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PensionsEurope's response to the FSB's Consultative Document on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

PensionsEurope welcomes the opportunity to comment on the Financial Stability Board's Consultative Document on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities.

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.

[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.

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.

Q1. Does this consultative document adequately identify the structural vulnerabilities associated with asset management activities that may pose risks to financial stability? Are there additional structural vulnerabilities associated with asset management activities that the FSB should address? If there are any, please identify them, as well as any potential recommendations for the FSB's consideration.

We agree with the FSB statement that pension funds contribute to the stability of the financial system thanks to their long term horizon and due to the fact that their investment choices are not significantly affected by temporary fluctuations of the markets.

Some asset managers seems to generalize or overestimate the risk that pension funds could pose to the financial system and request the FSB / IOSCO to also include pension funds in the NBNI-work. We note that pension funds are - as opposed to asset managers- subject to extensive regulatory (prudential) oversight, based on the European IORP Directive and on national regulations.

Although there was no question addressing the content of Annex 2 of the document, we urge the FSB and IOSCO to take into account PensionsEurope's comments, listed below:

a. General comments

We note that pension systems differ across the globe. Most pension funds in Europe are small, while there are also very large pension funds in Europe. Not only the pension structure but also the applicable regulatory framework differs across the globe. There are also differences in pension systems and structures in Europe.

In Europe, in its first European IORP Stress Test Report conducted in 2015 with the objective among others aims of asssessing the potential for systemic risk that may be posed by financial institutions to increase in situations of stress, the European Insurance and Occupational Pensions Authority (EIOPA) recognised that IORPs do not pose systemic risk, but vice versa, they are able to mitigate financial shocks and work as stabilising factor for the financial sector. In the Stress Tests, EIOPA notes that *„the extent to which IORPs transmit the shocks to the rest of the financial sector and the real economy is limited due to a number of factors. Direct linkages to other financial institutions are limited for IORPs when compared to other financial institutions. One reason is that the IORP Directive prohibits IORPs from borrowing. IORPs are only allowed to borrow for liquidity purposes, albeit only on a temporary basis and to some extent. Hence, IORPs are not exposed to liquidity risk like banks. They have long-term pension commitments which may usually not be redeemed as a cash lump-sum and only be transferred to other pension institutions under specific conditions. In some Member States, any cash lump-sum or transfer value may be reduced to reflect the funding position of the scheme, which limit the impact of financial shocks on these IORPs.“*[2]

It is crucial to understand pension systems and the applicable regulatory framework before any conclusions can be drawn as to the vulnerabilities that exist in the financial system and the risk that

[2] Page 82, IORPs Stress Test Report 2015, EIOPA

pension funds pose. In Europe, pension funds cannot make large sudden reallocations of assets due to the regulatory framework applicable to pension funds, their strategic asset allocation and (annual) investment plans. In times of turbulent markets, the long term investment horizon of pension funds allows them to "stay in the trade" as long as the company in which the pension funds invests or the governments from which pension funds buy bonds does not default. Pension funds are no forced sellers, and they can sit and wait in case the markets overreact. In 2008, pension funds were rebalancing to keep the desired asset mix and were acting countercyclical. During such events, pension funds will sell when prices are high and buy when prices are low and therefore can contribute to financial stability. In case of large moves on markets in one day, only the market participants that are not able or willing to "stay in the trade" will create problems on financial markets. Consequently, <u>controlling the assets does not mean that pension funds reallocate assets in a non-prudent manner or are a source of systemic risk.</u>

Specific comments to Annex 2:

b. The unproved potential for liquidity risk in some types of defined contribution pension funds

For IORPs which provide defined benefits, the liabilities of the pension plan, i.e. the obligations to make payments to plan members on reaching retirement age for the duration of their respective lives or to their survivors on earlier death where a survivor's pension is provided, are self-evidently long-term.

Leaving to one side the situation where the IORP may allow a member to transfer the capital value of his accrued benefit in the plan to another IORP or to an insurance company, the member cannot withdraw his benefits from the plan.

In the EU, although the position may differ from Member State to Member State, often the member has no right to transfer it to another arrangement once a pension has come into payment. Before the pension comes into payment, the member can ask that the capital value of his pension should be transferred to another IORP or to an insurance company or other pension provider (subject to receiving arrangements satisfying certain conditions). But, this is not a straight-forward exercise and differs very considerably from the position of someone who has placed cash on deposit at a bank and who can withdraw cash from a bank on very short notice.

