



PensionsEurope Position Paper on EIOPA's IORP Stress Test 2015

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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 systems¹.

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.

Contact:

Mr Matti LEPPÄLÄ, Secretary General/CEO
Koningsstraat 97, rue Royale – 1000 Brussels
Belgium
Tel: +32 (0)2 289 14 14 – Fax: +32 (0) 289 14 15
matti.leppala@pensionseurope.eu
www.pensionseurope.eu

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

- IORPs are able to mitigate financial shocks and work as stabilising factor for the financial sector, as EIOPA's stress test report recognises.
- The effect of financial market shocks on IORPs can be limited. The pension legislation existing in various countries may enable IORPs to spread financial shocks over a long period of time, for example through long recovery periods, as EIOPA acknowledges.
- The stress test results show that the Holistic Balance Sheet (HBS) methodology, now renamed as 'Common Methodology', does not work. PensionsEurope is willing to explain its concerns in advance of EIOPA publishing the Quantitative Assessment report in order to help EIOPA avoid taking a wrong path.
- EIOPA should not continue to work on the HBS model or any other similar 'Common Methodology' as a harmonised solvency framework. Rather, it should propose principles-based guidelines only, which can then be considered and adopted where appropriate by national competent authorities of the relevant countries. The stress test should be simpler and mainly based on national standards.
- Given that EIOPA finds pension funds pose no systemic risk, future stress tests would best be used to highlight the risks to individuals' retirement prospects. This would help to underpin the central message that we all wish to get across – that more people should be saving more for their retirement in workplace pensions.
- PensionsEurope welcomes EIOPA's recognition of the heterogeneity of the European IORPs and their respective financial assessment frameworks. A consequence of that heterogeneity is that funding requirements and funding ratios differ between countries.
- PensionsEurope welcomes that the important role of the IORPs as long-term investors is acknowledged. As such they are essential players in the realisation of the Capital Markets Union (CMU).

2. Introduction

The stress test was done by DB/hybrid and DC systems from 11 May until 10 August 2015 in 17 EEA countries. The objectives of the stress test were to produce a picture of the European occupational pensions' landscape, to test resilience of DB/hybrid pension schemes against adverse market scenarios and increased life expectancy, to identify potential vulnerabilities of DC schemes, and to reveal areas that require further supervisory focus. It was up to the national supervisors to invite IORPs to participate in the stress tests. In some countries the supervisor did the calculations and in some the IORPs themselves. Legislative provision for the stress test is contained in the EIOPA regulation (EU) NO.1094/2010. We recognise and accept that EIOPA has conducted the stress test for IORPs in order (...)”to examine the

sensitivity of the occupational pensions sector to adverse market developments and to reach robust conclusions for the stability of the financial system as a whole and to enhance consumer protection.”²

Separate stress tests were run for DB/hybrid IORPs and DC IORPs. The DB/hybrid stress test used three different scenarios. It assessed the immediate impact of shocks on the IORP itself by looking at the impact on the so-called “balance sheets” based on (i) a Common Methodology as introduced by EIOPA itself and (ii) the “National Balance Sheet (NBS, based on the national financial assessment framework of the home country)” of the IORPs. By contrast, the DC stress test assessed the long-term impact on the pensionable income of the members of these IORPs under these same three scenarios.

The “NBS” assessment confirmed the heterogeneity among countries. Valuation methods for the “NBS” are country specific. They are based on asset values assessed either on market or book bases. The liabilities are valued using discount rates varying between current market risk-free rates, expected returns on assets, fixed discount rates and other possible criteria. Also different national funding requirements and different prudential mechanisms coexist to deal with any funding deficit. In order to make the stress test results more comparable, EIOPA has tried to develop a so-called ‘Common Methodology’ where harmonised (market-consistent) valuation methods are used. However, the Common Methodology still contains some serious shortcomings calling into question its relevance and credibility.

