



PensionsEurope input to the ECB review of its monetary policy strategy

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1. Introduction

We welcome the ECB review of its monetary policy strategy which has undergone a process of gradual transformation since it was adopted in 1998 (and some of its elements were clarified in 2003). Today the euro area is facing various new economic challenges, such as the COVID-19 crisis, and there will be many new challenges to overcome in the upcoming years which need to be jointly tackled by monetary, economic, and fiscal policies.

Recently we have observed interesting discussion about Modern Monetary Theory and changing monetary policy strategies by several Central Banks. For instance, the Federal Reserve just importantly decided that it will make job growth pre-eminent and will not raise interest rates to guard against coming inflation just because the unemployment rate is low. As despite negative interest rates and QE programmes the ECB has not achieved its inflation target over the last years, possibly also the ECB could be more flexibility around its inflation target and consider targeting price growth in a band, in full respect of the ECB's price stability mandate as enshrined in the Treaty.

In general, we believe that unconventional monetary policies have had effect in many areas, including various positive and negative side effects. This applies for the economy at large, as well as for pension funds more specifically in the form of preventing a (severe) recession, realising relatively good returns but also substantially more expensive liabilities.

Pension funds have long-dated liabilities (usually pension funds' participants have annuity/lifelong payments which have long duration) and typically hedge a part, but not all their interest rate risk. Some countries require Mark-To-Market (MTM) valuation of liabilities of pension funds which entails a strong impact of interest rates on liabilities, leading to interest rate sensitivity of the liabilities and of the funding ratio (assets divided by liabilities)¹. Lower interest rates increased the value of the liabilities, often more than the increase in value of their assets². Pension funds therefore manage their funding level through interest rate hedging, but must weigh it against long-term return considerations, resulting often in policy to hedge a significant part but not all the interest rate risk. Consequently, their funding ratios become increasingly difficult to maintain, increasing pension inadequacy risks (predominantly for future generations)³. Many pension funds have been forced to increase their interest rate swap portfolios to maintain their interest rate coverage ratio level. Furthermore, there is (artificial) high demand (by the ECB/APP) for very safe long-term bonds which exacerbates the situation.

Even though the impact of interest rates on funding levels is a problem of defined benefit (DB) funds, defined contribution (DC) funds experience similar problems. DC pension funds do not have defined

¹ Also when MTM valuation is not imposed by prudential regulation, there is usually still a link to market rates (for instance, Germany has lowered discount rates various times in line with declining interest rates). In expected returns and supervision market rates do play a role.

² In the Netherlands, which discounts pension liabilities using a risk-free rate, a 100 bps drop in the rate results in a 12% drop in the funding ratio. Source: Netherlands Bureau for Economic Policy Analysis, 2016, [link](#).

³ Also, lower interest rates decreased pension funds interest rate coverage ratios further.

liabilities and experience gains in the value of their bond holdings from the falling interest rates. However, within the present investment environment it is becoming increasingly difficult to obtain returns for adequate pensions based on what previously were considered reasonable contribution levels. Furthermore, when DC pension fund participants purchase an annuity with their DC savings, they find the annuity far more expensive because of low or negative interest rates, so the risks for members are similar to those of DB funds with MTM. Therefore, in both DB and DC pension systems the contributions must be increased to meet adequate retirement ambitions.

On 12 September 2019, the ECB i.a. decided that in order to support the bank-based transmission of monetary policy, a two-tier system for reserve remuneration will be introduced, in which part of banks' holdings of excess liquidity will be exempt from the negative deposit facility rate. We are concerned (i) about compensating retail savers but not (institutional) pension savers participating in pension funds, and (ii) that monetary policy is making a distinction, for the purpose of compensating citizens, between people who put their pension savings on a bank account and people enrolled into a pension scheme, effectively encouraging saving on bank deposits.

COVID-19 disclaimer: We understand the recent extraordinary measures by the ECB to mitigate the impact of the coronavirus pandemic. After the world has (completely) returned to 'new normal', we might finetune some of our comments and positions.

2. PensionsEurope answers to the ECB questions

What does price stability mean for you?

