PensionsEurope Position Paper on EIOPA 2019 IORP Stress Test

March 2020

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1. Summary and key messages

- We would like to thank EIOPA for the constructive dialogue with PensionsEurope again on the EIOPA 2019 IORP stress test exercise. We have appreciated it, and we look forward to continuing the dialogue with EIOPA to further define its stress testing methodology in order to improve future stress tests.
- The results of the 2019 stress test show that the EEA pension sector is, on average, better funded in the baseline compared to previous exercises. In the baseline scenario under the national methodologies, the aggregated assets exceeded liabilities. Also, in the baseline scenario of Cash Flow Analysis (CFA) based on expected returns, IORPs in all the participating Member States are well funded. That is a major outcome of the stress test exercise, and we regret that EIOPA did not make explicit reference to that in the report.
- The results confirmed again IORPs' countercyclical behaviour and their important role in stabilising financial markets. As long-term investors, IORPs are able to mitigate financial shocks and collectively work as a stabilising factor for the financial sector.
- Good risk management is very important for running IORPs, and appropriate stress tests can have added value in assessing IORPs' risks and the impact on their financial stability. PensionsEurope is happy that EIOPA used the CFA approach to assess the financial position of IORPs, as it sheds new and, importantly, more relevant light on the financial position of DB and hybrid schemes. It gives greater insight into the timing and size of cash flows and can be related to economic indicators such as GDP and consumption.
- Also, the EIOPA stress test report highlights that the applied, extended CFA (compared to 2017) provided important insights into the effects of the stress on sponsors, members and beneficiaries. As EIOPA correctly notes in its report, the CBS cannot provide such useful information e.g. on the timing and allocation over time of the balance sheet items. In general, EIOPA could have focused more on CFA in its stress test report.
- When developing CFA further, the contract boundaries need to be the starting point, taking into account the heterogeneity across the EEA. The CFA approach based on 'going concern' IORPs, which was used by the Dutch IORPs participating in the 2019 stress tests (and also by IORPs in a few other EU member states), produces the most complete picture of the impact of shocks for the Dutch market. For other countries, a 'going concern' approach is not appropriate/applicable for many IORPs (they have very different situations also in one country). We strongly urge EIOPA to acknowledge this and ensure that also future stress tests take this into account.
- ESG analysis should be developed further based on scientific facts and EIOPA should take the new developments on sustainable finance into consideration.
- We would be happy to work with EIOPA to further develop its IORP stress testing methodology, particularly the CFA part. Furthermore, we would appreciate it if any research/analysis that EIOPA does on its own, based on quarterly data, is discussed and shared with the pension sector before being published.

2. Introduction

We would like to thank EIOPA for the constructive dialogue with PensionsEurope again on the EIOPA 2019 IORP stress test exercise[1]. We have appreciated it, and we look forward to continuing the dialogue with EIOPA to further define its stress testing methodology in order to improve future stress tests.

The results of the 2019 stress test show that the EEA pension sector is, on average, better funded in the baseline compared to previous exercises. In the baseline scenario under the national methodologies, the aggregated assets exceeded liabilities. Also, in the baseline scenario of Cash Flow Analysis (CFA) based on expected returns, IORPs in all the participating Member States are well funded. That is a major outcome of the stress test exercise, and we regret that EIOPA did not make explicit reference to that in the report[2]. Furthermore, it is important to note that also in the adverse market scenario (according to national valuations) funding ratios were above 100% in the large majority of Member States.

PensionsEurope is not surprised by the results. The 2019 stress test used the relatively challenging end-2018 as the reference date and applied a substantial shock, particularly to equity related investments on top of that. As some of the major stocks indices fell sharply in the autumn of 2018 - suffering one of the worst declines since the 2008 financial crisis - an additional shock in the stress scenario had a significant impact on the results: a “double whammy”.

It is clear that EIOPA’s severe stress scenario leads to lower funding ratios. If this unlikely severe scenario would happen, it would of course have impacts on stakeholders in the form of higher contributions and (where domestic provision allows benefit reductions) lower benefits. In many Member States, sponsor(s) would have to pay higher contributions, and in some situations, this could also be the case for members. Some Member States would grant a lower level of indexation or would, where permitted, cut benefits even those in payment.

