PensionsEurope Position Paper on EIOPA's IORP Quantitative Assessment 2015 and EIOPA's opinion for Risk Assessment and Transparency for IORPs

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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 EU Member States and other European countries with significant – in size and relevance – workplace pension systems[1].

PensionsEurope member organisations cover the workplace pensions of about **70 million European citizens.** Through its Member Associations PensionsEurope represents more than **€ 3.5 trillion of assets** managed for future pension payments.

PensionsEurope also has **27 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, 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. General remarks and key messages

- **PensionsEurope welcomes the fact that EIOPA has taken note of some concerns raised by us and by many other stakeholders by proposing that the European institutions refrain at this point in time from introducing harmonised funding or capital requirements for IORPs at the EU level. As EIOPA states, a one-size fits-all regime is not appropriate and would have (potential) significant negative impacts;**
- **EIOPA's Quantitative Assessment exercise (QA) shows that IORPs pose no systemic risk and capital requirements would have significant negative impacts on IORPs, sponsors and members. PensionsEurope stresses that impacts would be very harmful to the real economy as well in the form of higher contributions and lower benefits;**
- **PensionsEurope considers EIOPA's proposal for the mandatory use of a 'Common Methodology' (i.e. the holistic balance sheet (HBS)), to run alongside existing national regulations, impractical, unnecessary, costly, and sometimes even harmful to the market value of some sponsoring undertakings;**
- **PensionsEurope is against EIOPA's proposal that IORPs should regularly calculate the 'Common Framework Balance Sheet' and the standardised risk assessment and report to the national supervisory authorities and the participants on an annual basis. This would increase tension on standards and required information between national supervisors and EIOPA. Furthermore, PensionsEurope is deeply concerned that in the end this would result as an introduction of harmonised capital requirements for IORPs at the EU level through the back door;**
- **PensionsEurope is strictly against EIOPA's proposal for public disclosure requirements, as they would confuse participants instead of providing greater transparency;**
- **PensionsEurope is willing to elaborate further on the shortcomings of the HBS and have a dialogue on these shortcomings. However, PensionsEurope does not see any benefit from EIOPA continuing to work on the HBS model or any other similar 'Common Methodology' or use them in EIOPA's IORP stress tests, as was stated by PensionsEurope in its position paper on EIOPA's IORP Stress Test 2015[2];**
- **The use of the HBS for IORPs could lead to increased demand for insurance products. Sponsors might want to avoid the impact of the HBS on their own (corporate) balance sheet, and therefore, might prefer to use insured plans that do not have the same requirement.**

[2] See PensionsEurope Position Paper on EIOPA's IORP Stress Test 2015

2. Introduction

On 14 April 2016 the European Insurance and Occupational Pensions Authority (EIOPA) published the results of its Quantitative Assessment (QA) exercise and its opinion to the European Commission, the Council and the European Parliament for Risk Assessment and Transparency for Institutions for Occupational Retirement Provision (IORPs). Both of these were EIOPA's own initiative work launched in 2013. PensionsEurope notes that the QA sample contained only 101 IORPs and 41% of assets in six member states: Belgium, Germany, Ireland, the Netherlands, Portugal and the UK.

In its opinion to the EU Institutions EIOPA advises that the IORP Directive should be strengthened with a common framework for risk assessment and transparency for IORPs. **It is, of course, widely known that this recast Directive has been negotiated in the trilogue meetings in the spring 2016. At the same time, EIOPA states that its "opinion is expressly not intended to amend the existing Commission's proposal for the revision of the IORP Directive". PensionsEurope agrees with the Council and the Parliament that the next review of the Directive should take place no sooner than six years after the entry into force of the revision of the IORP Directive.**