The main contribution central banks can make to improving people's welfare is to maintain price stability. If the rate of inflation (the rate at which consumer prices increase on average from one year to the next) is low and stable, this situation is consistent with price stability. We currently aim at an inflation rate below, but close to, 2% over the medium term.

1. How do changes in general price levels affect you/your organisation and your members?

PensionsEurope answer:

The ultimate beneficiary is the pension scheme participant. All losses in asset prices and drops in funding ratio will translate into lower (real) pension benefits and only to a limited extent into higher contributions by sponsors and active members.

The changes in price level affect pension retirement provisions: the higher the price level, the higher the required retirement provision to sustain the purchasing power. The European pension funds often have a "real ambition", which means they provide indexation for inflation should their funding level permit this. However, this means that the required capital goes up if price level increases. If this is not possible and due to high inflation rates the purchasing power of the pension payments is diminished, the retirees will fall on hard times.

2. Are you concerned about either deflation or inflation being too high?

PensionsEurope answer:

We are concerned about too high inflation, as it could jeopardize an adequate (real) old age pension by diminishing the purchasing power. On the other hand, we also are concerned about deflation, because it would probably go hand in hand with very low interest rates. Low interest rate environments are harmful to pension funds' coverage ratios and make benefits (annuities) more expensive.

Pension funds need stability in the financial markets for the long term, as they are long term investors and tend / should buy and hold most investments. Therefore, swings in asset valuations will cause them to rebalance and this creates unnecessary trading costs to the detriment of the pension scheme beneficiaries.

Crucially, pension funds thrive best in a situation of sustained economic growth with 'normal' interest rate (e.g. 2% real and 2% inflation) environment. Currently, we face a low interest rate environment (0% real rate, and around 1% inflation). This is harmful to pension funds, because they need to increase pension premiums and put more effort on finding assets that have a reasonable return for the long term. Those assets tend to be riskier than in a normal interest rate environment. In summary, a low interest rate environment makes pensions saving more expensive and more uncertain.

In general, we find that the ECB may need more flexibility around its inflation target and could consider targeting price growth in a band. Economic fundamentals have changed since the ECB's last review in 2003 and there are now persistent downward pressures on inflation, which make some of the ECB's unprecedented stimulus efforts less effective than it may have been previously. The ECB's review should consider whether the ECB's control over inflation has diminished and how to amend policy if this was proven to be the case.

3. For which types of goods and services do you feel the effects of price changes most?

PensionsEurope answer:

Price changes are especially translated into asset prices via (private) equity valuations, real estate prices and exchange rates (although most pension funds to large extent hedge their currency risks). Pension funds are not only impacted through asset prices, but also through their (interest rate) derivatives portfolios used for liability hedging.

4. When you think about inflation, how relevant do you find the increase in the cost of housing?

PensionsEurope answer:

Consumer-price indices are meant to reflect the cost of typical baskets of goods and services. Unlike in the US, the Euro area's inflation index omits the cost of owning a home: it captures rents paid by tenants, but not the costs of buying and owning property—even though two-thirds of people in the Eurozone own their homes. The ECB's chosen measure captures only marginally the largest single lifetime expenditure of households.

The increase in the cost of housing is relevant to pension funds, especially concerning their investments in the real estate sector. The affordability of rents is a factor in making investment decisions in real estate and will affect the valuation of real estate portfolios.

What are your economic expectations and concerns?

We conduct monetary policy to make sure that the euro holds its value over time. To make our monetary policy as effective as possible, we want to better understand your expectations, as well as your economic concerns.

5. What economic concerns are you/your organisation and your members facing?

PensionsEurope answer:

Currently European and global financial markets are in unprecedented turmoil and our economies have rapidly slowed down. This crisis has a huge impact and consequences on the European citizens and our societies as a whole. Funded pensions are not exceptions as both their assets and liabilities are strongly affected. The stressed financial markets also pose major problems for well-developed pension countries as the value of assets decreases drastically and even lower interest rates further increase the value of liabilities. The Europeans still mainly rely on PAYG social security pensions and low economic growth and lower employment levels together with aging population make these pensions increasingly unsustainable and may well lead to decreasing replacement rates from public social security pensions.

