

EIOPA-OPSG-15-07
3rd November 2015

**Position paper of the EIOPA Occupational
Pensions Stakeholder Groups (OPSG)
on Quantitative Easing**

Summary and conclusions

Quantitative Easing (QE) should help in improving the growth prospects of the European Union. Pension funds¹ profit from QE via positive returns on bonds and via higher expected returns. At the same time QE also leads to lower funding ratios for Defined Benefit schemes (DB). As a consequence, sponsors and active members could feel the burden of higher contributions and lower pension accrual (for DB and Defined Contribution (DC)). Members and beneficiaries could not only be confronted with higher contributions, but also with lower pensions and more risks. QE could also lead to increased risks in the financial policy of IORPs via distorted risk measuring, could lead to risk-seeking behaviour of IORPs due to the 'search for yield' and there is tension between economics and risk management.

So members and beneficiaries could feel the consequences of QE in the form of higher contributions, lower pensions and more risk and sponsors in the form of higher contributions.

The OPSG would like to invite EIOPA to investigate the consequences of QE and the impact on IORPs, their policy and their behaviour, also by looking at the consequences for members, beneficiaries and companies. A topic that we should understand better is to what extent QE is distortive, leads to artificially high liabilities and mispriced assets and to what extent the low-growth environment itself is causing consequences for IORPs. Better understanding of the possible duration of the ECB's QE policy, the impact of prolonged low interest rates, the consequences for ending QE in the future and the impact that these will have on pensions of members and beneficiaries and IORPs is also an important issue. Investigating the impact on the attractiveness of occupational pensions and consequences for promoting the second pillar is another issue.

The OPSG is of the opinion that better understanding of the positive and negative consequences and being able to weigh these, will help in finding solutions for the undesired consequences. EIOPA can help in addressing these consequences and starting a debate on how to cope with these in a wider setting of institutions responsible for stimulating European growth, supervision and financial stability (like the European Commission, the European Central Bank and the other European Supervisory Authorities) as well as local supervisors.

The OPSG sees four possible routes in coping with the negative consequences of QE (see section 4):

- Adjust the discount rates (DB)
- Change the benefits or accrual (DB and DC)
- Relax the rules for annuitisation (DB and DC)
- Relaxation of capital requirements by supervisors (DB)

The OPSG recognises that it is the responsibility of national regulators and National Competent Authorities (NCAs) to set and relax the rules for supervision. EIOPA could support by investigating the four possible routes described above on their merits and consequences and help understanding what can be done on an IORP and on a supervisory level.

¹ In the remainder of the paper we will use the term Institutions for Occupational Retirement Provision (IORP).

1 Introduction

The European economy has undergone a severe setback due to the financial crisis starting in 2008. The recovery of European economic growth has been so slow that the European Central Bank (ECB), given its goals², took extra measures to support the European economy and to contain the risks of too low or even negative inflation³. On January 22nd 2015, the ECB announced that it would expand its asset purchase program⁴, also known as Quantitative Easing (QE). By purchasing government bonds, the ECB adds liquidity to the market, makes long-term lending cheaper and thereby tries to stimulate the economy and to accelerate inflation. The QE program was foreseen to continue into fall of 2016, but at the start of September 2015, ECB President Draghi indicated that the ECB would possibly extend its program, if and when necessary, implying that the impact can last (much) longer.

This paper will not discuss the soundness of the QE program itself. The OPSG accepts that QE can be beneficial for European economic growth and can be an instrument in achieving that goal. The OPSG recognises that a sound and well performing European economy is important for IORPs. The instrument of QE has significant effects on IORPs. They are confronted with both positive and negative consequences. The positive consequences are positive returns on their (government) bond portfolios and improving growth prospects which could lead to higher returns for other assets. The OPSG wants to address the consequences for IORPs and wants to draw attention to the impact of the low-rate environment on IORPs, their stakeholders and the economy. We will address the negative consequences further on in this paper.

1.1 QE leads to lower bond yields

QE leads to artificially low yields in bond markets. For IORPs the most severe impact is not so much on the assets, but much more related to their liabilities and to risks implied by the current environment. The low yield environment leads to a search for yield, lower expected returns for IORPs, the risk of asset bubbles and more difficulties in risk management (see section 3). The low yield also impacts the liabilities of IORPs. The present value of these liabilities surged substantially due to the falling discount rates, especially for these regimes using marked-to-market for the valuation of pension liabilities and regimes where IORPs convert their assets into annuities at retirement date. The present value of liabilities and the prices for annuities are artificially high to the extent that these are distorted by QE. Since the duration of these liabilities is very long, the rise in liabilities was (substantially) higher than the increase of assets due to good returns⁵, leading to a decline in funding ratios. The OPSG does not want to question the valuation of liabilities using market yields nor the fact IORPs have to cope with the consequences of low yields resulting from a poor economy. The OPSG wants to draw attention to the unforeseen and undesirable consequences due to the artificially low yields resulting from QE.

² One of ECB's goals is supporting the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union (see

<https://www.ecb.europa.eu/mopo/intro/objective/html/index.en.html>).

