMU) mid-term review 2017, PensionsEurope lists numerous actions that the EC should take in order to complete the current CMU programme. Particularly, PensionsEurope gives policy recommendations on fostering long-term investments in infrastructure and real estate, on sustainable investments and on the use of derivatives to hedge risks. For example, PensionsEurope notes that there should be enough "big" investment opportunities available across Europe that match pension funds' needs.

After two years from the publication of the EC's green paper Building a capital markets union, PensionsEurope stresses that there is still a lot to do for the EC and Member States. PensionsEurope calls for them to remove all the remaining barriers to cross-border investment, and particularly:

- More standardization and transparent information would increase pension funds' investments in alternative investments, such as: non-listed companies, private equity and debt, real estate, and infrastructure;

- The upcoming code of conduct on withholding tax (WHT) relief principles should be ambitious and PensionsEurope would also welcome a Directive in this field.

PensionsEurope highlights that legislation should never discourage long-term investments. Therefore, imposing inappropriate quantitative measures or capital requirements on pension funds, or imposing a short term risk free discount rate to value their liabilities would have negative effects on pension funds' investment capabilities. Furthermore, because of negative consequences to the real economy and pensions, a Financial Transaction Tax (FTT) should not be introduced, or at least pension funds should be fully excluded from it.

As promoter of workplace pensions, PensionsEurope invites the EC to investigate how to increase the good implementation of the IORP II Directive in countries with low or no workplace pensions.

1. **Question: Are there additional actions that can contribute to fostering the financing for innovation, start-ups and non-listed companies? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.**

It is important to note that start-ups are not a mainstream investment area of European pension funds. More standardization and transparent information constitutes would be important to increase alternative investments made by pension funds (e.g. investment in non-listed companies such as SMEs, private equity and private debt, real estate, infrastructure). The creation of specific alternative investment categories combined with the development of a common minimum set of comparable information for credit reporting and assessment, as well as the standardization of such information would represent a fundamental step to support investments (in terms of both availability and costs). A European data base of non-listed companies seeking funding, administered by a central institution such as the European Investment Bank (EIB) could also be helpful.

Venture Capital and Private Equity investments (although not a mainstream investment for most pension funds) are well suited for the stakeholders/trustees of (corporate) pension funds. Next to corporate bonds these investments are related to the real economy, such as SMEs. In general, investment in SMEs will lead to economic growth. Simultaneously this will highlight the benefits of Private Equity and Venture Capital in politics and media. Moreover SMEs are the core engine of the European economy. To stimulate this growth engine it is also important to speed up European-wide harmonization of insolvency legislation.

> Solvency capital requirements at national or at EU level, including the proposed new capital requirements for Norwegian pension funds[2], would reduce incentives for financing innovation. As also EIOPA has noted, solvency capital requirements for pension funds can have significant negative impacts on pension funds, sponsors, and members. They significantly increase pension funds' costs and decrease their possibilities to invest long term in real economy and to contribute to jobs and growth in Europe. Furthermore, they decrease the willingness of employers to provide occupational pension schemes, and therefore, also the future coverage of occupational pension schemes.

1.1. Question: Are there additional actions that can contribute to making it easier for companies to enter and raise capital on public markets? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

Central bank intervention and bank capital requirements have affected corporate bond liquidity which can in turn affect other markets. The ability either to source or provide secondary corporate market liquidity continues to be challenged, especially in stressed market conditions. The net stable funding ratio (NSFR) will increase capital and funding requirements for banks and as a consequence liquidity will decrease as trading and repo activity contract further.

Currently, the liquidity in the real economy is lower than prior to the financial crisis of 2008. The main reason is the decrease of bank financing to SMEs. In part this is also a consequence of prudent financial regulation related to capital requirements of Basel III. A robust and working Capital Markets Union will decrease the dependence of financing SMEs from banks and increase the contribution of more long term and relatively less leveraged (institutional) investors, such as pension funds.

