



Association Européenne des Institutions Paritaires

European Association of Paritarian Institutions

Liquidity risk management of IORPs

**AEIP reply to EIOPA's consultation paper
on the draft Opinion on the supervision
of liquidity risk management of IORPs**

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Q.1. The draft Opinion aims to be consistent with the FSB's proposed policy recommendations to enhance the liquidity preparedness of non-bank market participants. However, the draft Opinion covers all sources of liquidity risks within its scope rather than only liquidity risk relating to margin and collateral calls. Do you agree that the draft Opinion takes a comprehensive approach to liquidity risk of IORPs? Please explain.

Yes

No

It is understandable that liquidity management must be integrated in the risk-management processes of pension funds. In extreme cases, inadequately managed liquidity risk can have a negative impact on the pension fund, its members and beneficiaries and other financial institutions.

Pension funds consider all sources of liquidity needs, where applicable, to ensure a comprehensive approach of various liquidity risks. Based on our experience, we are not aware of sources of liquidity needs other than material margin and collateral calls on derivative positions that could qualify as material liquidity risks, as defined in section 3.2.

While we agree with EIOPA's approach (A2) on 'Scope covering all material sources of liquidity risk', we disagree with the examples of other sources of liquidity risk cited, at least as to whether they can be considered material. For instance, Annex II indicates that in most Member States, early withdrawals and transfers are not possible or only under specific conditions, and individual transfers by plan members are possible under specific conditions. Such scenarios have much longer time horizons than variation margin calls, which have to be settled on an intraday basis. It takes a long time to get a value transfer approved and lumpsums will need to be request ahead of time.

We point out that:

- a central element of liquidity risk is that events that result in obligations are difficult to be predicted upfront with a short to very short time horizon.
- what is evident from the Opinion is that most national competent authorities admit that liquidity risk exposures are low or non-existent, importantly only six NCAs identified medium or high liquidity risk exposures.

Considering the above we acknowledge that supervision should take a comprehensive approach, but due to the IORPs' diverse nature this should be in line with the minimum harmonisation principle. This is significant, as pension funds face different sources of risk, and the supervision of liquidity risk varies across Member States in terms of frequency and conditions, as shown in Figure 14 of the Opinion. Therefore, it should be determined at national level which additional requirements are necessary.

The cost of additional reporting requirements should be considered carefully as this cost should not lead to small and mid-sized IORPs no longer using derivatives to mitigate their risk exposure.

Q.2. Do you agree with the definitions of 'liquidity risk' and 'material liquidity risks' in paragraphs 3.1 and 3.2? Please explain your answer and provide any suggestions to improve the definitions.

Yes

No

We understand that the issues pension funds in the UK faced in 2022 points the attention of EIOPA to the liquidity risk that might exist in certain IORPs in the EU. The situation in the UK has laid bare the implication of margin rules against which the pension fund sector has long been warning for. Following the UK LDI crisis, pension funds and their fiduciary managers reviewed their interest

sensitivity analyses and liquidity management processes. The liquidity management of EU pension funds proved robust during the turbulence on the financial market in the COVID-19 crisis and the recent strong, albeit gradual, interest rate increases.

The level of interest rate hedging in IORPs in the EU is generally lower than the UK legacy DB funds, which were often fully hedged. Where derivative exposures of some pension funds are large, they do not nearly play the same role in the EU bond market as the UK pension funds do in the UK gilt market. Thus, the risk of setting off a negative feedback loop is smaller.

As it is also shown from this consultation paper, only a small number of pension funds make significant use of derivatives or engage in other activities with substantial liquidity risks in Europe. We agree with the definitions of "liquidity risks" and "material liquidity risk", and we focus on the word 'jeopardise' in the material liquidity risk definition. Our understanding is that this implies a pension fund is not required to implement specific liquidity risk measures unless a material risk is identified, which aligns with the current approach under the ORA. For instance, for liquidity risk management the evidence could be provided by a liquidity-surplus-calculation for short- and medium-term projections.