Along with many informed commentators, PensionsEurope considers EIOPA's proposal for the mandatory use of a 'Common Framework Balance Sheet', to run alongside existing national regulations, impractical, unnecessary, costly, and sometimes even harmful to the market value of some sponsoring undertakings. In the worst case, it could cause unnecessary confusion without delivering any material benefit to scheme members and scheme sponsors. PensionsEurope is not convinced of EIOPA's arguments in favour of the mandatory use of a 'Common Framework Balance Sheet', as (i) pension schemes are mostly offered at a national level being tied inseparably to national labour, social and tax law, (ii) the number of cross-border IORPs is very limited, and (iii) IORPs and insurers are different institutions with different aims. PensionsEurope **also notes that EIOPA has simply rebranded (without an explanation of the reason of this rebranding) what was the 'holistic balance sheet' as the 'Common Framework Balance Sheet' in spite of the fact that the informed commentators, including PensionsEurope, have advised that the use of the phrase 'balance sheet' can be misleading and despite the many shortcomings of the HBS itself[3].**

PensionsEurope does not support the idea of imposing a mandatory EU-wide balance sheet valuation for IORPs. There is no benefit from squeezing the different national pension systems into an EU-wide 'common framework'. Moreover, there is a tangible and unacceptable cost in doing so. Furthermore, by imposing a mandatory EU-wide balance sheet valuation for IORPs, the IORPs' management would get 'steering signals' that differ

[3] See PensionsEurope position paper on EIOPA consultation paper on further work on solvency of IORPs

from those resulting from the national regulations. EIOPA's argument that a common framework allows comparability across the variety of IORPs in the EU can mislead policymakers as such comparability is spurious and takes no account of the relevance and importance of first pillar (state) pension provision – which differs widely from Member State to Member State.

3. Costs to complete the QA exercise were excessive

PensionsEurope contends that the costs of completing the QA exercise were excessive for all IORPs. As EIOPA required exploring each single individual asset in the portfolio, the cost of analysing and capturing the necessary market data (provided by Bloomberg, Reuters etc.) can be significant. The average cost per IORP of completing the QA exercise was estimated at around EUR 33,000 with some variation across countries and clearly the costs were much higher for bigger and more complex IORPs. Scaling these figures up across all European DB IORPs, EIOPA concludes, would result in an overall annual cost, over and above current valuation costs, of up to EUR 300m to complete the 'Common Framework Balance Sheet' and standardised risk assessment according to the QA technical specifications. Furthermore, the cost estimates only consider the costs for calculating IORPs' figures, ignoring the communication costs to explain these figures to stakeholders, and do not take into account the additional costs for NSAs or additional costs for sponsors in providing data to the IORPs.

Moreover, it should be recognised that in the UK, the NSA permitted IORPs to carry out a much simplified assessment which the NSA then supplemented with its own data. EIOPA's cost estimate is therefore vastly understated. This is particularly relevant given EIOPA's own assessment that the number of affected IORPs in the UK means that 70% of the aggregate cost will fall on IORPs based in the UK.

4. Common Framework Balance Sheet

There are several shortcomings in the use of the HBS, now renamed 'Common Framework Balance Sheet'.[4] The common methodology proposed by EIOPA consists of a market-consistent balance sheet and a standardised risk assessment. **PensionsEurope notes that EIOPA has used the term "standardised risk assessment" instead of "solvency capital requirement".** In the quantitative assessment the pre-defined stressed risk factors were calibrated to a 0.5% probability of occurrence over a one-year horizon. **PensionsEurope notes that this is in line with the Solvency Capital Requirements (SCRs) for (re)insurance**

[4] See PensionsEurope position paper on EIOPA consultation paper on further work on solvency of IORPs and PensionsEurope Position Paper on EIOPA's IORP Stress Test 2015

undertakings which have to ensure that they have enough capital on their balance sheets to withstand a level of stress that is deemed likely to happen only once every 200 years. PensionsEurope finds that an alignment with the treatment of (re)insurers is inappropriate.