[2] See PensionsEurope's press release: Solvency capital requirements at national or at EU level would have significant negative consequences.

2. **Question: Are there additional actions that can contribute to fostering long-term, infrastructure and sustainable investment? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.**

PensionsEurope recommends looking at policy measures in the following fields: long-term investment, infrastructure investments, real estate, derivatives and sustainable investments. Please find below our members' comments on these areas as well as on other areas not addressed so far within the CMU.

POLICY MEASURES

Regulation shouldn't discourage long-term investment

Imposing inappropriate quantitative measures or capital requirements on pension and imposing a short term risk free discount rate to value liabilities would have negative effects on the investment capabilities of pension funds. These could discourage the development of occupational pension schemes which are important channels of finance for the European economy. Regulation should not unduly lock capital in the pension funds. Furthermore, increasing costs of pension schemes will leave less capital available for investments in the European economy. The European Commission should refrain from adopting EIOPA's proposal for the mandatory use of the 'common framework balance sheet' as a risk management and transparency tool and the call for regulatory responses by the national competent authorities based on it[3], and instead ensure capital requirements do not penalise long-term investment in infrastructure and other long-term assets. PensionsEurope stresses that risk management is essential for IORPs and they regularly carry out their own stress tests and scenario analyses (e.g. Asset and Liability Management studies) as part of their own risk management processes. Furthermore, the IORP II Directive contains a thorough framework for pension funds' future risk management and assessment.

When considering relevant financial market regulations, they ought to take into account the specific characteristics of pension funds. A one-size fits-all approach ignores important differences between markets and market players.

- As a general principle, prudential regulation applying to pension funds should not discourage long-term investments. At the moment, there are many examples of national prudential regulation or supervision that discourages long-term investments, by focusing on short-term liquidity and too strictly regulating ('punishing') illiquid assets. This is not sufficiently in accordance with the nature of the liabilities of pension funds, and may excessively limit asset allocation to long-term investment categories. PensionsEurope therefore calls on the Member States to identify and remove barriers for long-term investment in their national prudential regulation and supervisory frameworks.

[3] See PensionsEurope Position Paper on EIOPA's IORP Quantitative Assessment 2015 and EIOPA's opinion for Risk Assessment and Transparency for IORPs.

- The regulations applying to institutional investors which require a systematic use of a mark-to-market valuation should be reviewed, where they do not, in the best possible way, support long term investments. For example IFRS 9 in its current form is detrimental for equities investments.

- Furthermore, there are examples of unfavourable treatment of long-term investment asset classes such as infrastructure projects in national regulation. Member States could provide tailored solutions for these categories.

- The interaction between the current monetary environment and regulatory frameworks should be considered by Member States. The regulatory framework forces pension funds into holding very substantial allocations to low-yielding government bonds.

- PensionsEurope is concerned with EMIR because it is likely to increase the costs of pensions, and these costs eventually have to be paid by pensioners. As a result, pension benefits will decrease or contributions need to be increased – with negative effects on the economy.

<u>On infrastructure investment</u>

If a pension fund wants to create a portfolio with illiquid assets (such as real estate and infrastructure) currently much time is needed to build it up from the start. This could result in the perception that those investment are too slow to realize returns and too costly to be attractive. Furthermore for large institutional investors, size of a (infrastructure) project matters, therefore there should be enough "big" investment opportunities available across Europe.

Pension funds are already important investors in infrastructure (both directly and indirectly). Specific issues are:

- There is a shortage of high quality operational projects that offer an attractive investment propositions.

- In general, large (well structured) infrastructure projects have little difficulty attracting finance. However, often foreign investors have an edge over European investors.

- Standardization, documentation and data matter – and could make this asset category more attractive (in terms of risk-assessment and costs) for pension funds.

- Political and regulatory risks matter. Often, government policy is important in decisions on infrastructure projects.