To ensure proportionality, it is crucial that the IORP retains the discretion to assess what constitutes "jeopardy" and "material risk" to avoid imposing unnecessary burdens. Furthermore, based on the consultation paper, we conclude that material risk could jeopardise only for IORPs that make use of derivatives. Consequently, this should not introduce additional obligations beyond those already in place, which are functioning effectively in the context of liquidity risk management.

Q.3. The draft Opinion specifies that NCAs should gather relevant derivative data to assess liquidity risk exposures of IORPs. Are you aware of any issues or obstacles for IORPs:

- in collecting derivative data from asset managers to monitor and assess liquidity risks in relation to margin and collateral calls; Yes No
- in reporting relevant derivative data to NCAs? Yes No

If 'yes', please explain

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Q.4. The draft Opinion envisages a two-step approach. IORPs should first assess whether they are exposed to material liquidity risk and, if so, integrate liquidity risk in their system of governance and risk-management system, including an assessment in their own-risk assessment (ORA). Do you agree with this two-step approach? Please explain.

Yes

No

The IORP II Directive requires that IORPs have in place an effective and well-integrated risk-management system, in accordance with Article 25 thereof. IORPs are required to carry out and conduct their own-risk assessment (ORA), in accordance with Article 28 of IORP II. As part of the ORA already today IORPs assess their liquidity risks and take appropriate measures to mitigate these risks. AEIP agrees with this two-step approach as we believe that ORA should not solely focus on liquidity risk management. It is crucial for IORPs to maintain focus on processes related to other risks as well. The liquidity risks of IORPs will only qualify as "material" in a limited number of Member States i.e. where IORPs make extensively use of derivatives.

Q.5. The draft Opinion provides in paragraph 3.6 suggestions for possible sources of liquidity risk that IORPs are exposed to. Are you aware of any other sources of liquidity risk that should in your view be explicitly addressed? Please explain your answer.

Yes

No

No, we are not aware of other sources that need to be addressed.

Q.6. Do you agree that IORPs with material liquidity risk exposures should establish a contingency plan to deal with liquidity stress, as expected in paragraphs 3.8-3.10? If 'no', please explain why and provide any suggestions on what other measures IORPs would put in place.

Yes

No

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Q.7. The draft Opinion provides in paragraph 3.12 that IORPs should define their own liquidity risk indicators for day-to-day risk management. Subsequently two examples of commonly used risk indicators (liquidity coverage ratio & excess liquidity indicator) are suggested. Are you aware of any other liquidity risk indicators that are commonly used by IORPs? If 'yes', please explain.

Yes

No

Different indicators are used across Member States. In the Netherlands, pension funds define tailor-made indicators based on the indicators mentioned, adapted to the risk tolerance and specific risk profile of the IORP.

In Germany a tried and tested method for recording and analysing liquidity risks, for example, consists of consistently rolling liquidity planning, which takes into account all future (planned) incoming payments (contributions, interest and repayments, dividends, rents, etc.) and outgoing payments (pension payments and outgoing payments (pension payments, costs, investments, etc.) with the date on which they become effective.

Q.8. Do you agree that IORPs with material liquidity risk exposures should establish and maintain a clearly defined liquidity risk tolerance statement approved by the management or supervisory body of the IORP, as expected in paragraph 3.14? If 'no', please explain why not and provide any suggestions on alternative practices used by IORPs.

Yes

No

We agree with EIOPA that is prudent and necessary that IORPs have in place the necessary risk management functions. Such an approach is already safeguarded under the current rules since pension funds are already obliged to have in place risk management functions to deal with liquidity and concentration risk management in accordance with Article 25 of IORP II. Moreover, they are required to carry out and conduct their ORA, in accordance with Article 28 of IORP II. Furthermore, according to Article 30 IORPs, at least every three years, IORPs should prepare a written statement of investment-policy principles. The statement deals with matters such as investment risk measurement methods, the risk-management processes implemented and the strategic asset allocation with respect to the nature and duration of pension liabilities.