The results of the DB/hybrid and the DC stress tests were each strongly influenced by only one Member State: DB/hybrid by the Netherlands and DC by Italy. Given the continuing shift from DB to DC, EIOPA is considering a horizontal approach to align the DB/hybrid and DC parts of the stress test in order to make the future IORP stress tests more relevant. We would hope that EIOPA will acknowledge that the differences between DB and DC will lead to different methodologies being most relevant to assess DB and DC taking each of their specificities into account and that, consequently, harmonisation of methodologies will be difficult. PensionsEurope stands ready to cooperate with EIOPA and the National Competent Authorities (NCAs) to share our expertise and experience, to see how and to what extent a horizontal approach can be achieved.

[1] In 2019, EIOPA performed the third Europe-wide stress test on IORPs. 176 IORPs from 19 Member States participated in this exercise, the objective of which was to assess the resilience of IORPs to an adverse market scenario, and to analyse the second-round effects on the real economy and financial markets.
[2] See EIOPA 2019 Institutions for Occupational Retirement Provision (IORPs) Stress Test Report (December 2019).

The burden to participating IORPs was slightly lower for those IORPs that participated in the 2015 and 2017 exercises. However, for IORPs participating for the first time, the burden was significant and represents a material cost. For DB and hybrid schemes, having to run both the Common Balance Sheet (CBS) and CFA makes the stress test more burdensome. In general, it was helpful that EIOPA gave slightly more time for participating IORPs, even though extra time in some cases was still needed.

PensionsEurope agrees with many positions and concerns of the OPSG Advice on the IORP Stress Test 2019[3], particularly on the numerous benefits of CFA compared to CBS. PensionsEurope also agrees that vulnerability of plan members to adverse scenarios should ideally be seen in conjunction with first pillar pension entitlements. Furthermore, we do not see either the benefits of publishing the individual names of participating IORPs. As the OPSG stresses, this may in addition put pressure on these IORPs to publish at least parts of their stress test results, which cannot be the aim of a consolidated pan-European stress test exercise having a macro-prudential background. The OPSG continues that it may also confuse members and sponsors of the IORPs if the pan-European stress test leads to different results than the national stress tests, which exist in many countries.

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 (including the results of the ESG-part). Our intention in providing this feedback is to help improve the relevance and efficiency of future IORP stress tests.

3. General remarks on the methodologies and results of the EIOPA IORP stress tests

DB part

Common Balance Sheet is not appropriate for stress testing IORPs

The 2019 stress test for IORPs reconfirms in our view the inherent limitations of the concept of the CBS. As outlined in our earlier position papers[4], the CBS is not an appropriate instrument to cover the wide range of diversity of IORPs in Europe as it has many shortcomings. By way of examples, the CBS (i) is too complex, (ii) market consistent valuations in the CBS are unreliable and too dependent on arbitrary assumptions and approximations/simplifications, (iii) contains the misconception that option values (e.g. of benefit reductions) should be considered as expected values, and its execution is too expensive.

Contrary to the CFA, the CBS looks only at (an approximation of) market values and does not take into account future developments indicating the likelihood, timing and severity of events. Furthermore, CBS is incapable to include ESG, liquidity and other risks, whereas these can be assessed using CFA.

[3] See the OPSG Advice on IORP Stress Test 2019 (3 February 2020).

[4] See PensionsEurope Position Paper on appropriate IORP stress testing methodology and EIOPA IORP Stress Test 2017, PensionsEurope Position Paper on EIOPA's IORP Stress Test 2015 and PensionsEurope Position Paper on EIOPA's IORP Quantitative Assessment 2015 and EIOPA's opinion for Risk Assessment and Transparency for IORPs.