Treatment of infrastructure investments within regulatory and solvency frameworks should be appropriate. Furthermore, for pension funds in some Member States a proper framework (e.g. legislation, supervision) for investment in infrastructure is currently missing, which constitutes a serious obstacle for infrastructure investment.

The pension fund sector is very diverse. While in recent years some large pension funds have built in-house capacity with infrastructure investment, especially small and medium sized pension funds face a challenge as they lack the expertise necessary when dealing with infrastructure investments. On the other hand, large pension funds want infrastructure investments to have a certain scale, which is not always there. Because of this diversity, tailored responses are key.

In the UK the Pensions Infrastructure Platform is a good example of how knowledge and experience about infrastructure investments are shared. The advisory hub and technical assistance in the EU Investment Plan could also help.

Furthermore, using a consortium among small sized pension funds reasonably help overcoming some obstacles to the investment in infrastructures, as it allows an adequate mass of assets to be profitably invested, be the place to develop and share skills and know-how and develop economies of scale.

The EU can make a significant contribution by ensuring a strong, transparent pipeline of suitable investment opportunities. This could take the form of a transparent list of infrastructure projects – with the right level of detail required by pension funds to do due diligence and assess the risks or returns in a particular investment opportunity.

Pension funds need to have a stable long-term investment environment. This requires long term stability in public policy. Political risks (i.e. changes in policy with adverse effects on investments) discourage long term investments in the real economy, such as in infrastructure. Policymakers at national and EU level should ensure a stable and regulatory and fiscal framework. The ex-post interventions and changes with respect to parameters can heavily influence on the yields for investors and turn good deals into a loss. Such changes pose serious problems due to the illiquid character of infrastructure investments and the long-lasting and binding commitment of investors to these investments.

On real estate

- Pension funds fall under the tax framework of their home Member State. If they invest abroad, sometimes they are not treated like local pension funds and therefore pay different taxes. This applies also for infrastructure projects with real estate characteristics and creates tax costs and extra spending in consulting, tax advisory, legal services etc.
- In order to pool pension funds and like-minded investors, usually pension funds use tax transparent (“flow-through”) entities. However, there is no consistent tax treatment for these entities in the EU which leads to extra tax costs in the source country.

On derivatives

Pension funds, which are included in the EMIR definition of Pension Scheme Arrangements (PSAs), are long-term investors engaging in long dated derivative instruments to hedge their financial risks and their long-term liabilities in order to limit their investment risk.

As stipulated in the IORP Directive, European pension funds have a legitimate need to use derivatives to manage their financial solvency. Pension funds do not hold much cash. Previously, pension funds could easily access the derivatives market by posting high quality government bonds as margin for derivatives transactions, but as a result of regulatory reform they are now increasingly coming under significant pressure to only post cash as margin, particularly variation margin (VM), not only for cleared trades but also non-cleared trades. The exemption for cleared OTC derivatives should be maintained until a suitable clearing solution has been found. Clearing houses should be obliged to accept non cash solutions. It is of paramount importance to ensure that pension funds can post non-cash collateral in both cleared and non-cleared markets.

A transitional or indefinite exemption from mandated clearing rules is needed within EMIR while the non-cash VM issue remains unsolved for pension funds.

We urge the Commission to provide for a new transitional or indefinite exemption to give more time to explore technical solutions and measures to facilitate them, as Central Counterparties (CCPs) have not yet developed any solutions that would be suitable. Such solutions should "avoid materially adverse effects on pensioners" as set out in EMIR level 1 text and we believe this includes avoiding both disproportionate risks and costs to pensioners.

<u>On banking rules</u>

It is important that pension funds can access the non-cleared markets and post high quality government bond as margin. Currently this is not always possible due to bank capital requirements. Banks are now exerting pressure on pension funds to post VM only in cash for non-cleared derivatives. This has led to a dramatic reduction in the number of banks willing to provide liquidity to pension funds on non-cleared derivatives where pension funds post high quality government bonds as margin. We understand that this is a direct reaction of the banks to both the Basel III leverage ratio and NSFR rules. These rules only recognise cash VM posted to offset exposure in both leverage ratio exposure measure and NSFR derivatives asset calculations.

