

## **4. The European pension fund sector<sup>16</sup>**

**The ongoing macroeconomic environment generates increasing challenges to the European occupational pension fund sector.** Interest rates, which declined even more in the course of 2014 kept the pressure on pension fund liabilities. Traditional Defined Benefit plans (DB), 75% of the sector in 2014 in terms of assets, with guaranteed pensions based on a predefined formula, are directly adversely affected by those developments. DB funds are long term investors, for which the liabilities have a longer duration than the assets, leading to an asset-liability mismatch that is even greater than in the insurance sector. Consequently, lower interest rates can have a substantial negative effect on funding ratios. However, due to the non-existence of a harmonised market-based valuation reporting regime for pension fund liabilities, the impact on schemes based on national valuation regimes is not possible to assess across countries on a consistent basis. In those cases, when national prudential regimes are not sensitive to market price changes, the risk might be significantly underestimated.

By contrast, in Defined Contribution plans (DC), risks are transferred to the individual members instead of remaining with the individual funds or their sponsors. DC plans are always in 'balance' since the cover ratios always equal 100%. However, a material drop in plan members' future benefits driven by lower long-term expected returns could have systemic implications to the real economy since it might involve significantly lower pension benefits than expected for a significant part of the population with a potentially direct negative impact on aggregate demand<sup>17</sup> in the future. Significantly lower pension benefits, than expected, could have a negative impact on the aggregate demand for pension savings in the future with members choosing alternative forms of retirement provision. Members may choose to pay higher contributions over the accumulation phase or work longer to maintain their living standards and expect pension benefits.

**DB plans continue to pose affordability challenges for employers.** Due to fact that the cover ratios for technical provisions are not directly comparable and there is currently no consistent measure of the affordability of employers, the overall effect has not been quantified for the pension sector. The triggering of a risk reversal scenario such as the one described in chapter 1 (low risk free rates with increased

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<sup>16</sup> All data employed in this section refer to IORPs pension funds.

<sup>17</sup> Aggregate demand refers to the total demand for final goods and services in an economy.

credit risk premiums), could potentially impact the pension sector even harder than the insurance sector which would already be severely affected as confirmed by the EIOPA Insurance Stress Test 2014.<sup>18</sup>

The risk that DB funds would become underfunded (or subject to increased underfunding) in the short to medium future remains high through increasing pension liabilities. This could have an impact on the risk of possible future solvency of the sponsor; however this would depend on the structure and flexibility of the national regulatory framework in allowing for the sustainable growth of sponsors. Also, how the market changes affect the financial position of the employer itself can vary, e.g. lower yields could imply lower borrowing costs.

**New types of hybrid (HY) schemes have emerged to deal with the current challenging macroeconomic environment.** Despite a clear trend towards DC schemes in many countries, DB schemes still represent the largest part of the sector. In order to increase available options, in some countries new types of HY schemes have emerged. HY schemes combine elements of both DB and DC types but currently represent just 1% (in terms of assets) of the EU pension market. However, it should be noted that in a few countries, the DB type of scheme could include many types of schemes where risks can be shared by employers, members and beneficiaries.

**During 2014 many regulatory changes took place in the European occupational fund market.** The UK 2014 Budget abolished the effective requirement to buy an annuity with DC pensions' pots. From April 2015, the tax rules were simplified to give people unrestricted access to their pension savings from age 55. Drawdown of pension income under the new, more flexible arrangements will be taxed at marginal income tax rates rather than the current rate of 55% for full withdrawals. The tax-free lump sum will continue to be available. Individuals will have access to free and impartial guidance, to help them make the choices that best suit their needs in retirement. This is likely to have a negative impact on demand for individual lifetime annuities but may increase demand for other retirement products.

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<sup>18</sup> Pension funds are long term investors implying possible asset-liability mismatches greater than in the insurance sector. This could be translated into more severe impact of a risk reversal scenario.

