



EIOPA 2019 IORP STRESS TEST

AEIP First Response to the EIOPA 2019 IORP Stress Test

17 December 2019

European Association of Paritarian Institutions - AEIP

Executive Summary

The goal of the following points is to provide some preliminary comments on the conclusions reached by EIOPA in its final report on the IORP Stress Test, published on 17 December 2019, as well as general recommendations.

- AEIP appreciates the fact that EIOPA discussed with stakeholders the cash flow analysis and took it into account for the 2019 IORP Stress Test (ST).
- The 2019 ST exercise is seen as a ‘snapshot’ for Pension Funds (PFs), which does not show the potential for market recovery over time.
- The interpretation of the results of the cash-flow analysis (CFA) is straightforward and clear, since the CFA shows the size and timing of cash flows over time and for different scenarios.
- Stress Test results should be interpreted carefully and most importantly they should be linked to macroeconomic indicators, (such as EU GDP) in order to indicate the correct proportionality of the results.
- Due to their existing recovery mechanisms, PFs are well equipped to meet their engagements in the longer term.
- Financing sustainable growth and participating in the Capital Markets Union (CMU) requires a certain risk appetite, so conclusions deriving from the ST should not lead to PFs not participating in the CMU.
- Bearing in mind that the UK and Ireland do not participate in the 2019 EIOPA IORP ST exercise, but also that the Dutch PF sector amounts to approximately 60% of assets, we consider that the results of the 2019 ST report are not representative of the full EU market.
- Further development and incorporation of ESG factors should be done at the stage when methodologies are more developed but also when comparable and scientifically underpinned data is available. Moreover, any further development of ESG factors in the ST should be aligned with the proportionality principle, given the high cost of ESG data.
- Disclosure of names of IORPs participating in the ST 2019 should be avoided.

Introduction

IORPs play an important role in securing an adequate pension for the European citizens. They run counter-cyclically to economic cycles during periods of economic downturn.

Due to the specificities of their liabilities, Pension Funds are “by nature” long-term investors and therefore constitute a natural partner to finance sustainable growth. In the current economic environment with persisting low interest rates, we also see a growing interest among pension funds to invest in the real economy including alternative asset classes such as infrastructure and private equity.

It is important to also stress that second pillar pension plans supplement social security pensions and as such they are very heterogeneous within Europe; therefore, a one-size-fits-all approach does not work. Most of these occupational pension funds run as non-profit organizations, jointly managed by employee and employer representatives.

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AEIP welcomes the stance of EIOPA, organizing an informal consultation process for relevant stakeholders and giving us the opportunity to provide input. In addition, AEIP appreciates the fact that EIOPA discussed with stakeholders the cash flow analysis and took it into account for the 2019 IORP Stress Test.

AEIP would like to provide the following points below as preliminary comments on the conclusions reached by EIOPA in its final report on the IORP Stress Test, published on 17 December 2019, as well as general recommendations.

The 2019 ST exercise constitutes a ‘snapshot’ for Pension Funds, which does not show the potential for market recovery over time

The 2019 ST was performed in a period when the European financial markets were in a stress situation. At the last quarter of 2018, markets had already dropped by 12%¹ which means 30% lower than today². The stressed situation of the financial markets at end 2018 recovered in a period of 3 months. On the contrary, the ST assumes a drop of 40% in the stock market with no recovery in the future.

As a result, when referring to the 2018 market situation, the 2019 ST exercise is a harsh ‘snapshot’ for PFs, which gives information only on a certain moment in time but does not reflect the long-term evolution and eventual recovery of the funding situation. On top, it has to be taken into account that the existing benefit security mechanisms of PFs will offset the negative impact, if the recovery of the financial markets will take too long. Due to their existing recovery mechanisms, PFs are well equipped to meet their engagements in the longer term. Such a ‘snapshot’, which does not show the market’s recovery potential over time and which also provides unfit information on financial risk, is very likely to not only discourage DC Pension Funds that currently participate in the ST on a voluntary basis but also to dissuade members of DC schemes that in many cases join the former also voluntarily.

Stress Test results should be interpreted carefully, and most importantly they should be linked to macroeconomic indicators (e.g. EU GDP) in order to indicate the proportionality of the results. To that effect, it should be noted that not putting these ST results into perspective could lead to misinterpretations and, eventually, to wrong conclusions by policy-makers.

Financing sustainable growth and participating in the CMU requires a certain risk appetite. Conclusions deriving from the ST should not lead to PF not participating in the CMU, while ST results should not shy away Pension Funds from investing in equity. IORP II fully recognizes the long-term investment strategy of pension funds and respects a risk-based framework in the interest of the sponsors, members and beneficiaries.