In this context, it should be left to the IORP to determine how to document their risk exposures. For instance, some IORPs may report all their risk exposures under the ORA, while others might opt to differentiate among risks and report them separately. In countries such as the Netherlands, where pension funds are more likely to face material derivative calls, funds already have well-established statements defining their risk tolerance and addressing the concepts outlined in paragraph 3.14.

Conversely, in countries such as Germany and Belgium (and the majority of EU countries mentioned in Annex II), where pension funds are not significantly exposed to margin and collateral calls on derivative positions, IORPs document their risk assessments under their ORA. In such countries, it is unnecessary to implement a separate liquidity risk tolerance statement, as this would impose an unnecessary administrative burden. It goes without saying that if any risks related to material derivative positions were to arise, they would be identified and addressed through the ORA, as is the case with all other risks.

In summary, we believe that the issues that Q.8 seeks to address are already effectively managed, since in countries where a material derivative exposure risk exists for IORPs, IORPs already have clearly defined liquidity risk tolerance statements. In other countries where no such risk needs to be segregated from other risks, all risks are already effectively managed through the ORA and the statement of investment policy principles.

In conclusion, material derivative exposure should not lead to a blanket obligation for all IORPs to have in place liquidity risk tolerance statements as this will go against the minimum nature of the IORP II Directive and the diverse structure and nature of IORPs.

Q.9. The draft Opinion prescribes in paragraph 3.15-3.16 that IORPs should regularly review and update their liquidity risk-management system. What would in your view be appropriate triggers and minimum requirements for such a review?

In principle the review should align with the rules established in Article 28 of the IORP II regarding the ORA. Since liquidity risks are one of many risk factors, conducting an ORA every 1 to 3 years or on an ad hoc basis in response to significant changes in the risk profile appears to be a prudent approach.

Furthermore, we believe that the wording in paragraphs 3.15 and 3.16 is sufficiently broad to encompass all relevant scenarios, without prescribing specific scenarios that would trigger a review. Pre-defining these scenarios could lead to an exhaustive list of triggering events. Liquidity risk monitoring is not a one-off measure, but rather a process of continuous (daily) monitoring. Any adjustments made in the portfolio (in real assets or derivatives) should automatically result in new minimum liquidity buffers. As such there is no need for additional triggers.

Q.10. Do you agree that IORPs should perform stress tests and scenario analysis covering all material sources of liquidity risk, and assess the impact of a range of severe, but plausible liquidity stresses, as expected in paragraphs 3.17-3.20? Please explain and provide any suggestions on the proposed minimum requirements for the stress tests and scenario analysis.

Yes

No

In general, yes, as long as it is within the discretion of the IORP to determine and classify what constitutes a material source of liquidity risk or a plausible liquidity stress event. This flexibility is important for respecting and acknowledging the heterogeneity, specific characteristics, and investment approaches of each pension fund. Additionally, we only answer yes to this question

under the condition that the definition of material risks is appropriately refined, meaning it should be more narrowly defined.

Currently, pension funds or their fiduciary managers (to whom treasury and asset management is outsourced) regularly conduct these types of exercises, alongside the stress test conducted by supervisors. In the Netherlands, both internal and supervisory stress tests have shown that pension funds are able to withstand significant interest rate shocks.

Overall, such scenarios and stress tests should not be viewed as isolated exercises. Instead, they should be integrated with previous analyses of pension funds, such as those conducted under the ORA, and future practices. This approach ensures a more comprehensive understanding of the pension fund's long-term outlook and risks. Moreover, such practices should not lead to any comparative conclusions for IORPs either within or across Member States neither should lead to the creation of uniform and common stress scenarios. The minimum approach of the IORP II needs to be respected. Again, we emphasise that the heterogenous nature of IORPs needs to be respected and any rules should be principles based.

