EIOPA 2017 IORP STRESS TEST

AEIP Position on EIOPA's 2017 IORP Stress Test Report

21 March 2018

European Association of Paritarian Institutions - AEIP

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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

AEIP would like to thank EIOPA for the opportunity to participate in the exchange of views in Frankfurt on 6 February and 19 April 2017 and to provide comments on the draft technical specifications of the 2017 IORP Stress Test.

AEIP would like to stress on the following points as comments on the conclusions reached by EIOPA as part of its final report on the IORP Stress test from December 2017 as well as to provide indications to be taken into account by EIOPA in the preparation of the Stress Test in 2019.

EIOPA Conclusion: European Institutions for Occupational Retirement Provision (IORPs) providing defined benefits and hybrid pension schemes have, in aggregate, insufficient assets to cover their liabilities.

In the first place, AEIP appreciates that EIOPA has introduced the cash flow analysis in its 2017 stress test. AEIP believes that the cash-flow analysis should replace the Common Balance Sheet in future stress tests. This would substantially lower the burden on IORPs and will provide more useful indicators than the ones given by the CBS.

Further work is certainly needed in this context, AEIP is ready to provide its expertise and to cooperate with EIOPA to develop a sound cash-flows-based methodology for the 2019 stress test.

With regard to the above mentioned conclusion, we think that the IORP stress test is heavily influenced by an underdeveloped framework which is far away from being theoretically sound. As emphasized in our response to EIOPA's consultation on solvency of IORPs and at the occasion of the 2015 EIOPA stress test on IORPs, AEIP does not believe that the Common Balance Sheet (CBS) for IORPs can serve as an adequate tool for prudential supervision.

Based on the national balance sheet, EIOPA has concluded that the funding ratio of all IORPs included in the sample amounts to 97% corresponding to only 3% shortfall of assets relative to liabilities in the baseline scenario. This is only based on current assets, excluding sponsor obligations and commitments and other steering instruments - including these would improve the reported funding position. In our opinion this deficit cannot be counted as an actual funding problem, considering the adversity of the applied "double hit" scenario.

In addition, the CBS remains too complex for small and medium sized IORPs, where there are less complex and more efficient methods available[1].

AEIP believes that there is no need for CBS for IORPs across EU considering the following:

- National IORP systems and their supervisory frameworks are very different. They fall under national social and labour law and therefore specific rules are existing in each Member State making it difficult to compare the IORPs. This diversity is also recognized in the IORP II Directive.

[1] Tools as Asset Liability Management, Continuity Tests or national Stress Tests already exist and have proven their adequacy during the years following the financial crisis.

- We question whether market consistency will provide for a realistic picture of the financial soundness of an IORP due to their long-term horizon. Applied to IORPs it will lead to artificial results and will introduce short-term volatility;
- Protection of members and beneficiaries is demolished if in the end retirement plans are terminated or all risk is shifted to the individual;
- Long-term investments should be encouraged.

Other important issues with the CBS approach used to draw EIOPA's conclusions we want to point out are:

- Market consistent valuations of liabilities are unreliable and too dependent on arbitrary assumptions and approximations and simplifications;
- The misconception that present (option) values (e.g. of benefit reductions) can be interpreted as expected values);
- The execution of the CBS is very expensive. As a consequence we do not belief the CBS can be implemented in an effective way, especially for small and medium sized IORPs.

EIOPA Conclusion: A significant portion of sponsors may not be able to fully support the pension promise when it is needed signaling that pension obligations may exert substantial pressure on the solvency and future profitability of businesses and, hence, could have an effect on the European economy.

We appreciate that EIOPA has tried to lower the burden on IORPs for calculating the sponsor support, allowing them to use own models or publicly available data, or to declare that such data are not available. However, given such simplifications, we do not consider that the results will be comparable at EU level and of any meaning. AEIP believes that IORPs should not be encouraged to use approximations in assessing these numbers e.g. up-scaling data from the largest sponsors can lead to seriously wrong results.