According to EIOPA, *"Adverse scenario would wipe off almost one quarter of the investment assets' values in the sample, totalling EUR 270 billion."* We question how meaningful a number that is because of the various shortcomings of the EIOPA Common Framework/CBS. The present value of benefit reductions is not the value of possible benefit cuts in year one, but of all possible benefit reductions into the future (something similar is the case for sponsor support if and when calculated on a risk neutral basis). Relating that to this year's GDP instead of the GDP of all relevant future years will give an inappropriate picture and lead to incorrect conclusions. To analyse its impact on the real economy, EIOPA could have, at least, compared that number for instance with the aggregated GDP of the participating Member States. Furthermore, EIOPA states that *"Market risks under the adverse scenario would lead to substantial benefit reductions and increase of sponsor support."* However, the benefit reductions would have to take place in one Member State only and these will be spread out over various years, thereby limiting the impact on financial stability.

IORPs' policies are stabilising and countercyclical

Based on their national supervisory frameworks[5] (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 scope for long recovery periods, IORPs effectively mitigate financial shocks and do not transmit these to other financial institutions[6].

EIOPA concluded in the 2015 stress test report that IORPs' investment behaviour was on aggregate and on average countercyclical. In 2017, EIOPA e.g. noted that many IORPs follow a buy-and-hold strategy, and consequently alleviate selling pressure during stressed market conditions.

The results of EIOPA's 2019 IORP stress test confirmed again IORPs' countercyclical behaviour and their important role in stabilising financial markets. As long-term investors, IORPs are able to mitigate financial shocks and collectively work as a stabilising factor for the financial sector. IORPs' long-term investment horizon and their ability to follow countercyclical investment strategies support the observation 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, but buying these to rebalance their strategic asset allocation. The 2019 results support the results of EIOPA's previous IORP stress tests and confirm that IORPs have rebalancing asset strategies, buying equity related investments after they dropped. It is in our opinion therefore important that both EU and domestic legislation continues to allow IORPs' countercyclical behaviour.

Assuming a risk-free return in the CFA and applying a shock is an unrealistic double hit scenario. If acted upon, such assumptions might prevent IORPs from long-term investments into sustainable real assets, which seems counter to the aims of the CMU.

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[5] 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 projection of the national balance sheets/ statements of income.

[6] See also Beetsma, R., Maurik, R. van, Vos, S.J. en C. Wanningen, Meer Financiële Veiligheid door meer Pensioenbeleggingen, Economisch Statistische Berichten, Vol.103, 136-138 (15 March 2018).

Impact on sponsors relatively modest

EIOPA notes that the impact of the adverse market scenario on the real economy via the burden on sponsoring undertakings is lower than in the previous stress test exercises. It also recognises that a mapping of national recovery mechanisms demonstrated that sponsor support and (especially) benefit reductions may be spread over substantial timeframes.

National law often allows sponsor support and benefit reductions to be distributed over considerable time frames. Distributing sponsor support and benefit reductions over time means that they are not impacting instantaneously to the full extent on the real economy via sponsors and members/beneficiaries and thereby impact financial stability, but that the impact is smoothed over a longer period of time. Therefore, the impact is not as direct and, in particular, is smaller in a given period of time than would otherwise be the case.

PensionsEurope agrees with the OPSG that the market value of sponsor support in the CBS might not always be the right reference for comparison, and that the comparison of cash flows from sponsor support against the sponsors´ earnings, which was also partially done by EIOPA within the report, gives a much better insight into the abilities of sponsors to support the IORPs to the extent needed.

DC part

The results of the DC stress tests were strongly influenced by only one Member State (Italy) and the impact of the shock on DC assets was much smaller than in DB/hybrid. In general, the impact on replacement rates for the three representative plan members was not surprising. Particularly in the case of Italy, the rather modest decrease in the replacement rates in the adverse scenario would not have wider macroeconomic impact as the public (pillar I) pension still represents the bulk of members' income at retirement. Also, the OPSG in its Advice on IORP Stress Test 2019 recognised that the vulnerability of plan members to adverse scenarios should ideally be seen in conjunction with first pillar pension entitlements. PensionsEurope stresses that it is out of the scope of EIOPA to access in any way the role of first pillar pension entitlements.