PensionsEurope finds that the 'Common Framework Balance Sheet' (HBS) suffers from severe practical problems. Indeed, the EIOPA's QIS study in 2012 showed that in practice IORPs faced great difficulties in providing accurate numbers in response to the technical specifications provided by EIOPA, if available at all. This is due to the unavailability of data requested by EIOPA[5] and the complexity of the methods used. These data might be e.g. market prices for long time horizons, standard deviations and correlations and missing market data like the prices for wage inflation, data from the balance sheet of the sponsoring companies, the P&L statement or the cash flow statement from sponsoring companies etc. The latter makes the 'Common Framework Balance Sheet' (HBS) very sensitive to model and parameter assumptions. It can result in the valuation of the 'Common Framework Balance Sheet' (HBS) changing by tens of percentage points depending on the assumptions used. Moreover, it is important to note that the option values as shown on the 'Common Framework Balance Sheet' (HBS) do not say anything about the expected values or the probabilities of future ex-post reductions and indexations. This could be misleading for participants.

5. QA shows that capital requirements would have significant negative impacts on IORPs, sponsors and members

IORPs were asked to value the balance sheet including all security and benefit adjustment mechanisms and calculate a solvency capital requirement in two baseline scenarios: one using the risk free discount rate to value liabilities ('Level A') and one using the expected return on assets to value liabilities ('Level B'). Based on the results of these two baseline scenarios, the reporting spreadsheet automatically derived the outcomes for the six examples of supervisory frameworks. These examples represented a broad range of possible uses of the 'Common Framework Balance Sheet' (HBS).

The results of the QA show that the examples 1-5, which use the 'Common Framework Balance Sheet' (HBS) to determine capital and funding requirements, lead to very different results in different member states and could have significant negative impacts on IORPs, sponsors and members. The negative impacts would also act as a drag on growth in the real economy. The differing results are mainly a consequence of the different national

[5] The requested data is not ordinarily held as it is not needed for managing IORPs. Again, this highlights that EIOPA's assumption that IORPs are similar to insurers is wrong-headed.

funding requirements and security and benefit adjustment mechanisms available across member states.

PensionsEurope welcomes that EIOPA proposes to refrain at this point in time from introducing harmonised funding or capital requirements for IORPs at the EU level. As EIOPA states, a one-size fits-all regime would not be appropriate due to the (potential) significant negative impacts. Moreover, extensive transitional periods and transitional measures may be required, which could appropriately take into account the differences between member states' IORP systems. **PensionsEurope is pleased that EIOPA has taken note of the concerns raised by us and by many other stakeholders. PensionsEurope stresses that an EU-wide basis for imposing additional capital requirements is detrimental for pension provision and the growth of the European economy. PensionsEurope welcomes the fact that EIOPA has recognised this.**

6. Alternative risk management studies

PensionsEurope agrees that risk management is essential for IORPs. IORPs already routinely and regularly carry out their own scenario analyses (e.g. Asset and Liability Management studies) and stress tests as part of their own risk management processes. As well as carrying out their own analyses, IORPS also are required to do so by their national supervisors. Policy adjustments or recovery plans usually have to be agreed with supervisors. Based on the stress tests, IORPs have an obligation to adjust their policy accordingly. Supervisors have to intervene when deemed necessary. The specifications and methodologies of national stress tests differ significantly from the 'Common Methodology' (HBS) used in EIOPA's stress test and QA exercise. It is doubtful whether the outcome of the 'Common Framework Balance Sheet' (HBS) will have any additional use to national financial assessments in the day-to-day supervisory practice. In fact, the opposite applies as these outcomes could lead to different and contradictory signals for IORPs and their stakeholders, and as a consequence, can also cause misunderstanding amongst the stakeholders (including participants) and the general public. This is for example due to the fact that the Common Framework Balance Sheet (HBS) only provides for 'snapshot' values on the necessarily historic balance sheet date, but does not say anything about future pension benefits.