In AEIP's opinion, the CBS with a valuation approach does not give much indication (if any at all) about the future capacity of sponsors.

A European Common Framework that assesses the risks of the pension arrangement is not possible as it goes beyond the borders of EIOPA's mandate and competences.

Pension arrangement between employer and employee can be executed via an IORP, an insurance company, or it could simply stay on the books of the company. Therefore, it is not clear why an assessment of the sponsors' capability of keeping up its pension promise is due only when this sponsor opted to organize its pension benefits via an IORP.

AEIP believes that given the different impact of national prudential regulations on sponsors of pension funds and the lack of adequate information on sponsor strength, it will not be possible to give an adequate and balanced assessment of the sponsor support.

As already stressed in the informal consultation of February 2017, AEIP does not agree with the avenue for assessing the impact of the adverse scenario even for more practical reasons: normally IORPs simply do not have data about sponsors.

EIOPA Conclusion: Vulnerabilities could spill-over to the real economy either through the adverse impact on sponsors and/or on beneficiaries through benefit reductions.

Recovery mechanisms mitigate the short-term effects on financial stability, but in the longer-term put the burden of restoring the sustainability of pension promises disproportionately on younger generations.

Acknowledging the heterogeneity of the institutional setting of IORPs in EU member states is important for a European-wide stress test. The importance of the occupational pension sector differs from one country to the other. It is also essential to take into account the different nature of IORPs that first and foremost are social institutions and provide pensions as social products. Since pensions are a social product they are subject to the social and labour law of the MSs and the pension deal is part of subsidiarity.

We want to stress that the 3% shortfall of assets relative to liabilities in the adverse market scenario cannot be considered as a factor for potential major spill-over risks considering IORPs' specific nature: IORPs can absorb financial shocks without amplifying or transmitting effects and have stabilizing impacts on the financial markets.

The extent to which IORPs transmit the shocks to the rest of the financial sector and the real economy is limited due to a number of factors as limited linkages to other financial institutions, prohibition from borrowing, long-term pension commitments. In addition, it has to be considered that NCAs generally grant longer recovery periods for IORPs to mitigate a low funding situation, spreading out the impact over several years.

Going forward

We believe that EIOPA's role and position is to assess the impact of stress scenarios at a macro-level. This means the macro-economic impact on society in a Member State and at an EU-level. The added value of the next EIOPA stress test would be to look at the broader picture and to which implications financial shocks could have for the members and sponsors of an IORP. This would be more useful than assessing the impact on the IORP itself. The cash flow analysis, if further developed to this end, could prove to become a very useful tool.

More developed cash-flow analysis should replace the CBS. We appreciate that EIOPA has recognized in its response to our input that the limited cash-flow analysis in this stress test exercise constitutes a first step towards a more comprehensive analysis, including sponsor support and benefit reductions. This method could be developed further by including steering instruments. These steering instruments can consist of (if applicable) sponsor support, future contributions and benefit policies such as indexation and reduction mechanisms. Additionally, these can also consist of the asset allocation of the IORP and the expected returns.

In its response to AEIP's input to the Consultation with stakeholders in February 2017, EIOPA has indicated that market-consistent balance sheet valuations and cash-flow analysis can supplement each other, instead of being mutual exclusive. However, we consider that it is too burdensome to work with both approaches.

AEIP suggests the inclusion of a realistic scenario to the next stress-test. The provided stress scenario referred to unrealistically adverse market conditions. In addition, safe heaven assets, which in practice often consist of high quality government bonds, did not exist. Moreover, this scenario also treated government bonds from Europe and outside Europe so differently that it compromised the results of stress test.

EIOPA has stated that Environmental, social and governance (ESG) aspects will also be of growing importance for the pensions sector and will require cautious assessment of any financial stability implications. **AEIP would like to stress on the key role EIOPA can play in sharing best practices and ensuring capacity building.**

We would like to stress that there is a need to further consolidate the 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.