

OPSG Feedback statement on EIOPA's IORPs stress test report 2015

0. Executive Summary

The OPSG welcomes the thorough and well written "IORPs Stress Test Report 2015" EIOPA issued in January 2016. The OPSG underlines the importance of stress testing as a risk management tool for Institutions for Occupational Retirement Provisions (IORP). The OPSG agrees that the economic and financial market impacts need to be investigated further as the importance of 2nd pillar occupational pensions in the total retirement income increases.

The OPSG recognises that in order to be able to compare Defined Benefit (DB) schemes in a consistent manner, a harmonised method (Common Methodology, i.e. the Holistic Balance Sheet (HBS) approach) would need to be adopted. But the OPSG is concerned about the confusion this may cause for stakeholders, including National Supervisory Authorities (NSA): in what way the conclusions under this harmonised method would have an impact on the policy of the IORPs and the national supervisory approach? The OPSG concludes that the calculations for the HBS have become (slightly) easier, less complex and costly, but at the same time lower the market consistency and comparability between IORPs and countries. The OPSG doubts whether these shortcomings can be overcome in the Common Methodology (CM).

The OPSG sees tension between applying the National Balance Sheet (NBS) approach and the CM and the conclusions being drawn from the CM which is "more realistic" and sensitive to market movements. This conclusion seems to imply that the NBS level approach is not reliable, which the OPSG would disagree with.

Future IORP stress tests, especially for DB, should be easier and cheaper if they should be applied by medium and small sized IORPs as well. A simpler, more principle based approach, relying first and foremost on national frameworks and leaving more freedom to NSAs, could be a more appropriate alternative instead of the HBS. The concept of risk assessment which is expected to be part of the new IORP II Directive could also be a useful basis for further stress tests. One other option the OPSG wants to give in consideration is to have the NSAs to conduct the stress test. This would not put the administrative burden and costs directly and exclusively on individual IORPs.

The OPSG welcomes that the DC stress test gives insight into the risks to members' and beneficiaries' pensionable income and contributions. This is particularly relevant as there is a trend towards more DC based pension schemes offered through IORPs across Europe.

That the IORP stress test considers both DB and DC schemes is being appreciated by the OPSG. However, the aim and the methodology used in the two exercises are very different and this makes it difficult to analyse and to compare the results. In OPSG's view, a stress test on DB IORPs could be more useful if it assessed the impact of stress scenarios on the contributions of members, the pensionable income of beneficiaries and the contributions of sponsoring companies. As such it would provide information on the more macroeconomic consequences of financial shocks through IORPs. The stress test for DC IORPs is better suited in this respect. The shift from DB toward DC schemes highlights the need for more comparable information.

EIOPA also assessed the second round effects on financial markets. The OPSG would support EIOPA to do further analysis on these in future IORP stress tests which enable stronger conclusions to be drawn.

The timing and frequency of the stress test should be considered. Based on the results published now, the OPSG finds that conducting the next tests already in 2017 may not be justified. The OPSG would urge that any future IORP stress test should take the proportionality principle into consideration and the tests have to be useful and justified also from the point of view of the IORP and its stakeholders. The OPSG is ready to provide further advice on all the above mentioned issues and to enter into a dialogue with EIOPA how to improve the future stress tests.

1. Introduction

On 26 January 2016, EIOPA published its "IORPs Stress Test Report 2015" that presents the results of the first EU stress test for Institutions for Occupational Retirement Provision. This test was performed in 17 Member States during the summer of 2015 to identify risks and vulnerabilities for the delivery of safe and sustainable pensions and the potential financial stability consequences. The OPSG underlines the importance of stress testing as a risk management tool for IORPs. EIOPA's stress test report is rich in information, but the information has to be transferred to the stakeholders and they have to be able to gain added value from it. This can indeed represent quite a challenge. Our suggestions for the way forward are set out in section 7.

The OPSG wants to take the opportunity to congratulate EIOPA for the enormous amount of work accomplished and for the excellent quality of the report. The "IORPs Stress Test Report 2015" is a report written in a comprehensive language. It makes a lot of useful information available regarding the impact of shocks on both Defined Benefit (DB) (including hybrid) and Defined Contribution (DC) pension schemes. The comparison of methods and results on DB/DC schemes is developed in section 5 below.

For DC schemes, the report shows the effect for the members of the shocks on their replacement ratio at retirement age and analyses ways to cope with the decrease of this ratio caused by the

shocks, for example increase contributions or delay retirement. The approach for the DC part (bottom up) is interesting, because it provides information for the (only) stakeholders of pure DC plans namely the members; they are the ones bearing the risk. It is however necessary to define ways of communicating the conclusions of the report to the plan members. Section 4 will go more into detail on the DC stress test.