³ Another important goal of the ECB is its inflation target for the euro area of below, but close to, 2%. A too low inflation or deflation thus sets the ECB goals at risk.

⁴ http://www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html.

⁵ It is good to recognise that unwinding QE in the future, will lead to falling (government) bond prices and possibly to falling assets as well.

1.2 QE could indirectly impact investments in Europe

Finally, in addition to stimulating the European economy, QE also poses some risks to the European economy which undermine the goals the ECB strives for. Firstly, European supervision for financial institutions is much more based on marked-to-market than for instance in the US. The OPSG recognises that valuation on a marked-to-market basis can have added value in the assessment of the financial position of financial institutions, but also sees that it leads to QE impacting European IORPs and financial institutions more directly than in the US. This decreases their resilience and ability to absorb further shocks. Secondly, the lower funding ratios of IORPs – as well as the poorer financial position of other European financial institutions – results in less capacity and willingness to invest in the European economy. This puts pressure on the Juncker Plan and the Capital Markets Union and thereby could jeopardise the ambitions of the European Commission to stimulate investing in the European economy and would possibly also harm the growth prospects for the European economy, thereby undermining the goals of QE. These two negative consequences combined put the effects of QE – to some extent – at stake and could put the European Union in a poorer competitive global position, thereby reducing the positive results from QE.

2 Negative impact of QE on IORPs and on pensions

In section 1, we noted that the positive consequences of QE for IORPs are positive returns on their (government) bond portfolios and improving growth prospects which could lead to higher returns for other assets. In this section we will address the negative consequences for IORPs. QE leads to pressure on IORPs and occupational pensions (as well as a similar pressure on private pensions). As a consequence more of the risks of the IORPs will possibly be borne by members and beneficiaries. More risks for members and beneficiaries could lead to the desire for improved and more secure state pensions, putting extra pressure on government budgets.

2.1 Lower funding ratios for Defined Benefit schemes

The first undesirable impact of QE is lower funding ratios of Defined Benefit (DB) schemes. The lower bond yields lead to more expensive benefits (especially when using marked-to-market for the liabilities) and to more expensive annuities. The impact will be more severe for IORPs already underfunded and the duration mismatch between assets and liabilities will deteriorate the funding position even further.

Consequences of the lower funding ratio will be the increased risks of lower benefits (for consequences for sponsors and contributors please see 2.2). The likelihood of giving extra benefits, being conditional or discretionary, will shrink and in some situations the likelihood of benefits cuts will increase as well. Benefits become less secure and will be possibly lower, which will undermine the confidence in IORPs and capital funding, possibly leading to the desire for more secure state pensions which is the opposite direction seen from the path desired by the European Commission, i.e. developing complementary private retirement savings⁶.

⁶ See White Paper on Pensions: ‘An Agenda for Adequate, Safe and Sustainable Pensions’, COM(2012) 55, February 16th 2012.

2.2 Negative impact on sponsors and contributors: higher contributions, lower pension accrual (for DB and DC)

Both DB and Defined Contribution (DC) schemes will see lower accrual of new pension benefits as well as higher contributions. The lower yields resulting from QE will increase the cost price of DB schemes and annuities (DB and DC) and will negatively impact the return expectations of all IORPs. This will make new pension accrual more expensive, with as a likely consequence that the new accrual will be lower, especially when pension contributions already have hit their ceiling affordable for sponsors and members and there is no willingness and capacity to increase these contributions even further.

There will be even more upward pressure on contributions when IORPs (DB) will have a funding ratio too low according to capital requirements, with recovery plans including contribution rises to repair the funding ratio. The rise in extra contributions will be steeper when the IORP is underfunded.

The extra contributions and risks in the IORPs will also put extra risks on sponsor's creditworthiness (especially for DB). This will have negative effects on the global competitiveness of European business and the economy. The pressure on sponsors will lower their willingness to sustain DB schemes and would strengthen the move to DC, in which case more risks will be borne by members and beneficiaries.

So QE puts upward pressure on contributions due to the rising costs of new accrual and extra contributions needed to restore the funding ratio. Both have a negative impact on the real economy and spending power of consumers and companies. In the case of consumers, the switch to DC would also imply that they will bear more risks making them even more reluctant to spend money.

2.3 Negative impact on members and beneficiaries: higher contributions, lower pensions and more risks

In the previous section, we have already highlighted that the deteriorating funding of IORPs will lead to higher contributions. We also mentioned the lower pension accrual, the likelihood of more risks and the possible strengthened trend towards DC, shifting the risks from business and governments towards households. This will lead to less adequate and less secure pensions.

In section 3, we will address the impact of QE on the financial policy of IORPs and on their asset allocation, leading to lower expected returns and very likely to higher risks as well. Next to impact on their asset allocation, it will also have consequences for the hedging of longevity risks. Liability hedging will become more expensive and possibly the capacity in the market will shrink as well since banks and insurance companies offering liability hedging possibilities will also feel the consequences of QE.