The computations on the three representative plan members replacement rates can cause concerns and misunderstandings for plan members who could reflect on the difference between their Pension Benefit Statement and the stress test results. We therefore ask EIOPA to consider carefully if the way in which the second-round effects are currently assessed for DC schemes is the best way to work on the task. Furthermore, the hypothesis used to perform the stress test for the long run (35 and 20 years away from retirement) does not appear completely feasible. A possible solution to further explore the second-round effects may be represented by the potential investment reactions to the adverse market scenario. This suggestion could also be taken into account for the future work to define the envisaged horizontal approach for DB/hybrid an DC IORPs proposed by EIOPA for the next stress test.

ESG part

In this year's exercise, EIOPA also explored the integration of ESG factors by IORPs. According to the results, the majority of IORPs have integrated all three ESG factors. PensionsEurope Member Associations and the pension funds they represent expect that the share of sustainable investments will continue increasing in the coming years. In general, ESG investments are becoming more and more mainstream, and there is an increasing awareness and interest in ESG consideration amongst pension funds and asset managers.

In its report, EIOPA notes that "less than 20% of the IORPs in the sample currently assess the impact of ESG factors on risks and return". However, it is important to note that in terms of assets, the impact of ESG factors on risks and return has been considered in the clear majority of the IORPs' assets.

EIOPA also notes that the average carbon footprint of IORPs' equity investments exceeds the average greenhouse gas intensity of all economic activities in the EU, while the average carbon footprint of debt investments is lower. However, clearly, the stress test outcomes do not provide a thorough picture of IORPs' ESG investments because of (i) various general shortcomings of NACE (for instance, it focuses too much on the main economic activities by ignoring the other activities),(ii) its shortcomings (for instance, it is not representative for portfolio[7]) to be used in stress tests, and (iii) the average carbon footprint of IORPs' equity related assets exceeds the average footprint of all economic activities in the EU and their return is needed to reach the ambition for a good pension at a reasonable price and acceptable risks. EIOPA should have considered IORPs' ESG involvement in a wider approach as IORPs (and the other financial intermediaries) also exercise their ESG policy in the domains of Social and Governance.

EIOPA's reporting formats deviate from national standards

The format of the assets that EIOPA uses in its stress test deviates from that used by the NCAs in their national reporting standards. This leads to extra costs in performing the stress test without getting better information on financial stability. It could also lead to (slightly) different conclusions by EIOPA (compared with when a national approach would have been used).

The valuation rules in the EIOPA stress test differ from the new ECB Regulation on statistical reporting requirements for pension funds[8], which highlights that the accounting rules are laid down in the relevant national laws implementing the IORP II 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 new regular information requests to NCAs regarding provision of occupational pensions information[9], 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. The future IORP stress tests should benefit from (and be aligned with the requirements of) the above-mentioned new reporting requirements of the ECB and EIOPA itself.

[7] IORPs can have investments in sectors with completely different footprint than NACE codes implies (e.g. only investing in 'green' part of sector) or IORP strives to make brown assets green via engagement or impact investing.

[8] See the Regulation (EU) 2018/231 of the ECB of 26 January 2018 on statistical reporting requirements for pension funds (ECB/2018/2).

[9] See the Decision of EIOPA Board of Supervisors on EIOPA's regular information requests towards NCAs regarding provision of occupational pensions information (10 April 2018).

4. We are ready to co-operate with EIOPA to further develop ESG and CFA (for DB/hybrid)

Cash flow analysis should be developed further

Good risk management is very important for running IORPs, and appropriate stress tests can have added value in assessing IORPs' risks and the impact on their financial stability. PensionsEurope is happy that EIOPA used the CFA approach to assess the financial position of IORPs, as it sheds new and, importantly, more relevant light on the financial position of DB and hybrid schemes. It gives greater insight into the timing and size of cash flows and can be related to economic indicators such as GDP and consumption. In its 2017 IORP Stress Test report, EIOPA included an analysis of the internal rate of return in baseline scenario expressed as effective risk premium over effective risk-free rate. For future stress tests, EIOPA could include that analysis again, possibly with the required excess return approach as indicators of the sustainability of the (funding of) pension agreements. These two extensions would allow clearer insights into the potential macroprudential risks stemming from IORPs.