Q.11. Do you agree that IORPs should maintain an adequate buffer of liquid assets to cover any shortfall of incoming relative to outgoing cash flows, also under severe but plausible stress conditions, as expected in paragraphs 3.21-3.23? Please explain and provide any suggestions on the conditions imposed on the liquid assets in paragraph 3.22 and 3.23.

Yes

No

Yes, we agree that IORPs with material liquidity exposures should maintain an adequate buffer of liquid assets to cover any shortfall of incoming relative to outgoing cash flows. Also, we believe that overall, it is sensible for pension funds to have a certain operational liquidity. Still, since liquidity risk buffers inherently come with alternative costs, they should be minimized and restricted to only what is necessary to address real liquidity risks specific to the pension fund's operational model. Even if liquidity risks may arise under "severe but plausible risk conditions," the IORP's risk management function should be permitted to address this through non-liquid assets that could be sold at a discount if necessary. This approach allows for a more flexible and cost-effective risk management strategy, tailored to actual liquidity needs without overburdening the fund.

We have the following comments about the definition of liquid assets and buffer:

First, the "buffer" should not only consist of assets, but should also take into account the availability of short-term borrowing facilities, most importantly repo. Primary liquid assets will need to be transformed into cash through sale or repo, and pension funds will often use the latter, in particular to meet collateral calls. Therefore, we would add to the first sentence of paragraph 3.22 that assets should be readily marketable "or transformable".

Second, we believe that the list of primary liquid assets is too restrictive and should be expanded. Even if paragraph 3.22 does not appear to limit the assets eligible for the buffer of liquid assets to just those included in the list of primary liquid assets in the Annex, the Annex could be interpreted as an exhaustive list by NCAs or for other regulatory initiatives in the future. It is therefore important that, for example, money market funds and other money market instruments are considered. MMFs are a key asset for IORPs' liquidity risk management. Also, the sale of reverse repos is a key source of liquidity for IORPs and essential for being able to cover shortfalls and these facilities should be taken into consideration as such.

In this context, we emphasise that for IORPs, particularly large Dutch IORPs, cash in practice does not exist (in its traditional sense). Specifically, in the Netherlands, holding cash in a bank account results in (100%) counterparty credit risk exposure. Furthermore, Dutch IORPs indicate that banks are unwilling to allow them to maintain large amounts of cash at bank accounts at all times, as this would be too costly for the banks. Consequently, any cash is invested in money market instruments and is considered part of the buffer. It should be taken into account that a cash buffer will come with transformation risk.

Third, we consider that equities could also be included as liquid assets with an appropriate haircut, also considering that equity markets have better liquidity than, e.g., credit markets.

Fourth, we note that liquidity buffers always come with opportunity costs; therefore, they should be kept at a proportionate level. We believe that even when there might be liquidity risk under "severe but plausible risk conditions", the risk management function of the IORP should be allowed to cover this by non-liquid assets that could be sold with a haircut if the necessity emerges.

Q.12. Do you agree that IORPs with material liquidity risk exposures should periodically test their liquidity contingency plan through simulation exercises in order to ensure operational readiness, as expected in paragraphs 3.24-3.26? Please explain and provide any suggestions on the conditions imposed on the periodical testing.

Yes

No

While periodic testing should be part of an effective liquidity contingency plan, proportionality should be a key consideration (such as risks and costs of testing) in determining how this testing is conducted. Conducting actual trades may be too costly, but appropriate to hold so-called fire drills during which operational processes are tested. For instance, these drills could verify, whether processes are in place to port positions, in case of a default of a clearing member. It is important to acknowledge that there is a wide spectrum of market conditions that could occur during a real liquidity squeeze, and it is impossible to simulate all possible scenarios.

Q.13. To prevent operational lags in fulfilling margin requirements, do you agree that IORPs should ensure that investment funds to which IORPs have outsourced the management of derivative instruments should hold sufficient buffers of liquid assets to cover margin calls in times of market stress?