3 Increased risks in financial policy

3.1 Risk measuring distorted

To the extent that markets are distorted and bond yields are artificially low and possibly other asset prices are distorted as well, risk measures will also be distorted. Indicators like volatilities and correlations are possibly not as indicative as normally. For bond yields, the risk can be skewed since

the likelihood of long yields declining by percentage points, making them significantly negative, seems much more unlikely than these yields rising by percentage points.

3.2 Extra risk taking possible

The skewness in the risk of bond yields makes liability hedging less sensible and attractive. If the likelihood of a severe decline is substantially lower than that of a similar rise, the benefits of liability hedging are outweighed by the shortcomings. If bond yields were to decline even further and would become negative, then liability hedging and buying long bonds with negative yields would make even less sense: why should IORPs pay to hold long bonds (with negative returns)? The risk of too prudent risk management and supervision increase the risk of a self-fulfilling prophecy with bond yields continuing to decline, especially when liabilities are marked-to-market or benefits are paid out in ever more expensive annuities.

At the same time, the unattractiveness of long bonds as an asset class will possibly lead to a search for yield that could lead to more investments in equities and other riskier assets (especially linked to credit and growth), which could lead to the creation of asset bubbles.

3.3 Tension between economics and risk management

On the one hand, common economic sense and established economic theory tell us that one should buy low and sell high. Given that (government) bonds are (very) expensive, the consequence of this theorem would be to sell bonds which would lead to higher bond yields. This would mitigate the intended impact of QE, namely stimulating the economy via low yields.

On the other hand, as mentioned in 3.2, the low funding position of IORPs could lead them to de-risk further by extra liability hedging and selling of equities and related assets and buying of (long) bonds (leading to the above mentioned self-fulfilling prophecy). IORPs thus have to choose between sound economic investment principles (i.e. selling bonds) and prudent risk management and supervision (buying bonds).

4 Possible solutions for coping with unforeseen and undesired consequences of Quantitative Easing

The OPSG sees possible solutions in both the area of changing the way pensions and pension schemes are handled as well as temporarily relaxing supervision.

4.1 Adjust the discount rates (DB)

On the pension side, possible solutions may lie in the way pension benefits are discounted, how new accrual is organised and in changing the benefits themselves. The OPSG would urge IORPs and supervisors to reconsider how pension liabilities are discounted, to the extent that these are distorted by QE. The OPSG suggests finding ways to neutralise the effects QE has on liability discounting, for example by making adjustments to the discount rates being used. In Solvency II, some adjustment mechanisms are introduced to dampen undesired volatility in discounting liabilities in the form of using an Ultimate Forward Rate (UFR) for discounting long dated liabilities (instead of using distorted market yields) and dampeners (e.g. equity dampener). A solution for QE could be to introduce a QE adjustment to discount rates or to use corporate bond yields instead of (distorted) governments yields or interest rate swaps.

4.2 Change the benefits or accrual (DB and DC)

Alternative solutions in the pensions area the OPSG sees are changing the nature and characteristics of the benefits. This could be done in the form of lowering the guarantees (or even stop offering these) and shift towards DC. The OPSG wants to stress though, that even though this would increase the clarity with regard to who is bearing the risks, the consequence of these measures would be that risks will be shifted towards members and beneficiaries. A solution with possibly less sustainable impact on members could be to – temporarily – lower the accrual of new benefits; this would also safeguard beneficiaries.

4.3 Relax the rules for annuitisation (DB and DC)

The OPSG recommends that for members and beneficiaries there should be more transparency and understanding of the impact on their pensions. The expected negative impact of QE on the benefits should be communicated in a way so that members and beneficiaries understand them and can take action if and when necessary. This should include the impact of longevity to the extent that these risks are not borne by the IORP or the sponsors but by the members. If they have to purchase an annuity or have the ability to do so and it is their responsibility to decide on that, then to the extent that annuities have become more expensive due to QE, they should be aware of the consequences. The OPSG would suggest considering the introduction of medium term annuities – with a term of 3, 5 or even 10 years – with the option for subsequent life annuities if and when market conditions have normalised after QE has halted.

4.4 Relaxation capital requirements by supervisors (DB)

The OPSG sees various ways that supervisory rules can cope with the unforeseen and undesirable consequences of QE. They all would impact how capital requirements and not meeting these will be handled. The OPSG suggests that these could be applied and extended to the extent that and for the time period QE impacts pensions negatively, but no more and longer than necessary.

The OPSG considers that the most appropriate way in which supervision can be relaxed is to permit lengthening the horizon of recovery plans and extending the period that new recovery plans have to be filed to the supervisors.

The OPSG also sees possibilities in accepting (temporarily) higher risks. This can be in the form of accepting less liability hedging (given the skewness of interest rate risks, see 3.2), less bond buying and higher exposure to equities and other riskier assets. The switch from government bonds towards equities and other higher yielding assets could also be helpful in achieving the goals set for the Capital Markets Union.

*

* *

Adopted by the EIOPA Occupational Pensions Stakeholder Group on 16 November 2015

The Chairperson of the EIOPA Occupational Pensions Stakeholder Group

PHILIP SHIER