For DB schemes (see section 3 for our feedback), the approach is twofold: on the one hand EIOPA looks at the robustness of the IORP's funding on the basis of the national balance sheet (in case of deficit, the supervisory response will indeed be based on the NBS) and on the other hand EIOPA uses a Common Methodology. Given the importance of the Common Methodology – using the concept of a Holistic Balance Sheet – in the DB stress test, before giving feedback on the DB outcomes, the OPSG will start with commenting on the HBS concept in section 2.

The OPSG recognises that in order to compare at EU level the resilience of DB schemes against adverse market scenarios and increases in life expectancy in a consistent manner, a harmonised method for the valuation of liabilities and assets as well as the definition of funding ratio would need to be adopted. But the OPSG is concerned about the confusion this may bring for stakeholders such as IORPs, sponsors, members and beneficiaries and National Supervisory Authorities. A Common Methodology (like the HBS concept used in EIOPA's stress test report) would – for a large number of IORPs – imply a third view on the IORP's funding position is given, next to the NBS and the application of International Accounting Standards (such as IAS19R). Therefore, the OPSG insists on the importance of focussing on a methodology for IORPs consistent with already existing legal requirements from national supervision, i.e. the NBS, and accounting standards, in order to be able communicate the outcomes of the stress test to stakeholders in a recognisable manner. The OPSG therefore suggest to give more weight to the national approaches (the NBS) in future stress tests.

EIOPA assesses the impact of shocks on financial stability at EU level and EIOPA concluded that there is only a limited link between IORPs and financial stability and furthermore that IORPs do not represent a systemic risk: 'The extent to which IORPs transmit the shocks to the rest of the financial sector and the real economy is limited' (see chapter 4 of EIOPA's report). These conclusions are reassuring (see section 6 for comments and suggestions).

In the report, EIOPA recognises the heterogeneity of the IORP landscape which is welcomed by the OPSG. The CM allows for the explicit recognition of relevant steering and adjustment mechanisms of IORPs (these mechanisms differentiate IORPs from insurance companies) such as the use of sponsor support, pension protection funds and benefit reductions as a last resort and visualises the relative importance of these mechanisms, giving at the same time input to sponsors as well as members.

2. Common Methodology/Holistic Balance Sheet

Given the importance of the Common Methodology – using the concept of a Holistic Balance Sheet – in the DB stress test, before giving feedback on the DB outcomes in section 3, the OPSG will start with commenting on the HBS concept in this section. EIOPA has been working on the HBS for many years. In May 2013, the OPSG stated that the proposed Holistic Balance Sheet approach is highly

complex¹. The OPSG noted that EIOPA mentioned – justly – a lot of disclaimers to the reliability of the outcomes of this first Quantitative Impact Study (QIS) and highlighted the preliminary nature of the QIS results. IORPs may have used different assumptions, interpretations and simplifications and the outcomes also show substantial variation between participating countries as a result of differences in assumptions. Therefore, an appropriate comparability of results of IORPs between and within different Member States is not possible. The OPSG raised its doubts whether – after this QIS – it would be possible that the HBS could be used as a supervisory tool. The OPSG proposed that more studies were necessary in order to improve the valuation of the HBS and to test what would be the appropriate place of the HBS in a future European supervisory framework, if at all. The OPSG notes that the current IORP stress test and the forthcoming Quantitative Assessment will shed more light on the usefulness of the HBS. The simplifications and options given for the calculation in the IORP stress test possibly make individual calculations (slightly) easier and better understood, but most likely also diminish the comparability.

In January 2015, the OPSG said that it was supportive of proposals that the approach to valuation of elements of the HBS, and its use, should be an option of the Member States, subject to overarching EU principles². This would enable the specificities of IORPs in different member states, and the relevant national social and labour law to be taken into account. The OPSG notices that the Common Methodology still does not comply with this approach (using overarching EU principles). The OPSG also mentioned that market consistent valuation poses a problem. Either a full stochastic valuation is used or simplifications. On the one hand, the stochastic valuation is complex, expensive and would use concepts like risk-neutral valuation. On the other hand, the simplifications by their nature will, at best, give approximations of the market value. The OPSG was also strongly of the view that the proportionality principle must be applied where possible, especially given the high number of small and medium sized IORPs in the EU, for whom lengthy and complex calculations would impose an excessive burden. Simplifications should also be permitted where possible and appropriate e.g. by treating sponsor support and/or pension protection schemes as balancing items. The OPSG is happy to see that EIOPA has given the option of applying the balancing item approach to IORPs, thereby possibly lowering the complexity and costs, but at the same time lowering the market consistency and comparability of outcomes across and within countries.