Yes

No

Should this apply to all outsourced derivative arrangements or only a specific subset, considering for example segregated accounts/mandates versus multi-client/pooled funds and AIF versus UCITS funds? Please explain.

all outsourced derivative arrangements

only a specific subset

Yes, we acknowledge the need for careful assessment in the case of material liquidity risk exposures. As an example, in the Netherlands, pension funds predominantly operate through mandates under which fiduciary managers trade on their behalf. These fiduciary managers are responsible for all aspects of asset management, including treasury functions. As a result, the Dutch pension sector would not encounter the same operational challenges that were present during the UK LDI crisis,

since a single actor is responsible for meeting variation margin calls. However, we believe that investment funds should be held to the same level of supervisory expectations.

Q.14. Do the expectations put forward in the draft Opinion achieve a proportionate approach to liquidity risk management of IORPs? If not, please provide your suggestions to improve proportionality of the draft Opinion.

Yes

No

The regulatory burden should take into account the risk profile of IORPs, as well as the limited and unlikely relevance of liquidity risks for the majority. Most IORPs should be exempt from excessive regulatory burden, ensuring proportionality is applied. Article 25 of the IORP II Directive rightly acknowledges “size and internal organisation” alongside “nature, scale, and complexity” of IORP activities. Small investments by smaller or medium-sized IORPs do not influence the markets in the same way the GILT crisis did. Therefore, in line with EIOPA’s technical advice for the IORP II review, all proportionality measures should remain available to IORPs and their NCAs. Liquidity risk is just one of many risks and is not a major concern for most IORPs. It should be addressed through the usual procedures and structures within IORP risk management, particularly within the ORA framework. As part of the ORA, it is up to the management of the pension fund to determine if their liquidity risk qualifies as “material” liquidity risk.

Q.15. Do you agree that the Impact Assessment in Annex I provides a balanced view of the costs and benefits of the relevant policy issues in the draft Opinion? Please explain and provide any suggestions.

Yes

No

The draft Opinion specifies that NCAs should collect relevant derivative data to assess the liquidity risk exposures of IORPs. However, this would result in an expansion of the already extensive reporting requirements for all IORPs. Any implicit assumption that this can be done without additional costs for IORPs is incorrect. The impact assessment should therefore take these additional costs into account.

The impact assessment misses the most important cost factor under policy options A1 and A2: the opportunity costs of holding a liquidity buffer. Cash and cash-like assets deliver a low return compared to the rest of the portfolio. Consider the hypothetical situation where European pension funds hold a liquidity buffer to protect against a 1%-point interest rate shock of 67bn euros. Assuming an average annual return of 6% on the broad portfolio and €STR (currently 3,1%) on a liquidity buffer of cash and near-cash instruments, holding the liquidity buffer would entail an annual opportunity cost of 1.9bn euros annually. This is just a theoretical example, but it shows that a pension fund must balance liquidity risks with the interest of its participants in obtaining decent returns. A requirement to hold an excessive buffer would be incorporated into the ALM process and subsequently lead to lower levels of interest rate hedge, leaving participants more exposed. It is important to keep in mind that both interest and currency derivatives are entered into in order to reduce risk in the balance sheet, on behalf of participants.

The impact assessment also misses a qualitative or quantitative assessment of the financial stability risks. These relate to two elements: the ramifications of closing out the position of an IORP at a CCP and the potential to create a negative feedback loop as witnessed in the UK.

It is, of course, undesirable for an IORP to be forced to close out a position at the CCP, but the impact on the pension fund or the CCP has not been fully covered. A more detailed impact assessment could describe the potential ramifications and costs of being closed out. It is important to note, however, that this would occur during a scenario of rising interest rates. For instance, Dutch pension funds are generally not fully hedged against interest rate risk, which means that during such a scenario, their coverage ratio could improve. While the pension fund would default due to liquidity, its solvency position would be improving. As a result, the pension fund would not default on other obligations, and the expected pensions for participants could rise. The main concern in this scenario is that participants would lose a part of their interest rate hedge. If interest rates would fall, this would lead to losses, while if rates would continue to rise, this would lead to even larger gains than before.