In PensionsEurope's response[6] to the Consultation Paper on Further Work on Solvency of IORPs on 13 January 2015, we stated that other supervisory instruments could be used instead of the 'Common Framework Balance Sheet' (HBS): *"Other instruments can for example consist of some sort of solvency projection (continuity analysis), ALM calculations*

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[6] http://www.pensionseurope.eu/system/files/PensionsEurope%20final%20response%20EIOPA%20consultation%20solvency%20for%20IORPs%20-%2013-01-2015.pdf

…". These might serve the similar goals as EIOPA asserts for the 'Common Methodology', but have the advantages of:

i. lower complexity;
ii. lower costs;
iii. less model uncertainty;
iv. can be better tailored to national law and specifics.

Moreover, smaller and medium-sized IORPs in the EU are much more likely to be able to make use of these measures; not least because of their lower cost.

Enforced mark-to-market valuation could create, in many countries, inappropriate "steering responses" from IORPs. They would deviate from national supervisory regimes and lead to short-term and pro-cyclical investment behaviour, which would:

- be detrimental for the investment returns;
- introduce systemic risks to the EU financial markets;
- harm the EU economy growth prospects.

An ALM analysis, already done on a regular basis by IORPs in many countries anyway, includes future projections and provides information about the potential impact on the (future) pensionable income and contributions of members and beneficiaries. It allows for an analysis of what happens after a shock in both high return and low return scenarios. Moreover, it provides metrics (such as expected impact and impact in a 'bad weather' scenario over multiple time horizons) that give insight into the consequences of a shock. Such ALM analyses would take all the country specific aspects and rules for IORPs fully into account. Therefore, **developing a true 'harmonised' framework for such an exercise seems impossible.**

PensionsEurope is willing to further elaborate on the shortcomings of the Common Framework Balance Sheet (HBS) and have a constructive dialogue on these shortcomings. However, PensionsEurope does not see any benefit from EIOPA continuing to work on the HBS model or any other similar 'Common Methodology' or use them in EIOPA's IORP stress tests. Taking into account the fact that second pillar pensions are:

i. built on a foundation of national social, labour and tax law, and;
ii. integrated with first pillar (State) pension provision; which varies markedly from country to country.

The use of the 'Common Framework Balance Sheet (HBS)' is not practically possible other than at a purely cosmetic level. If EIOPA intends to do so i.e. via a 'Common Methodology', then it should only propose principles-based guidelines to be used on a voluntary basis that respect the diversity of the European pension landscape and are in line with the national supervisory regimes. Furthermore, the IORP II Directive stresses

that the further development at the EU level of solvency models, such as the holistic balance sheet (HBS), is not realistic in practical terms and not effective in terms of costs and benefits, particularly given the diversity of IORPs within and across Member States. No quantitative capital requirements - such as Solvency II or HBS models derived therefrom - should therefore be developed at the EU level with regard to IORPs, as they could potentially decrease the willingness of employers to provide occupational pension schemes. PensionsEurope calls for policymakers and EIOPA to respect this. Now it is time for a period of legislative calm to which former Commissioner Jonathan Hill also referred in his speech[7] in PensionsEurope's Conference on 23 June 2016 in order that pension funds can concentrate on delivering adequate, safe and affordable pensions and retirement provisions for their members and beneficiaries.

7. EIOPA's proposal to disclose the results to the public

PensionsEurope regrets that EIOPA proposes to disclose the results of the common framework to the public. EIOPA's Consultation Paper on Further work on Solvency of IORPs[8] shows that the value for the sponsor support highly depends on the assumptions and the methodology used to value the sponsor support. This makes the values for the sponsor support very artificial. This might become an even bigger issue when the results of the common framework are disclosed publicly, as in doing so this artificial value of the sponsor support will impact the capital market value of the sponsoring undertaking.