Some parameters in the stress test simulated extreme negative market conditions, which seem to be less frequent in practice. If acted upon, such assumptions might prevent IORPs from long-term investments into sustainable real assets, which seems to counter to the aims of the CMU as envisaged by the European Commission. PensionsEurope acknowledges that EIOPA’s constituting regulation requires the authority to carry out stress tests on IORPs in a consistent manner. Stress tests can be helpful in improving the recognition of weak spots in IORPs and financial stability. For this reason, IORPs themselves often regularly and routinely carry out their own stress test and scenario analysis (e.g. Asset and Liability Management studies) as part of their own risk management processes.

PensionsEurope recognises that the results of EIOPA’s IORP stress test do not necessarily give a complete picture of the aggregate of European IORPs’ ability to cope with stress scenarios. This test did not cover small and medium-sized IORPs, which still represent a majority of IORPs in Europe. The stress test results that were published on 26 January 2016 can be read in many different ways as there is no common interpretation of what certain figures really mean in practice. Therefore, PensionsEurope advises interested parties to be cautious when interpreting the stress test results. A misinterpretation of these numbers

² <https://eiopa.europa.eu/financial-stability-crisis-prevention/financial-stability/occupational-pensions-stress-test>

could lead to wrong conclusions and inappropriate reactions. In turn, this could have negative effects for the interests of stakeholders i.e. members, beneficiaries, and sponsoring companies.

PensionsEurope has previously pointed out several problems with EIOPA's HBS framework. PensionsEurope has also expressed serious concerns³ about the inconsistency with national supervisory regimes. Therefore, PensionsEurope rejects the so-called Common Methodology which is actually the HBS. The results based on existing national prudential frameworks differ in many ways from those based on the 'Common Methodology' used by EIOPA. PensionsEurope is convinced that such a European 'Common Methodology' as envisaged by EIOPA is neither suitable nor useful.

In this respect, PensionsEurope welcomes that the ECON Committee of the European Parliament has also rejected the further development of IORP's solvency models at EU level in its recently adopted report⁴: *The further development at Union 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 institutions within and across Member States. No quantitative capital requirements - such as Solvency II or HBS models derived therefrom - should therefore be developed at the Union level with regard to institutions for occupational retirement provision, as they could potentially decrease the willingness of employers to provide occupational pension schemes.*

PensionsEurope thinks it remains unclear how the sponsor support should be taken into account, especially if there are (i) several sponsors in one scheme, (ii) several schemes (within or outside the EEA) sponsored by one sponsor, or (iii) one local sponsor and a wider group (possibly overseas). For IORPs, which have a big sponsor company with strong credit fundamentals, there is a realistic chance to pass the stress test without remarkable deficits in most scenarios. This could be fundamentally different for companies that do not have such a sponsoring entity, or if sponsor support is not taken into account. On the other hand, it is unclear what additional consequences may derive from the fact that for the purpose of a stress test an IORP takes the value of its sponsor support into account, e.g. would this then have to be shown in the annual report or the financial statements of the sponsoring entity?

3. Financial market stability and systemic risk of IORPs

After EIOPA published the stress test results 26 January 2016, Lord Jonathan Hill, Commissioner for Financial Stability, Financial Services and Capital Markets Union, tweeted:

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

⁴ See the paragraph 60a of the Report of the Committee on Economic and Monetary Affairs of the European Parliament on the activities and supervision of institutions for occupational retirement provision (recast) (COM(2014)0167 – C7-0112/2014 – 2014/0091(COD)) as adopted by this Committee 25 January 2016.

EIOPA stress tests: no concerns for financial stability; occupational pensions safe & important investment.