Moreover, there is a requirement for the assets of an IORP to be invested predominantly on regulated markets (see Article 18(1)(b) of the IORP Directive. Subject to that restriction (and any Member State's specific additional quantitative restrictions permitted by Article 18(5)) whether the IORP invests in liquid or illiquid investments is a function of the way in which the IORP operates within the prudent person rule (see the introductory wording of Article 18(1)).

In other words, there is no need for additional regulation in this area. If anything, it might be said that IORPs that invest all or substantially all of their assets on regulated markets and which are generally realised at T+3 or T+1 could be viewed as not taking advantage of the additional returns which could be achieved by holding a proportion of their assets in illiquid investments (the so-called "illiquidity premium").

c. Defined Contribution plans vs. Open-Ended Funds

<u>PensionsEurope disagrees with the sentence in the Annex 2 which states that the vulnerabilities associated with Defined Contribution plans "resemble those of investment funds" (page 39, first</u>

paragraph) as well as with the claim that in the case of DC schemes "there could potentially be liquidity risk similar to that of open-ended funds" (page 40). Such statements are misleading as they do not properly take into account the prudential regime pension funds are subject to.

First of all, national legislation specifies a minimum age at which retirement benefits may be accessed, whether in defined benefit or defined contribution pension plans. If there is a minimum age before benefits may be accessed of, for example, at the age of 55 (and in the absence of death or incapacity which are not voluntary in general), then there is a very considerable stability in the assets held by an IORP in respect of a DC pension plan.

In contrast, an open ended investment company will, depending on its exact terms, generally provide for daily or weekly dealings with the possibility, depending on the particular regulatory regime, of a right to suspend, in special circumstances, redemptions where assets are held by the IORP are not readily realisable.

In a DC plan it is usually the member that chooses his/her's investment options for his/her retirement account or is defaulted in to the default investment option for his/her retirement account. The member may switch from one investment option to another investment option in respect of his retirement account, by giving appropriate direction. But none of those switches has a direct impact on the DC plan itself. Instead they simply impact on the underlying investments held by the DC Plan to back the member's retirement account. The ability of the member to give instructions to switch out of one investment option and into another investment option is regulated by the documentation in place between the IORP and the relevant provider of the investment option in question.

In some EU Member States, the member of the DC Plan has the option to require the IORP to transfer the value of the plan assets allocated to his/her retirement account to another pension plan. This, in turn, simply leads to the underlying assets having to be realised in order to allow the transfer to take place. There are a number of reasons why the plan member may do this. It is highly unlikely that there would be a scenario where there would be a "run on the bank" via transfers out and, if there were, then it is the underlying investments of the plan that have to be sold.

Similarly, where the member is permitted to draw all of his retirement account out in cash, after attaining a certain minimum age (often 55) albeit, subject often to tax disadvantages, this is no different from transferring to another pension plan. It is the underlying investments that have to be realised.

d. The use of derivatives by IORPs

We would like to reiterate that pension funds can only use derivatives to hedge risks and not to speculate and hence the potential build-up of leverage is limited. Article 18(1)(d) of the current IORP Directive (Directive 2003/41/EC), which says as follows: "*Investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risk or facilitate efficient portfolio management …*". Consequently, IORPs in the EU cannot by law use derivatives for speculative purposes. In addition, Article 18(1) of the IORP Directive (which will be Article 20 in the IORPII) lays down the prudent person investment principle. This reinforces further the requirement for a pension fund not to speculate. Hence we find that the FSB draws conclusions which are not backed by a proper research or arguments.

When pension funds invests in investment funds that employ leverage (if any), the risk of losses is limited to the investment in that specific investment fund and there is no run risk for the pension funds itself. Pension funds also employ an anticyclic policy with regard to interest rate, i.e. low hedges in case of low interest rates and higher hedges in case of high interest rates. Additionally, pension funds are subject to prudential supervison with regard liquidity risk.

Regarding the use of less liquid assets, we recommend to authorities to refrain from overregulating the pension funds sector, as requirements decrease the liquidity in the markets making them more rigid. A more rigid market may prove not to be resilient in times of crisis. Therefore, to avoid a rigid and illiquid market, there is a need of a flexible approach and readiness to adjust regulations (such as the impact of banking regulation on the liquidity in repo markets).