Also, the EIOPA stress test report highlights that the applied, the extended CFA (compared to 2017) provided important insights into the effects of the stress on sponsors, members and beneficiaries. As EIOPA correctly notes in its report, the CBS cannot provide such useful information e.g. on the timing and allocation over time of the balance sheet items. In general, EIOPA could have focused more on CFA in its stress test report.

When developing the CFA further, the contract boundaries need to be the starting point, taking into account the heterogeneity across the EEA. The CFA approach based on 'going concern' IORPs, which was used by the Dutch IORPs participating in the 2019 stress tests (and also by IORPs in a few other EU member states), produces the most complete picture of the impact of shocks for the Dutch market. For other countries, a 'going concern' approach is not appropriate/applicable for many IORPs (they have very different situations also in one country). We strongly urge EIOPA to acknowledge this and ensure that also future stress tests take this into account.

Finally, we would like to note that assuming a risk-free return in the CFA and applying a shock is an unrealistic double hit scenario. If acted upon, such assumptions might prevent IORPs from long-term investments into sustainable real assets, which seems counter to the aims of the CMU.

ESG analysis should be developed further based on scientific facts

The future EIOPA IORP stress tests should take consideration of the new developments on sustainable finance. The disclosure and taxonomy regulations will require IORPs to disclose extensive ESG information when funds promote environmental and social objectives. ESG information on pension funds will be screened on the basis of ESG data disclosed by investee companies under the forthcoming non-financial reporting requirements that will be defined soon, through a review of the respective Directive. Any unnecessary additional burden in terms of ESG data reporting should be avoided in order to minimise the costs of the exercise. It is also important to ensure full transparency on the use of the ESG data and inform IORPs about any potential ad-hoc analysis based on the data.

In general, we urge EIOPA to objectively consider the merits of applying quantitative climate stress scenario. While climate science is developing, there will always continue to be uncertainty about how it will affect the economy, as climate policy and regulation will be potentially the most crucial factor impacting the market valuation of investee companies. Methods should be tried and tested before being imposed at a sector-wide level. The basis of any climate stress test should remain the mandate provided by the EIOPA Regulation and not the wider policy objectives of the European institutions. If deemed necessary, the test should be designed in order to provide insight into the impact of a realistic and science-based scenario on the financial position of pension funds and the tone of communication of the results should be commensurate to the level of uncertainty such a test would unavoidably entail.

We are ready to provide our expertise to EIOPA to improve its ESG stress testing methodology in the future, and we also believe that the new EU legislation on ESG taxonomy and disclosure, if implemented on an adequate and balanced manner (in the context of which PensionsEurope is prepared to cooperate with the European Commission and the ESA's) might be helpful and useful for that purpose.

Significant heterogeneity across European IORPs: NCAs should continue to have the 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 pension funds in Europe. IORPs are subject to national social and labour law. As a consequence, the supervisory frameworks of IORPs across Europe vary from Member State to Member State including capital requirements and steering mechanisms. There are major differences between second pillar pensions in the Member States. The natural home of micro-prudential supervision is at the NCAs, whereas EIOPA should have a more important role to play in macro-prudential supervision from the perspective of financial stability.

Going forward

We look forward to continuing the dialogue with EIOPA to further define its stress testing methodology, particularly the CFA (for DB/hybrid) part, in order to improve future stress tests. This is, from the perspectives of both EIOPA and IORPs, by contributing to financial stability and for IORPs themselves by ensuing that the stress tests are carried out as efficiently as possible (and so, minimising costs). Furthermore, we would appreciate it if any research/analysis that EIOPA does on its own, based on quarterly data, is discussed and shared with IORPs before being published.

We welcome that EIOPA will conduct the next IORP stress test exercise in 2022 instead of 2021, and that EIOPA will hold a consultation on improving its IORP stress testing methodology in 2020. We look forward to continuing to exchange views and sharing our ideas with EIOPA on improving the methodology.