All in all, the OPSG concludes that the approach in the IORP stress test makes HBS calculations (slightly) easier, less complex and costly than in the QIS, but at the same time lowers the market consistency and comparability between IORPs and countries. The OPSG doubts whether these shortcomings can be overcome in the Common Methodology (i.e. the HBS approach). Given these doubts, the OPSG suggests EIOPA should consider giving more weight to the national standards in a future IORP stress test.

The OPSG would like to restate its suggestion from our feedback statement to EIOPA “QIS on IORPs – Preliminary results for the European Commission” (EIOPA-OPSG-13-04) using a holistic approach rather than a HBS. Such a holistic approach should take into account the steering and adjustments

¹ See ‘OPSG feedback statement to EIOPA “QIS on IORPs – Preliminary results for the European Commission” (EIOPA-OPSG-13-04).

² See ‘OPSG input to the consultation paper on further work on solvency of IORPs’ (EIOPA-OPSG-15.01).

mechanisms, but should leave freedom to NSAs to calibrate the system with a view on national practices.

In terms of encouraging risk management tools, the OPSG would also like to note that a number of DB schemes already provide e.g. ALM studies as well as a level of qualitative risk management reporting to their trustee boards in line with sound risk principles. These will be further developed following the new IORP Directive requirements and could be the basis for future IORP stress tests.

3. Stress tests for DB

The OPSG has an issue with the conclusion drawn from the DB stress test analysis. Due to the high level of heterogeneity, it is “fundamental” to include both the stress test measured at NBS level and then a second CM approach which is “more realistic” and sensitive to market movements. This seems to imply that the NBS level approach is not reliable, which the OPSG would disagree with. The CM clearly has an illustrative purpose for EIOPA’s goal in information gathering. If the aim of the stress test from the DB perspective is to draw conclusions in order to address issues in terms of policy or behavioural change, then EIOPA needs to look at the local NBS and not use an additional methodology. Having a comparable method across countries may be useful for fact gathering, whereas having a different stress test to that developed from ‘within’ the context of the national prudential framework can be confusing and worrying for stakeholders of DB IORPs.

But even allowing for a non NBS level measurement, there are a number of problems with the methods chosen. The OPSG would for example disagree that there is indeed one ‘reliable’ way of assessing assets and liabilities. The critical point is that the methods used should be kept consistent. There are ranges of more appropriate ways in which the long term nature of liabilities in an IORP can be recognised, other than the use of a risk free interest rate being applied in the CM. The OPSG would not consider the use of a risk free rate to be more realistic per se given the long term nature of the IORP liabilities, the discount rate should reflect the nature and certainty of the benefits: ‘for “soft” benefits, where the pension promise is not guaranteed, discounting using expected return is appropriate, especially when the benefits depend on the investment return achieved’.³ It is not surprising that the CM shows a considerable increase in the value of liabilities given this interest rate approach and the valuation method.

The OPSG would therefore question whether the results from the CM approach are useful enough to warrant such costly and complex analysis, particularly given that EIOPA’s IORP stress test has concluded that IORPs do not present a systemic risk and are able to mitigate financial shocks.

The OPSG has been asked to comment on the sustainability of IORPs given the stress test results. As stated above the results are not a surprise, and the OPSG sees the very extensive closures of DB pension schemes in several MS. The potential lack of sustainability and the risks inherent in the DB model have already been well recognised by sponsors and have led to the growth and development of DC pension provision. The pace of closure of DB schemes to existing members as well as to new

³ See ‘OPSG input to the consultation paper on further work on solvency of IORPs’ (EIOPA-OPSG-15.01).

members has been rapid, and has been a combination of many different reasons: volatility of funding, the risk appetite of sponsoring corporates, the accounting standards, concern not to increase already large deficits, being among them. But closure does not remove historic legacy deficits to be managed by sponsors and trustees, while using whatever liability management and investment techniques they consider best. It would be helpful if EIOPA could more closely examine the barriers and difficulties which can impede the transitioning from DB to DC schemes. In some jurisdictions where this transition is limited to new members and excludes existing DB members it should be examined how this transitioning can be supported, given the difficulties of sustaining the DB environment.