We feel that the key reason EIOPA published this Own Opinion are the events in the UK in 2022. LDI strategies of pensions caused a negative feedback loop that pushed interest rates up sharply, as they were selling government bonds in order to meet variation margin calls, gravely undermining financial stability and leading to BoE intervention. To provide insights into the benefits of this own Opinion, it would be useful to quantify the risks of the European pension sector having a similar role in continental European bond markets.

We strongly believe that these risks are significantly smaller than those observed in the UK, for various reasons. First, only a limited number of countries have large IORPs with derivative portfolios, with the Netherlands dominating the landscape. Additionally, it is important to consider the holdings of insurers in this analysis. However, to the best of our knowledge, such holdings are primarily concentrated in Denmark. The role of pension funds and pension insurance companies in euro bond markets is considerably smaller compared to the dominant role of British pension funds in the gilt markets. Their role was further exacerbated by the fact that many DB funds in the UK have derisks, completely hedging the interest rate risk. Average hedges have increased in the Netherlands due to de-risking as pension funds are preparing to convert their liabilities from DB to DC, as well as dynamic hedging policies, but currently stand at 64% (DNB: <https://www.dnb.nl/media/jb5djjc0/ofs-najaar-2024.pdf>). Arguably the level of the hedge will fall, particularly for the longer maturities that swaps are used for, once the conversion has been completed and pension funds no longer use a coverage ratio.

Q.16. Do you have any other comments on the draft Opinion / consultation paper? If yes, please provide these other comments?

Yes

No

Comments for our reply 'No' in Question 3

While we are not aware of any issues or obstacles for IORPs in reporting relative derivative data we wish to emphasise that this Opinion should not lead to any new standard reporting requirements for all IORPs. Proportionality needs to be respected, and consideration must be given only for IORPs who run the risk towards material derivative exposures. To report more data in a standardised form and specified frequency to NCA will pose an additional burden and require more managerial input.

Comments for our reply 'Yes' in Question 6

Developing and regularly updating a contingency plan to deal with liquidity risk is a prudent approach. But this requirement should be limited to situations where a material liquidity risk is likely to arise with a high degree of certainty.

Additionally, regarding section 3.9, we recommend against requiring pension funds to make exact estimates on amounts that can be raised through various liquidity sources and the associated costs. It is not possible to know exactly what the market circumstances will be during a liquidity squeeze, and estimates would likely be unreliable. It is preferable to have a wide set of adaptable instruments in place, enabling funds to respond flexibly to a range of market scenarios.

Other Comments

We remain concerned that in times of stress, the repo market does not work efficiently to prevent systemic risks occurred from liquidity challenges. While it is right to expect that risk management and governance of pension funds are adequate, pension funds rely on intermediaries and other actors to access cash to meet margin calls, as pension funds cannot hold sufficient cash to meet calls that occur under adverse market conditions. They will need to rely on liquidity facilities and asset transformation.

Prior to central clearing, these liquidity risks did exist to the same extent for pension funds, as pension funds could use government bonds as collateral in bilateral derivatives trades. While the backbook still is significantly bilateral, all new trade must be cleared centrally, with cash become the only way to meet variation margin calls. Pension funds were given a 10-year exemption from EMIR, while the European Commission and market participants sought for a solution to this problem, but without success.

In other jurisdictions a solution was found. Central banks in the United Kingdom, the United States, and Canada have recognized this issue. They put in place, or are in the process of doing so, liquidity facilities to prop up the resilience of repo markets or to provide a backstop repo facility directly to pension funds and insurance companies, as is the case in the UK. Unfortunately, the ECB has refused to consider similar arrangements, thereby exposing EU pension funds to risks that are beyond the scope of their own policies and governance structures. We believe supervisors must recognise these limitations when communicating their expectations, while weighing all risks, costs and benefits of interventions.

Additionally, in contrast to Guidelines for insurance companies, the EIOPA Opinion is aimed exclusively at the NCAs. This should also be reflected in the wording of the Opinion.

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