While some banks are still open to providing liquidity for pension funds posting high quality government bond as collateral, we are concerned that it will only be a matter of time before even the few remaining banks stop providing this.

As a result, pension funds are facing the same cash VM issues within the non-cleared regime as within the clearing regime.

The leverage ratio and net stable funding ratio (NSFR) rules must recognise high quality government bond margin with appropriate haircuts to be equivalent to cash margin. While European Commission has amended in the last months the NSFR rules as part of its CRR II package, the leverage ratio rules have not been amended yet to address this issue.

To this end PensionsEurope urges the Commission to amend the leverage ratio within the Capital Requirement Regulation (CRR) II package as the current rules push banks to request cash as variation margin.

The leverage ratio framework impacts pension funds through the way it recognizes cash in favor to high quality government bonds. Currently, high quality government bonds are not on an equal footing with cash in the leverage ratio rules. This can be harmful for pension funds that use government bonds to obtain short term funding through the repo market, resulting in lower liquidity and higher costs.

<u>Sustainable investments:</u>

Sustainable investment should be at the "heart" of the Capital Markets Union. Furthermore, it would be helpful to have policies in place that address the European transition to a low-carbon and climate resilient economy. Within the Capital Markets Union this could include policies on greater disclosure of climate related risks by both companies and financial institutions and integrating this information into relevant risk management frameworks that are also used for investment and regulatory purposes.

In this respect, PensionsEurope welcomes the establishment of the High Level Group for Sustainable Finance.

The role that ESG factors play in the investment decisions of investors can be diverse as there is a wide interpretation of what 'ESG' means across pension funds and the wider investment community. Including ESG factors in investment decisions can take different forms, e.g. screening, integration, engagement.

Social returns are not a substitute for financial returns, but some funds express an ambition to generate social returns without compromising financial returns.

<u>On the call for evidence</u> – The cumulative impact of EU financial legislation on pension funds is very cumbersome and not appropriate.

For example, given the multiple layers of definitions in the benchmarks regulation, the perception is that the use of a customized benchmark - where one draws upon an existing benchmark with the ability to adjust certain elements in order for it to better fit clients' needs- could result in the <u>user</u> simultaneously qualifying as administrator. This could happen where - for instance - a pension fund is using a custom region-weighted equity benchmark (40% Europe, 40% US, 20% rest of the world) or applies a tailor-made currency hedge to the benchmark.

<u>Costs</u>

The level and fee structures of funds are more and more important to an investor in a low yield environment. Investing through a commonly used Fund of Fund (FOF) structure has unfortunately disadvantages. It's one of the most expensive ways to invest, because of its double layer of fees. These are costs to the fund manager, but also the manager of different types of underlying funds. Furthermore, investing through "Initial Public Offering" is burdened by costs from accompanying banks and other transition parties. These costs are relatively high at the time the company is sold to the public.

<u>Finally promotion of occupational pension provision in Member States</u>

As promoter of workplace pensions, PensionsEurope would invite the European Commission to investigate how to increase the good implementation of the IORP II Directive in countries with low or no workplace pensions. For the already mentioned advantages of pension funds being long-term investors, a European pension fund market would certainly help to make the Capital Markets Union a success. To this end the high level group on pensions as stipulated by the IORP Directive could take a leading role to help spreading the setting-up of sound funded supplementary pension systems in Europe taking into account the national pre-conditions. Some countries as France and Germany have already proposed or are proposing new laws on funded pensions. Countries with mature occupational pension systems such as the UK, Ireland and the Netherlands could help other countries in their quest towards multi-pillar pension systems that would in addition be supportive of more investments in the European economies. PensionsEurope is certainly ready to provide its expertise and advise to the European Commission in this respect.[4]

4. **Are there additional actions that can contribute to fostering retail investment? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.**

PensionsEurope would like to stress the difference between retail financial services and occupational pensions. Occupational pensions are a social benefit negotiated by the employer directly with the provider and offered to the employees. As laid down in the IORP II Directive[5], pension funds are therefore first and foremost institutions with a social purpose, and they should not be treated as purely financial service providers.