## 4.1 Market growth

**Total assets owed by occupational pension funds increased by 11% in 2014 following a more moderate growth of 3% in 2013 (Figure 4.1).** This can be partly attributed to the drop in interest rates as well as to the outstanding performance of the equity markets over 2014 compared to the year before as described in chapter 1 (see Figure 1.8). Two countries, the UK and the Netherlands, account for most of the European occupational pensions sector (87% per cent of the total assets, see Table 1). Cross-country differences are mainly driven by the relative share of private and public provision of pensions based on countries' legislations and state supports. Pension funds under Pillar I are not covered by this chapter.

*Table 4.1: Total assets per country as a share of total assets reported for 2014*

UK	NL	DE	IT	IE	ES	NO	IS	AT	SE	PT
55.89%	30.67%	4.46%	2.76%	2.39%	0.92%	0.79%	0.51%	0.49%	0.46%	0.42%
LI	LU	SK	SI	PL	LV	RO	HR	BG	HU	Total
0.12%	0.05%	0.04%	0.01%	0.011%	0.007%	0.006%	0.003%	0.00012%	0.00011%	100.00%

Source: EIOPA

Note: For a few countries 2014 figures are preliminary and subject to major revisions.

**The penetration rate of the occupational pension fund sector increased somewhat in 2014 compared to the previous year.** This ratio is calculated as the total size of assets over GDP and gives an indication of the relative wealth accumulated by the sector (Figure 4.2). In 2014 the un-weighted average of the penetration rate across the countries of the sample increased by 3% compared to 2013 (the weighted average by total assets increased by 14% in 2014). In most of the countries penetration rates did not significantly change. The increase in the weighted-EU average was mainly driven by the increase in the Netherlands.

Figure 4.1: Total Assets

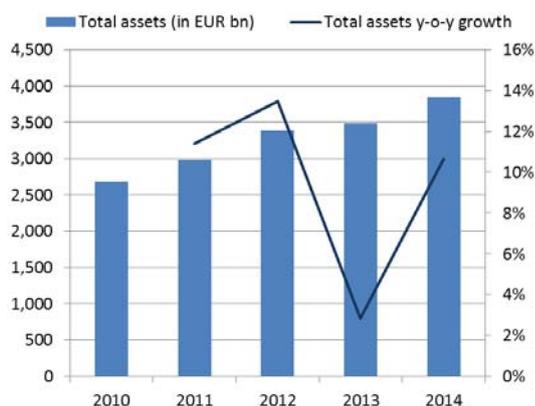
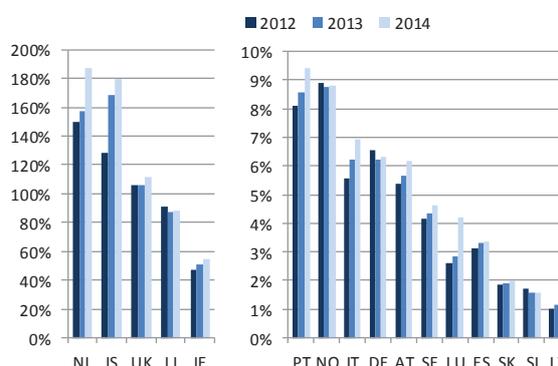


Figure 4.2: Penetration rates (total assets as % of GDP)



Source: EIOPA

Note: For many countries 2014 figures are preliminary and subject to major revisions. Penetration rates for HR, RO, PL, HU and BG are lower than 1%.

## 4.2 Performance and Funding

**Overall, the investment allocation of pension funds has remained broadly unchanged in 2014** (Figures 4.3 and 4.4) Debt and fixed income securities account for the highest share in the portfolio investment allocation of pension funds. The total exposure to sovereign, financial and other bonds added up to 47% per cent in 2014. Due to the long-term horizon of pension funds, equity generally represents a much higher share of investments in the pension fund sector than in the insurance sector (approximately 35 per cent for the countries of the sample in 2014).