Stability in financial markets is important to pension funds, as they are long-term investors and tend to buy and hold most investments. Therefore, swings in asset valuations will cause them to rebalance and making possible unnecessary trading costs for the long-term.

Secondly, pension funds thrive best in a situation of sustained economic growth with 'normal' interest rate (2% real and 2% inflation) environment. Currently, we face a low interest rate environment (0% real rate, 1% inflation). This is harmful to pension funds because they need to increase premiums and find assets that have a reasonable return for the long-term. A low interest rate environment makes pension savings expensive⁴.

6. How have changing economic conditions affected you in the last decade (for example, how have they affected your prospects of finding a job)?

PensionsEurope answer: -

7. How do low interest rates and monetary policy in general affect you/your organisation, your members and the overall economy?

PensionsEurope answer:

⁴ As an example, in order to pay 100 euro pension income after an investment horizon of 30 years, requires a contribution of 31 euro ($100/(1.04)^{30}$) if the annual return on investment is 4%, but 55 euro ($100/(1.02)^{30}$) if the return is only 2%.

The ECB unconventional monetary policy should help in stabilising financial markets and improving the growth prospects of the European Union. Pension funds have profited from unconventional monetary policy e.g. via higher expected returns, but however, at the same time it has also led to lower funding ratios for DB schemes. Consequently, some sponsors and active members have felt the burden of higher contributions and lower pension accrual (for DB and DC). Members and beneficiaries could not only be confronted with higher contributions, but also with lower pensions and more risks. The unconventional monetary policy could also lead to increased risks in the financial policy of pension funds via distorted risk measuring, could lead to risk-seeking behaviour of pension funds due to the 'search for yield' and there is tension between economics and risk management.

The majority of pension assets in Europe are still held in DB arrangements, but due to low/negative interest rate environment, various economic challenges, and changing demographics (ageing societies and increasing life expectancy) there is a growing trend towards the establishment of DC pension plans for ongoing workplace pension provision. Millions of citizens across Europe already rely upon workplace DC pension plans to supplement the pension benefits that they receive from the state. This number is likely to continue to increase significantly in the coming decades, as employers look for a less risky alternative to DB pension plans and governments across Europe consider ways to help close the gap that is emerging – for economic and demographic reasons - between state pension provision and citizens' income needs in retirement.

In **the Netherlands**, where most of the assets of DB/hybrid IORPs in the EU are, the low interest rates have caused low funding ratios for pension funds, and that is mainly caused due to the regulatory regime wherein pension funds need to value their pension obligations with the market interest rates. The result has been a cut in pension benefits for some pension funds in the recent years, the risks of (substantial) benefit reductions going forward, almost no indexation and increased premiums. Furthermore, low interest rates and lower funding ratios have resulted in higher contributions and lower accrual of new pension obligations. This all in all has resulted in lower trust in pension funds and societal unrest about pensions, especially in the Netherlands.

In general, it is important that adequate conclusions are drawn from the fair-market value of pension funds' assets, for instance when the values of equities drop in a financial crisis. This represents an excellent opportunity for long-term investors to buy, and therefore, pension funds should not be forced to sell when the value of their assets is at the lowest.

According to Report of 'PensionsEurope Pension Funds Statistics and Trends (March 2020)⁵, the envisaged monetary policy is expected to lead to various kind of changes in pension funds' asset allocation in the upcoming years. In Austria, investments in shares, infrastructure, and emerging markets will rise. In Belgium, it is expected that there will be increasing interest in infrastructure and other long-term investments. In Croatia, particularly decreasing portfolio allocation in fixed income is expected.

⁵ See the Report of [PensionsEurope Pension Funds Statistics and Trends](#) (March 2020).

In **Bulgaria**, pension funds have started to observe the impact by increasing pressures to keep acceptable yield levels through minimizing the cash components, extending the duration of the bond and fixed income instruments to find plausible assets. They are concerned by the resulting increased risks in the portfolios since even though state bonds investments increase at the account of reduced corporate bonds, these developments materially uphold the level of the credit risks due to the declining credit quality (i.e. Investments in lower rated government papers and stocks but with acceptable positive yields).