Methodology used: Cash-flow analysis compared to the Common Balance Sheet

The interpretation of the results of the cash-flow analysis (CFA) is straightforward and clear, since it shows the size and timing of cash flows over time and for different scenarios. Applied to IORPs, it would avoid artificial results and the introduction of short-term volatility. In addition, CFA can be related and expanded to macroeconomic indicators, thus showing the ST effects over time on consumption and the economy. Importantly, CFA can be used whatever the characteristics of the underlying pension plan provisions are (so regardless whether it concerns DB, DC or hybrid schemes). Since the current stress test methodologies

¹ Source: MSCI World index

² Ibidem

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for DB and DC plans are completely different, the adoption of a CFA by EIOPA could bring these results substantially closer. Finally, in CFA it is easier to take into consideration the various national recovery mechanisms, which differ among member states.

On the other hand, we would like to stress that the CFA only makes sense with realistic market scenarios. Risk neutral scenarios, which were also considered in the 2019 stress test, are inappropriate in a CFA method since CFA isn't about pricing. CFA should be done with realistic scenarios and with stresses in realistic scenarios. Moreover, it only should be done with an appropriate time horizon such as 10 to 15 years.

In addition, AEIP would like to point out the following concerns over the CBS approach used to draw EIOPA's conclusions in the 2019 ST Report:

- Market consistent valuations of liabilities are unreliable and too dependent on arbitrary assumptions, approximations and simplifications. We question whether market consistency will provide for a realistic picture of the financial soundness of an IORP due to their long-term horizon;
- The misconception that present (option) values (e.g. of benefit reductions) can be interpreted as expected values);
- The execution of the CBS is linked to high costs for IORPs;

As a consequence, we do not believe that the Common Balance Sheet can be implemented in an effective way, especially for small and medium sized IORPs.

More developed CFA should replace the CBS. We appreciate that EIOPA has elaborated the cash-flow analysis in this ST exercise to come to a more comprehensive analysis, including sponsor support and benefit reductions.

Representativeness of the 2019 EIOPA IORP Stress Test results

The ST should be indicative of the picture of IORPs at the European level. Bearing in mind that the UK and Ireland are not participating in the 2019 EIOPA IORP ST exercise, but also that the Dutch PF sector amounts to approximately 60% of assets in EU, we consider that the results of the ST report are not representative of the full EU market and cannot be indicative of the situation at the European level. Due to this fact, further reflection is needed whether a European stress test is 'fit and proper' for the purpose.

Consideration of ESG Factors

We welcome the consideration of ESG factors in the ST exercise for the first time. We would like to stress that further development and incorporation of ESG factors should be done at the stage when methodologies are more developed but also when comparable and reliable data is available, as corporate reporting of quantitative non-financial information is still non-standardized and largely voluntary. Moreover, we believe the further development of ESG factors in the ST should be aligned with the proportionality principle, given the high cost of ESG data.

AEIP agrees with the integration of transparency rules for ESG factors related to the decision-making and investment choices of institutional investors. Nevertheless, the latter should have the discretion to choose the form and way of such integration, which would reflect the participants' preferences and according to the market practice. We would like to also underline that there is a need to further consolidate the

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approach towards sustainable finance at European level, ensuring there is a degree of consistency between the policy instruments promoted by the European Commission and EIOPA.

Non-disclosure of names of participating IORPs

Disclosure of the names of IORPs that participated in the ST 2019 should be avoided. By disclosing the names of participating organizations, there is the risk of creating a *de facto* situation and pressure for revealing the ST results as well. In the recent review of EIOPA's mandate, the co-legislators clearly rejected the notion that EIOPA should have the power to disclose the results of individual IORPs. By disclosing the names, which could lead to pressure on IORPs to disclose the results on a voluntary basis, EIOPA is acting against the spirit, if not the letter, of its mandate. Providing information on stress test results would not be beneficial for members, as they would struggle to appreciate the severity of the adverse scenario (in particular without recovery) as well as understand the difference with the national valuation, which is more relevant to their pension outcomes.

AEIP will work on a position paper in order to provide detailed comments on the results and conclusions of the 2019 EIOPA Stress Test, to be published later at the beginning of 2020.

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The European Association of Paritarian Institutions – AEIP, founded in 1996, is a Brussels-based advocacy organization, representing Social Protection Institutions established and managed by employers and trade unions on a joint basis within the framework of collective agreements.

In the context of social protection, paritarism is a type of self-organization of social relationships which on the basis of equal negotiations, brings about agreements which are equally binding on both employers and employees. This kind of self-organization goes from the paritarism of negotiation to the paritarism of management and results in various types of agreements, from adhesion to a particular form of cover to the creation of a paritarian institution.

The Association has 20 Associate and Affiliate members - all leading large and medium-sized Social Protection Institutions, from 12 European countries, as well as 13 Task Force Members from 3 European countries. All AEIP members are not-for-profit organizations.

In particular, AEIP deals – through dedicated working groups – with EU coordinated pension schemes, pension funds, healthcare, unemployment and provident schemes, paid holiday and health & safety at work schemes. Complementary to their role as non-for-profit social protection providers, AEIP members are also long-term institutional investors.

AEIP represents its members' values and interests at the level of both European and international institutions.

For more information: www.aeip.net