As Commissioner Hill, PensionsEurope does not find the published results of the stress test surprising with regard to the outcome about financial market stability and the systemic risk of IORPs. The results show that:

- the European IORPs do not pose a threat to the financial system thanks to how they are organised;
- given their long-term liability horizon, IORPs are able to mitigate financial and many other shocks effectively. Furthermore, IORPs have adjustment and security mechanisms to accommodate lower funding ratios in the short to medium term;
- as a consequence, IORPs do have a stabilising influence on financial markets, a conclusion that EIOPA draws as well. However, financial market shocks can still have an impact on pension beneficiaries and employers. In specific extreme situations, this could lead to measures such as limiting or ending indexation or even the cutting of pension rights;
- the risk to retirement income does not only depend on the pay-out method, but also on the way it is measured;
- IORPs switch into lower risk and lower return assets as the member approaches retirement;
- a top-down approach applies a stylised model of a DC plan and does not take into account all specificities. Most notably, the tool does not consider derivative hedging of interest rates, inflation, equity, spread and longevity risk, which may materially impact the outcomes of the (instantaneous) market and longevity shocks;
- the sponsor support plays a very important role;
- generally the results based on the Common Methodology (HBS) stress tests show that the Common Methodology (HBS) is pro-cyclical and contradictory to many national regulations. There is also a sharp increase in liabilities due to a different valuation method (especially the interest rate curve) in the Common Methodology.

PensionsEurope acknowledges that, when properly done, risk scenarios can examine the sensitivity of the occupational pensions sector to adverse market developments and to draw conclusions for the stability of the financial system. PensionsEurope agrees with EIOPA on the fact that the potential impact on the real economy and financial markets are important issues and need to be investigated further. The results show that the current investment environment, particularly low interest rates, has posed challenges to IORPs and these must be addressed. Certain policies, such as liability-driven investment (LDI), have led increasingly to investments such as government bonds that in the current market circumstances offer low-to-negative real returns.

Many countries already conduct stress tests at a national level based on their own legislation. Based on these 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. The EIOPA stress test is more about testing the resilience of the sector (per country), rather than individual funds, and stability of the financial system as a whole and it is doubtful whether the outcome of the European stress test will have any use in the day-to-day supervisory practice. These outcomes could on the contrary lead to different and contradictory steering signals for IORPs and for their stakeholders and as a consequence, can also cause misunderstanding amongst the stakeholders and general public.

4. DB/hybrid stress test outcomes are difficult to interpret

PensionsEurope finds that the DB/hybrid stress test results are difficult to interpret. In addition to the difficulties in explaining the differences between the results based on the Common Methodology (HBS) and the different national supervisory frameworks, the very nature of the European IORPs is also diverse. EIOPA is right in stating that it is difficult to compare the different countries' IORPs. National financial supervisory frameworks stipulate different discount rates. In a few countries, such as the Netherlands, both assets and liabilities are mark-to-market (fair value), whereas in many other countries only the assets are mark-to-market.

Another difference lies in the investment portfolio according to the national or IORP specific risk appetite. For instance, Dutch IORPs often invest more in shares and real estate than many others do. We would like to stress that these types of investments are necessary for an effective diversification of the assets and thus achieving good investment returns and their good member outcomes, which is the primary purpose and fiduciary duty of IORPs. In addition these investments are needed in order to achieve the aim of the CMU.

PensionsEurope also finds that in addition to the fact that the Common Methodology (HBS) approach has many shortcomings, these results are difficult and complex to communicate and to be understood by the IORP's members, beneficiaries and other stakeholders. An example of this is that an adverse market scenario could lead to a substantial decrease in the funding ratio of an IORP based on the "National Balance Sheet". At the same time, it is possible that this IORP will present a surplus based on the "Common Methodology" (HBS) as a result of an increase in the values of its benefit control mechanisms, such as benefit cuts. After a shock, the funding ratio could appear to have improved, because future benefit cuts have already been taken into account. Such results present a severe communication challenge. Members might not understand a message along the lines "the good news is that the funding position has improved because we are cutting back the retirement income you are going to receive". This could be amplified because these values (which are discounted

present values (possibly) based on complex (option) valuation techniques), may (incorrectly) be interpreted as expected values or likely to happen.⁵

5. How to improve Common Methodology DB/hybrid stress test

There are several shortcomings in the use of the HBS, now called “Common Methodology”.⁶ Therefore, PensionsEurope has concerns with regards to the use of this model for the stress test. Calculating the HBS including all conditional and mixed benefits as well as all security instruments requires that all extra possible future funding - like extra sponsor support and instruments such as benefits cuts - is included. If the HBS does not balance, no further recovery plan is possible, since all security instruments are already included in the HBS. The only conclusion one could draw is that the funding policy is insufficient to pay out the benefits as promised, thus the pension agreement appears to be unsustainable.