4. Stress tests for DC

Contrary to the stress test for the DB IORPs, the stress test approach for DC IORPs focuses on the impact of stress scenarios on the scheme members' expected pension benefit via the replacement rates at the retirement age and not on the IORP's solvency position using the HBS or NBS. It therefore gives insight into the risks to members' and beneficiaries' pensionable income and contributions, which is welcomed by the OPSG. At the same time, the OPSG believes that the DC stress test could be improved to take better account of more modern DC plans that utilise, for example, life-cycling techniques and derivatives 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 scenarios. 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, the OPSG recommends 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 the DC pension schemes are relatively new, the 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 subscription. 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, for instance in Italy, 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 in line with other MS.

The OPSG is ready to provide further advice on the above mentioned issues and to enter into a dialogue with EIOPA how to improve the DC methodology. This is particularly relevant as the OPSG observes a trend towards more DC based pension schemes offered through IORPs across Europe.

5. Comparison of the methods for DB and DC

The OPSG appreciates that the stress test considers both DB and DC schemes. However, the aim and the methodology used in the two exercises are very different and this makes it difficult to analyse and to compare the results.

The focus of the DB stress test is essentially on IORPs funding ratio resilience to adverse market developments (2 scenarios) and to a permanent decrease in mortality rates (longevity scenario). Less focus is placed on the impact for sponsors and even less on the impact for members and beneficiaries. Two different approaches are used: the NBS and the CM (i.e. HBS approach). In addition, an analysis covering second round effects on financial markets is conducted, with the main purpose to evaluate the effects on DB IORPs asset allocation behaviour in stressed scenarios (see section 6 below).

The aim of the DC satellite module is to assess the impact on future retirement income of three representative plan members (5-20-35 years to retirement) to adverse market scenarios and an increased longevity scenario. Useful indicators, such as the percentage decrease in replacement ratio and the impact in terms of additional contributions and postponing retirement, are introduced. In the DC satellite module, two low return scenarios are considered in addition to the three scenarios in the DB analysis. The impacts of the stressed scenarios on DC schemes are more homogenous across different national regimes with respect to DB IORPs.

The OPSG notes that the outcomes of the DB and the DC stress tests cannot be directly compared. In the DB stress test, the consequences of stress scenarios are shown in the form of their impact on the balance sheet (both NBS and HBS) in the form of the discounted, present value, whereas the DC stress test looks at the consequences of shocks on the replacement rate using projections. So the first difference is using balance sheets versus future replacement rates. And the second difference is using discounted values versus projected values, whereby the discounted value excludes risk premiums and the projected value does include them.

Even if the difference in the DB and DC IORPs characteristics justify a separate analysis, the OPSG would consider that it could be useful to introduce some common metrics/indicators for obtaining more comparable results between DB and DC schemes. This could include to test:

1. The impact for members – i.e. regarding the replacement ratio or the increase in contribution to keep the replacement rate unchanged. This should also be calculated for DB;
2. The impact for sponsors that should be made more visible and comparable.

In addition, considering the increasing relevance of DC schemes at a pan-European level, the OPSG would suggest EIOPA that it could be useful to better evaluate the shift in investment decision following the shocks also for DC schemes.

6. Second round effects on financial markets

In section 4 of its report, EIOPA sets out its findings in relation to the extent to which IORPs would transmit the shocks to the rest of the financial sector and the real economy. There are two elements to the impact: the direct response of IORPs in relation to their investments and the so-called "second round" effects of changes to contributions and/or benefits which may be a consequence of the shock. The report does not address the second element and this is recognised in paragraph 32 of EIOPA's report as an area that needs further work. The OPSG would support EIOPA to do further analysis on this aspect in future IORP stress tests. It is clear⁴ that – based on the Common Methodology – there would need to be significant increases in sponsor support and/or benefit reductions in some MS which, if implemented, might be expected to have a significant impact on the real economy.

The OPSG notes that the findings in relation to investment strategy are primarily based on two sources of data:

1. A questionnaire issued with the DB/hybrid stress test asking IORPs to indicate how they would respond to the adverse market scenarios;
2. Data previously collected in relation to actions taken in relation to the investment allocations of IORPs in response to the market crash of 2008.