When it comes to pension funds' costs, the research has shown that focusing on cost alone may ultimately result in poorer investment outcomes for pension savers. Therefore, focusing purely on costs is not enough. Investing in more complicated investment products can be more costly, but at the same time it can lead to higher returns.

The main purpose of pension schemes is to provide a retirement income for the individual member, while maximising the investment return. Next to the asset side of the balance sheet, the liabilities are also important - as well as longevity trends/risk, interest rate (for conversion into pension/annuity), and inflation. The liability matching, risk appetite, diversification, regulatory requirements or any of the other factors that go into investment strategy need to be considered.

Pension funds do not involve a bilateral contractual relationship between a consumer and a service provider, which characterises Retail Financial Services. We thus believe that the Green Paper on Retail of Financial Services should not address occupational pensions as they are not part of retail financial services.

That being said, PensionsEurope welcomes the European Commission's works on an EU initiative in the field of personal pensions as a way to increase the overall pension savings and also as one of the building blocks of the Capital Market Union.

PensionsEurope promotes good pensions for the people in Europe in different shapes and forms. Most of the retirement income is and will continue to be provided by social security pensions and workplace pensions but voluntary personal pensions are and may be particularly needed and useful for those who don't have access to workplace pensions (new forms of employments) or where personal pensions offered are not reliable or attractive. At the same time PensionsEurope calls for

[4] See Design Principles for good DC Design and the upcoming paper on good workplace pensions.
[5] See DIRECTIVE (EU) 2016/2341 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, Recital 32.

the European Commission to promote occupational pension systems and sharing of best practice examples between countries.

The impact of any EU initiative on personal pensions is likely to depend on the maturity of the markets: It would be useful serving as a model for EU countries currently building up their complementary pension savings system and could also help enhancing the quality of products in more developed markets by introducing sort of a EU label.

PensionsEurope believes that a standardized pan-European personal pension product regulated by a second regime - with a defined set of flexible elements - could contribute to the policy objectives of ensuring of high minimum standard of consumer protection while fitting into national context. It appears as a much more feasible way and would promise superior outcomes than harmonizing regimes.

PensionsEurope believes that the attractiveness of personal pension products will depend on the tax treatment it will receive compared to other products. A personal pensions initiative must respect the exclusive competence of the Member States in the field of taxation and of statutory public pensions.

5. **Question: Are there additional actions that can contribute to strengthening banking capacity to support the wider economy? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation**

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6. **Question: Are there additional actions that can contribute to facilitating cross-border investment? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.**

Withholding tax procedures

The obstacles with the withholding tax (WHT) procedures pose a major barrier to cross-border investments in the EU and to build the Capital Markets Union[6]. In order to boost the economic growth in the EU, PensionsEurope calls on the European Commission to remove all the WHT barriers to cross-border investments. This means that the EU Member States shall respect the case-law of the Court of Justice of the European Union, reciprocally and automatically recognize pension funds, and simplify their WHT processes.

A large number of practical problems with the WHT refund processes still exist in spite of the EFTA judgment “Fokus Bank” (2004) and the case law of the Court of Justice of the European Union i.e. “Denkavit” (2006), “Amurta” (2007), “Aberdeen” (2009), and “Santander” (2012). The above-mentioned cases have shown that the WHT practices in many EU Member States are discriminatory with respect to dividends earned by foreign funds, and therefore, contradicting the European law.

[6] See PensionsEurope position paper on the withholding tax refund barriers to cross-border investment in the EU.