This investment mix is relatively constant over time and across countries also due to strict legal or contractual obligations for pension funds that aim to maintain stability over time. A shift towards fixed income securities and away from equities has been reported by the UK (derisking). A few other countries reported changes in the asset allocation of the pension funds. In this respect two major trends were identified: (1) The increase of DC-scheme investment allocation to equity (2) Given the low returns on bonds, some first signs of 'search for yield' to more 'risky' and 'higher yielding' investments was reported (currently very low in volumes). Both trends require caution and close monitoring.

Figure 4.3: Investment Allocation (in %)

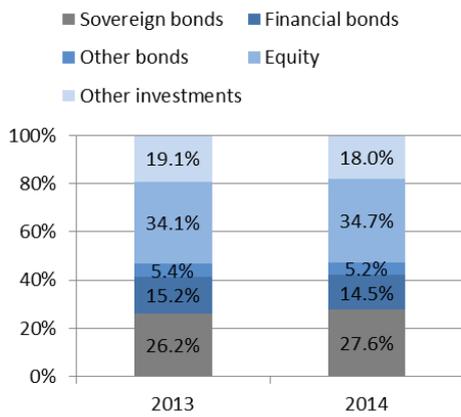
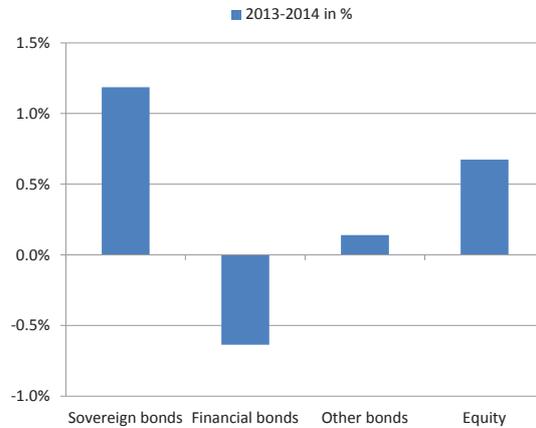


Figure 4.4: Change in investment allocation in 2014 (in %)

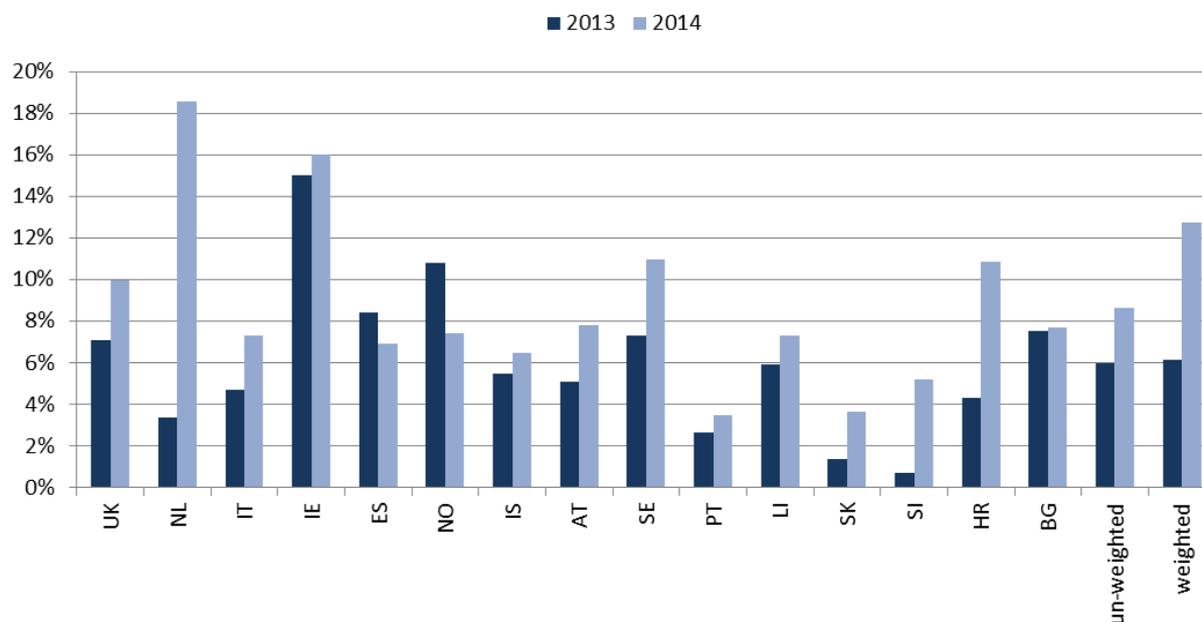


Source: EIOPA

Note: The UK figure used for the calculations of these figures relates only to DB and HY schemes.