In addition to these fundamental problems, the HBS also implies severe practical problems. Indeed, the EIOPA's QIS study in 2012 showed that in practice IORPs faced great difficulties in providing accurate numbers reflecting the technical specifications provided by EIOPA, if available at all. This is due to the unavailability of necessary data 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, the P&L statement or the cash flow statement from sponsoring companies etc. The latter makes the HBS very sensitive for model and parameter assumptions. It can result in the valuation of HBS changing by tens of percentage points depending on the assumptions used.

PensionsEurope would be ready to elaborating some principles to be used in a possible Common Methodology i.e. the HBS approach after the publication of EIOPA's QA report and opinion on the future solvency framework for IORPs in 2016. We are also willing to explain our concerns before EIOPA publishes the QA report in order to help EIOPA to avoid taking a wrong path. PensionsEurope invites EIOPA to think instead about encouraging alternative risk management tools. In PensionsEurope's response⁷ to the Consultation Paper on 13 January 2015, it was already stated that other supervisory instruments could be used instead of the HBS: *“Other instruments can for example consist of some sort of solvency projection (continuity analysis), ALM calculations ...”*. These might serve the similar goals as EIOPA asserts for the “Common Methodology”, but have the advantages of:

- i. lower complexity

⁵ See IPE December article by Agnes Joseph, Niels Kortleve, Wilfried Mulder, Sibylle Reichert, Peter Vlaar and Siert Vos: [“A Dutch view on stress tests”](#)

⁶ See [PensionsEurope position paper on EIOPA consultation paper on further work on solvency of IORPs](#)

⁷ <http://www.pensionseurope.eu/system/files/PensionsEurope%20final%20response%20EIOPA%20consultation%20solvency%20for%20IORPs%20-%202013-01-2015.pdf>

- ii. lower costs, and
- iii. less model uncertainty.

Moreover, they are much more feasible for many smaller and medium sized IORPs in the EU. 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 and introduce new systemic risks to the EU financial markets.

An ALM analysis, already done on a regular basis by IORPs in some 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, whereas EIOPA's stress test only looks at the impact of the shock itself on the IORP. Such an ALM analysis would have to take all the country specific aspects and rules for IORPs fully into account in any case. Therefore, developing a harmonised framework for such an exercise seems impossible. Rather, EIOPA should propose principles-based guidelines only, which can then be considered and adopted where appropriate by national competent authorities of the relevant countries.

6. DC stress test and possibilities to improve it

Contrary to the stress test for the DB/hybrid IORPs, the stress test approach for DC IORPs focuses on the scheme members' expected pension benefit via the replacement rates at the retirement age and not on the IORP's solvency position via a Common Methodology i.e. HBS or NBS. It therefore gives insight into the risks to members' and beneficiaries' pensionable income and contributions. At the same time, we think that the DC stress test could be improved to take better account of more modern DC plans that utilise, for example, life-cycling techniques to manage investment risk.

The calculated replacement ratios should not be judged in terms of absolute levels of the pensionable income, but only on the relative changes caused by the stress shocks. The outcomes in terms of replacement rates heavily depend on model parameters, namely salary level, career path, contributions made and transferred-in pension wealth for the older scheme members. Also against this background, we recommend to EIOPA not to focus on the level of the replacement rates per se, but on the changes in pension benefits and replacement rates due to stress scenarios.

In some countries where DC pension schemes are relatively new, simulations have raised concerns regarding the estimate of the replacement rate for DC schemes. While for the

youngest generation (represented by members who have 35 years until retirement) the simulation runs a sufficient number of years in the scheme, for the older generations (respectively 20 and 5 years to retirement) the results of the simulation are affected by the relatively late implementation of DC pension schemes. The impact on the results is substantial for the third representative plan member with 5 years to retirement.