Unfortunately, the data obtained via the questionnaire in (1) are not representative of IORPs for the EU as a whole. The questionnaire was answered in a quantitative manner by only 16% of the participating IORPs. At the same time, about half of all participating IORPs provided a qualitative or indicative response. In particular, no responses were provided directly by UK IORPs, although the Pensions Regulator reported that the action taken would depend on the position of each individual IORP, including the level of sponsor support available. The majority of IORPs who responded quantitatively indicated that they would rebalance by selling bonds and buying equities. As a consequence, IORPs would act as stabilisers in financial markets in the event of an adverse market scenario. Other IORPs indicated that they would take no action i.e. they were operating on a buy and hold basis, and some would sell equities and buy bonds. Given the non-representative nature of the data, and the fact that it was considering a hypothetical situation, the OPSG thinks that it would be unwise to draw any firm conclusion from the responses received.

The data collected in relation to actions taken in response to the 2008 financial crisis (which included UK IORPs) might be more reliable as they capture actual practice. However, the response rate is disappointing. The responses also included DC IORPs. This indicates that the extent to which IORPs sold bonds and bought equities to rebalance portfolios was relatively limited. In NL and DE the crisis was partly addressed by using derivative instruments. The large UK IORPs in the sample were net sellers of equities in 2008, accelerating the general trend to de-risk investment strategies. The OPSG believes that such data are very interesting and would urge EIOPA to undertake and publish further analysis thereon.

⁴ See figure 30 in the report.

The OPSG supports the conclusions which EIOPA has drawn from the exercise. It is not possible to infer that IORPs generally will act in a countercyclical manner in the event of adverse market scenarios. However, there is likely to be a variety of possible responses. The reactions to the questionnaire indicate that Dutch IORPs would rebalance in the event of a market crash. As one of the largest IORP sectors this could have a material stabilising effect on markets. However, the data from 2008 (which is not fully representative, but does include UK) suggests that "full rebalancing may not be realistic".

7. What does the OPSG expect from EIOPA for the next IORP stress tests?

In OPSG's view, a stress test on DB IORPs could be more useful if it assesses the impact of stress scenarios on the contributions of members, the pensionable income of beneficiaries and the contributions of sponsoring companies and as such provides information on the more macro-economic consequences of financial shocks through IORPs. The stress test for DC IORPs is better suited in this respect. The shift from DB toward DC schemes highlights the need for more comparable information.

The IORPs that participated in the stress test found it complicated and costly. The tests covered mostly bigger IORPs. If they were as well to cover small and medium size ones this would be even more the case. EIOPA concludes that IORPs did not pose systemic risks nor threatened the financial stability. Thus the need for future stress tests needs to be carefully considered as well as the way in which they are conducted. In addition, the frequency of testing is an important issue. Based on the now published results the OPSG finds that already conducting the next tests in 2017 may not be justified. The OPSG would urge that any future IORP stress test should take the proportionality principle into consideration. The tests have to be useful and justified also from the IORPs point of view. This can be achieved by making the stress test as simple as possible, principle based and relying also in the future first and foremost on national frameworks (NBSs). One option the OPSG gives in consideration is to have the National Supervisory Authorities to conduct the stress test. This would not put the administrative burden and costs directly and exclusively on individual IORPs.

As the importance of the 2nd pillar occupational pensions in the total retirement income increases, the OPSG agrees with EIOPA that risk management is important for IORPs and that the economic and financial market impacts need to be further investigated. The proposed new IORP II Directive will change risk management requirements when implemented. The concept of risk assessment that most likely will be introduced in the new IORP II Directive should be given time to develop and could then be a useful basis for further stress tests.

The results of the stress test show that the current investment environment, and in particular the low interest rate, has posed challenges to IORPs. The results based on existing prudential frameworks in each country are in many ways different from those based on the CM. The OPSG is not convinced that the results using the CM are suitable or useful as the competence to act continues to be at national level. As occupational pensions are strongly linked with national social, labour and tax law, the use of the HBS-type Common Methodology is practically not possible. That should be taken into

consideration when assessing the development of stress tests and the CM. Good results can also be achieved by using e.g. ALM-studies, which many IORPs already do.

Should EIOPA decide to continue developing the Common Methodology, all stakeholders should be included in this debate. The OPSG recognises that EIOPA is interested in gaining comparable data on IORPs. At the same time, the OPSG thinks that it could be possible to develop European principles, which would respect the diversity of the pension landscape and be in line with national supervisory regimes. This would also take better into account the behavioural aspects of IORPs in stress situations. Once again, the OPSG wants to suggest a principle based approach, leaving freedom to NSAs to calibrate the system with a view on national practices.

*

*

*

Adopted by the EIOPA Occupational Pensions Stakeholder Group on 15 March 2016

The Chairperson of the EIOPA Occupational Pensions Stakeholder Group

PHILIP SHIER