**The current low yield environment puts some pressure on the overall performance of occupational pension funds. However, the average rate of return slightly increased during 2014.** The average ROA (Figure 4.5) in 2014 (un-weighted 8.6%, weighted 12.6%) was higher compared to 2013 (un-weighted 6.0%, weighted 6.1%). This can be attributed to the exceptionally good performance of the equity and fixed income markets during 2014.

Figure 4.5: Rate of return on assets (ROA)



Source: EIOPA

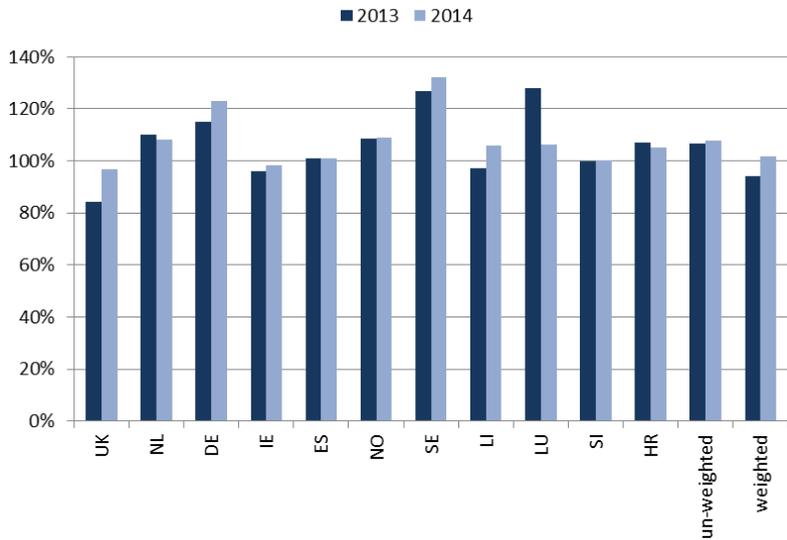
Note: Both the weighted and un-weighted averages for ROA were calculated on the basis of the 15 countries that provided data and are depicted in the chart. The weighting was based on total assets. For many countries data are preliminary and subject to major revisions.

**Cover ratios for DB schemes have increased but remain a big concern for a number of countries.**<sup>19</sup> Overall, the average cover ratio slightly increased in 2014.

The weighted average cover ratio increased from 94% in 2013 to 102% in 2014 whereas the un-weighted average cover ratio increased from 107% to 108% for the same period (Figure 4.6). Cover ratios below 100% are a great concern for the future of the sector given the existing low interest rate environment. In a few cases there is full sponsor support as well as existence of guarantees. However, an extreme adverse scenario may strain the ability of the sponsors to deal with the potential cost increases. In some countries, e.g. DE, sponsor support is complemented by additional mechanism which might provide necessarily support in case of sponsor default. In other cases benefit adjustment mechanisms may apply meaning that underfunding can be (partially) addressed through a reduction of current and expected future benefits for members.

<sup>19</sup> Cover ratio is defined as net assets covering technical provisions divided by technical provisions.

Figure 4.6: Cover ratio (in per cent)



Source: EIOPA

Notes:

- (1) Cover ratios refer to DB schemes. Pure DC schemes present in IT, AT, SK, PL, BG and HU are not included in the chart and in the average calculations.
- (2) Both the weighted and un-weighted averages for the cover ratio were calculated on the basis of the 11 countries depicted in the chart. The weighting was based on total assets.
- (3) Due to different calculation methods and legislation, the reported cover ratios are not fully comparable across jurisdictions.