[7] See Speech by Commissioner Jonathan Hill at the PensionsEurope's Conference 2016

[8] See Table 4.2 on page 77 of EIOPA's Consultation Paper on Further Work on Solvency of IORPs

Annex

PensionsEurope notes that IORPs identified:

1. Many difficulties in calculating the figures on the holistic balance sheet, such as:
   - The valuation of deferred tax assets and liabilities;
   - The required, detailed breakdown of the investment portfolio;
   - The valuation of mixed benefits/for-profit benefits/surplus sharing benefits;
   - High level of (expensive) expert judgement required for the assumptions underlying stochastic valuations;
   - Difficulty in performing stochastic valuation of non-unconditional benefits over the entire duration of pension obligations;
   - Understanding the assumptions to be used for the valuation of liabilities and particularly whether the provided curves were spot or forward rates;
   - The definition of "benefits and contributions to be included in cash flows" is not clear with respect to whether future contributions should be included when specific risks can be hedged, but when future contributions cannot be rejected;
   - The use of multiple discount curves: market risk-free interest rate curve, national risk-free interest rate curve and EIOPA interest rate curve;
   - Categorising pension obligations in pure conditional, mixed and pure discretionary benefits;
   - Projection of plan member option to choose lump sum instead of annuity;
   - Multiple ways of trying to place a single number on the value of sponsor support, which is, in any case, only a snapshot. Moreover, EIOPA has also not been able to suggest any way to carry out a meaningful valuation of sponsor support where a single employer sponsors multiple IORPs or multiple sponsors participate in a single IORP;
   - Whilst a 'formula' can, of course, be developed to place a single number on the value of sponsor support this is only spuriously objective; and the only thing that can genuinely be known is that whatever number is produced is wrong.

2. Several elements of the 'Common Framework Balance Sheet' (HBS) that do not properly take into account the IORPs' specificities, such as:
   - The specified methods to value technical provisions do not match the needs of IORPs since national frameworks are different and the relative importance of IORPs in comparison to State (first pillar) pension provision varies enormously between the Member States;
   - Several issues with the risk free interest rate, such as:
     - Valuing liabilities using the risk free interest rate results in a level of technical provisions which is too high when the IORP applies cash flow matching of liabilities through an LDI approach;

- The basic risk-free interest rate curve does not reflect the appropriate risk free curve;
- Market valuation of assets and liabilities using the risk-free interest rate swap curve conflicts with the national framework, which is relevant for the IORP's financial policy and strategy.

3. Several challenges related to SCRs when calculating the figures on the 'Common Framework Balance Sheet' (HBS), such as:
   - The SCR is very complex and still requires the calculation of many stressed balance sheets, even when the balancing item approach is applied;
   - Applying a look-through approach and structuring the input data for the calculation of the SCR (sub-)modules;
   - It is challenging to understand the concept of and determine the loss-absorbing capacity in the SCR calculation, especially in relation to the loss-absorbency of technical provisions;
   - The projection of cash flows for fixed-income assets to evaluate the SCR for interest rate risk;
   - Difficult to understand how to evaluate the SCR for counterparty default risk for cash and deposits at bank;
   - The appropriate modelling of financial derivatives in the SCR calculation;
   - IORPs also pointed out that the establishment of a one-year SCR based on a market-consistent balance sheet results in short-term steering signals for IORPs' management, which are inconsistent with the long-term nature of occupational pension provision.

4. A multitude of difficulties related to assessing the value of sponsor support when calculating the figures on the holistic balance sheet, such as:
   - Understanding the criteria for applying the balancing item approach to the valuation of sponsor support;
   - Valuing sponsor support and in particular determining the financial strength of the sponsor (maximum sponsor support, sponsor default risk), especially for multi-employer IORPs (in four years of technical analysis, EIOPA has not proposed any meaningful suggestions as to how multi-employer sponsors or multi-IORP sponsored arrangements can be accommodated);
   - Level of judgement needed for making projections of the sponsor's future cash flows in order to establish its financial strength;
   - The access to and availability of financial reporting data of the sponsor, especially in the case of multi-employer IORPs;
   - In addition, IORPs stated that the approach to value sponsor support and maximum sponsor support does not reflect the complex and dynamic nature of sponsor support and its specific characteristics – particularly in relation to complex group

corporate structures, which may be further compounded by applying across multiple jurisdictions inside and outside of the European Union; with associated differences in, for example, insolvency law.