PensionsEurope comments to OECD document on DB pension arrangements (DAF/AS/PEN/WD(2017)1)

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www.pensionseurope.eu

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 19 EU Member States and 3 other European countries with significant – in size and relevance – workplace pension systems[1].

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 **25 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;

Workplace pensions 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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[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. PensionsEurope general remarks and works on key design for DB pensions

PensionsEurope welcomes and shares OECD's interest in DB pension arrangements. In our previous comments on OECD's work (January 2017), we invited a representative of OECD to take part in our roundtable meeting to discuss the key design principles of DB arrangements. We highly appreciate OECD's participation in this meeting and we recognize all the valuable contributions that were made during the discussion.

Our DB Standing Committee paper "Towards a New Design for Workplace Pensions" provides a manual for a new design for DB workplace pensions. It gives an insight into what a good workplace pension should look like in order to ensure adequate, sustainable, reliable and efficient pensions for European citizens. It is a manual for Member States and stakeholders reflecting on introducing or reforming already existing workplace pension systems. Based on the experience of mature pension countries and their reforms in the current economic and financial circumstances, the paper is a guideline towards better pensions for all.

PensionsEurope finds that OECD's current project on DB pension arrangements addresses important questions for the design of funded occupational pension plans: (i) how do different models look like, (ii) what is their regulatory background, and (iii) how are they affected by the current economic situation, in particular the persistent low interest rate environment.

In our previous comments to OECD on DB pension arrangements (January 2017), we focused on solvency requirements. This time we would like to particularly comment on weaknesses of mark-to-market valuation of pension assets and liabilities, as they are also discussed in the OECD interim report on the *DB pension arrangements: Solvency and interest rates (DAF/AS/PEN/WD(2017)1)* and they were also further discussed in the last meeting of the OECD Working Party on Private Pensions (WPPP) on 19 June 2017. PensionsEurope warmly welcomes this discussion, as we have particularly stressed the weaknesses of mark-to-market valuation. Please find below PensionsEurope's further remarks.

2. PensionsEurope comments to OECD on mark-to-market valuation of pension assets and liabilities

A good example of a disadvantage of mark-to-market valuation is a pension fund's bond portfolio. If the bonds are held to maturity, the pension fund will not lose money because the bonds will pay interest and return principal at maturity. If the market value of the bonds declines, the fund will have to recognize a loss even though it intends to hold the bonds; it may look as though the pension fund does not have enough money to meet its pension payment obligations, even though the appearance is erroneous.

Thus, PensionsEurope welcomes the Section I on *pension accounting standards and mark-to-market* of the OECD interim report on the *DB pension arrangements: Solvency and interest rates* (pages 3-6).

We fully agree that:

- Pension accounting standards have led to (i) higher volatility, (ii) real economic cost to sponsors, and (iii) the pressure on corporate sponsors to close DB plans;
- Market-based valuations are highly sensitive to movements in bond yields, investment returns and inflation. This means that defined benefit pension accounting can create considerable volatility in the sponsor's financial accounts and obscure rather than clarify the true extent of the sponsor's pension liabilities and its ability to make good on its pension promises;
- Low interest rates – which are politically intended – have created a "double whammy" for funding levels. Under mark-to-market rules, the present value of liabilities has gone up mechanistically - the calculation is driven by changes in high-grade corporate bond yields. The value of assets has not kept pace because pension funds invest in a variety of asset classes that all perform differently and increasingly hedge their liabilities with low-yielding bond portfolios;
- Mark-to-market can create distortions. For instance, high-grade bond yields do not currently accurately reflect economic conditions, and therefore the time-value of money, leading to pension accounting outcomes that make DB provision less attractive for sponsors;
- Mark-to-market has weakened the funding position of DB plans because interest rates are low and it has also made funding ratios more volatile. Liability values are especially sensitive to interest rate movements.

We stress that OECD should keep the above-mentioned statements in the final OECD report.

Furthermore, and also related to EIOPA's "Common Framework" (Holistic Balance Sheet) and *Opinion to EU Institutions on a Common Framework for Risk Assessment and Transparency for IORPs*, we would like to stress that 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 harm the EU economy growth prospects.

Market valuation of assets and liabilities using the risk-free interest rate swap curve conflicts, in many countries, with the national framework, which is relevant for the IORP's financial policy and strategy.

We would be happy to provide more information to OECD, if needed, and we are looking forward to further discussions about the OECD interim report in the next WPPP meeting in December 2017.