Consequently, the results of the simulation seem to reveal that in some countries the estimated replacement rate for the older members is lower than in other EU Countries, but this result is largely affected by the relative new implementation of the DC pension systems. This is demonstrated by the fact that for the youngest representative plan member the results of the simulation in terms of replacement rate are largely satisfying.

7. Comparability of DB/hybrid and DC stress tests and way forward

PensionsEurope finds that the outcomes of the DB/hybrid and the DC stress tests cannot be compared. In the DB/hybrid stress test, the consequences of stress scenarios are shown in the form of their impact on the balance sheet (either NBS or Common Methodology i.e. HBS) in the form of the discounted, present value. On the contrary, the DC stress test looks at the consequences of shocks on the pensionable income using projections. So the first difference is that the DB/hybrid stress test looks at the balance sheets of a pension fund, whereas the DC stress test looks at the future pensionable income. The second difference is using discounted values in the DB/hybrid stress test versus projected values, whereby the discounted value excludes risk premiums and the projected value does include them. Excluding the risk premiums will make the impact on DC schemes look less severe than on DB/hybrid schemes.

In our view, a stress test on DB/hybrid IORPs could be useful if it assesses the impact of market and longevity stress on the contributions of members and the pensionable income of beneficiaries. As such it provides information on the more macroeconomic consequences of financial shocks through IORPs. The stress test for DC IORPs is better suited in this respect.

PensionsEurope agrees with EIOPA, firstly, that risk management is essential for the IORPs, and secondly, that the impacts on the real economy and financial markets are important issues and need to be investigated further. The results show that the current investment environment, particularly low interest rates, has posed challenges to IORPs and these must be addressed. However, PensionsEurope has serious doubts about the value and purpose of a Holistic Balance Sheet model or any other similar common European methodologies used by EIOPA. The results based on existing prudential frameworks in each country are in many ways different from those based on the European methodology and PensionsEurope is not convinced that a European framework as envisaged by EIOPA is suitable or useful.

Especially for smaller and medium sized IORPs these stress tests would create an undue administrative burden and a disproportionate cost to the detriment of members and beneficiaries. As EIOPA requires exploring each single individual asset in the portfolio, even only the needed market data (provided by Bloomberg, Reuters etc.) can be significantly costly for the IORPs.

The frequency of any such future stress tests should be limited to situations which justify the exercise. We would assess that bi-annual stress tests would be excessive and the frequency and content of the possible future stress tests has to be carefully considered. Taking into account the fact that second pillar pensions are built on a foundation of national social, labour and tax law, the use of the HBS (or any other single European solvency standard) is practically not possible other than at a purely cosmetic level. The harmonisation of the European social, labour, and tax laws would require major legislative change and is not within the competence of the European institutions due to the subsidiarity principle.

PensionsEurope is willing to further elaborate on the shortcomings of the HBS and have a dialogue on these shortcomings. However, it does not see any benefit from EIOPA to continuing to work on the HBS model or any other similar Common Methodology that go beyond a mere principle based level. We also note that this is the settled will of the European Parliament, as demonstrated by tabling an amendment on recital 60a of the current IORP II proposal (see page 4). If EIOPA intends to do so i.e. via a 'Common Methodology', then it should only propose principles-based guidelines. These can then be considered and adopted where appropriate by national competent authorities of the relevant countries for the use of a stress test. These principles-based guidelines should respect the diversity of the European pension landscape and are in line with the national supervisory regimes. PensionsEurope stresses once again that exploring the impact on retirement income in the stress test seems more useful than the impact on the balance sheet. Given that EIOPA finds pension funds pose no systemic risk, future stress tests would best be used to highlight the risks to individuals' retirement prospects. This would help to underpin the central message that we all wish to get across – that more people should be saving more for their retirement.