The WHT refund processes are complex, expensive, and long-lasting. Often they can last even 10 years and cost half of the expected refunds, as costly tax advice in foreign languages is needed. Since the legal outcomes are uncertain, given that the legal recourse involves several levels of jurisdiction, often pension funds do not assert their justified reclaims. Therefore, PensionsEurope calls on the EU Member States to ensure simple, transparent, and inexpensive WHT refund processes.

PensionsEurope emphasizes that relief-at-source systems for the WHT are the most effective way to promote cross border investment and therefore calls upon the EC to study the possibilities for a Directive to facilitate this, for amongst others pension funds, in the internal market. PensionsEurope adopted in December 2016 a Position Paper on the EC's Code of Conduct for relief-at-source from the withholding tax procedures[7].

Meanwhile, the EC's code of conduct should be ambitious and it should not only list the best practices in different Member States, but it should also contain (i) clear deadlines, (ii) a list of the questions that the authorities are entitled to ask from pension funds (and which not), and (iii) clear procedures how authorities should handle the information in order that procedures are not too long and burdensome for pension funds. Furthermore, Member States should make a strong political commitment to respect the code of conduct.

Furthermore we urge the Commission not to delay the work on the study on discriminatory tax obstacles to cross-border investment by pension funds and life insurers which results are expected in September 2017.

FTT

PensionsEurope calls upon the Commission and Member States to refrain from developing a Financial Transaction Tax (FTT), because of the extra costs it would impose on pension scheme members. This implies either lower benefits or increasing contributions by employees or employers (which will also have negative effects on the economy). In case of introduction, we call for a full exemption for pension funds. Furthermore; an FTT, if implemented, will not only be detrimental to pension funds but for the entire European capital markets. In fact, the introduction of an FTT would have adverse impacts in the attractiveness and competitiveness of the European capital markets, both to international and EU investors.

Discriminatory tax treatment

Even though the EU legislation prohibits discrimination of foreign investors, this practice still occurs in various Member States. Often long and costly judicial procedures influence not only on pension funds' investment decisions regarding in which country to invest, but also regarding the structure of investments, e.g. direct or indirect. An example in the field of real estate:

• Pension funds fall under the tax framework of their home Member State. If they invest abroad, sometimes they are not treated like local pension funds and therefore pay different taxes. This applies also for infrastructure projects with real estate characteristics and creates tax costs and extra spending in consulting, tax advisory, legal services etc.

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[7] See PensionsEurope Position Paper on the EC's Code of Conduct for relief-at-source from the withholding tax procedures.

• To pool pension funds and like-minded investors usually tax transparent (“flow-through”) entities are used. However, there is no consistent tax treatment of these entities within the EU, which would lead to extra tax costs in the source country;

• Current practice: indirect investments that creates tax costs (based on current legislation but also due to the expected tax rules in the OECD initiative BEPS and the proposed rules in the EU Anti-Tax Avoidance Directives) and extra spending on consulting, tax advisory and legal services. Non-CIV discussion in BEPS initiative as pension funds use externally managed funds to invest in EU real estate. Clarity should be provided how the new tax rules under BEPS and ATAP work for Non-CIV vehicles and the investment structures they use. Preferred two options in this respect: 1) full tax transparency for Non-CIV vehicle that holds the real estate/property company directly (so pension funds can make use of their tax status directly) or 2) make use of an EU based platform company under the Non-CIV vehicle, which meets the substance requirements and holds the buildings/property companies.

Another important topic to mention is data and valuation:

In order for an investor to be able to analyze return and risk of an investment (project) the value of the investment has to be appropriately estimated. However, due to a lack of (relevant) data(platforms) it is not always possible to make a sufficient value assessment. This hampers investment. Agreements and policies on what information to report, where to centralize it, and how to disseminate are therefore necessary. However, it is important to note that extensive reporting requirements will not work. Therefore, it is essential to define the data requirements as efficient as possible by using working groups of companies, data providers and investors.