In **Germany**, new investments or reinvestments are generally difficult due to prolonged low interest rate environment. Where possible, DB IORPs (particularly Pensionskassen) are decreasing their investments in euro bonds, while increasing their holdings in investment funds. Many IORPs will try to increase their holdings in alternative assets (real estate, private equity, private debt and infrastructure).

In **Italy**, in the long run, presumably no big changes will occur as pension funds' portfolio has always been largely allocated in bond securities. However, in the short run, it is plausible that duration of portfolios could be extended to benefit from the reduction in interest rates. During the last years there has been increasing interest in illiquid assets (private debt, private equity, and real estate funds) to find for alternative sources of yield. Even though more and more pension schemes have started to invest in them, their total allocation remains small.

In **Switzerland**, on the investment side, the proportion of fixed-interest investments has been reduced in favour of equities and real estate in response to the persistently low level of interest rates. In addition, pension funds are once again becoming increasingly involved abroad and are taking care to hold as little liquid assets as possible - the share of liquidity in total fixed assets is currently at an all-time low.

In **Sweden**, based on the assumption that the low-interest environment will remain, it is expected that pension funds will have an increasing interest in alternative investments, such as private equity, real estate and infrastructure. In **Spain**, prolonged low interest rate environment will probably lead to savers choosing riskier options in their investment preferences. In **Hungary**, pension funds are not expecting significant changes in their investments in public equities in the upcoming years, but they expect that the share of sustainable investments will continue increasing.

Finally, we believe the impact from some past monetary policy decisions on the economy – and on asset prices – has been positive. The low funding costs has helped encouraging companies to take risks, hire people and invest.

What other topics matter to you?

The ECB's main task, its "primary objective", is to maintain price stability in the euro area. However, once price stability is guaranteed, it is the ECB's task to support the general economic policies of the European Union. These include, for example, the sustainable development of Europe based on balanced economic growth, a highly competitive social market economy aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.

8. Do you think the ECB should give more or less attention to these other considerations and why?

PensionsEurope answer:

The ECB's main concerns should be price stability and financial stability also considering the impact on pension funds and their members ('pension savers'). The involvement in general economic policies is only desirable to a certain extent. We believe economic policies should mostly be based on fiscal policy not monetary. Therefore, we think the ECB should give less attention to these secondary considerations and let governments take more of their responsibility.

9. Are there other issues not mentioned above that you think the ECB should be concerned with when setting its policies?

PensionsEurope answer:

The ECB should be concerned with liquidity issues for all financial market participants including pension funds. The focus of the ECB is currently mostly on the banking and insurance sector. However, liquidity needs for other market participants should not be overlooked.

In this respect pension funds have large interest rate derivative portfolios that under EMIR are required to be centrally cleared at clearing houses. However, in times of stress sudden interest rate spikes can cause large liquidity needs at pension funds. Banks have access to central bank liquidity, however pension funds not.

10. How will climate change have an impact on you/your organisation, your members and the economy?

PensionsEurope answer:

Climate change is likely to manifest itself as a long-term risk or value driver of assets and may impact funding levels of pension funds in this manner. Therefore, pension funds strive to invest in a responsible manner, and they are required by law to consider ESG issues in their risk-management.

An increasing number of pension funds is measuring the carbon exposure of the portfolio and some have reduction plans in place. To this end, we already observe divestments from or under-allocation of carbon intense sectors.

How can we best communicate with you?

We know that understanding how monetary policy works helps people make decisions about how to spend, save, invest or borrow money. We would like to find out how successful we have been in explaining what we do and why we do it.

11. To what extent do you feel well informed about the ECB/your national central bank?

PensionsEurope answer:

We feel well informed, although we would appreciate more engagement of the ECB with pension funds.

About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace and other funded pensions. Some members operate purely individual pension schemes. PensionsEurope has **24 member associations** in 18 EU Member States and 3 other European countries⁶.

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 **26 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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⁶ EU Member States: Austria, Belgium, Bulgaria, Croatia, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Iceland, Norway, Switzerland.