

Position Paper on EIOPA 2022 IORP Stress Test

March 2023

PensionsEurope
European Association of Paritarian Institutions (AEIP)

Main messages

- We would like to thank EIOPA for good communication and constructive dialogue with us during the preparations and exercise of EIOPA 2022 IORP stress test. We appreciated it, and we look forward to continuing the dialogue with EIOPA to further define its stress testing methodology and to improve future stress tests.
- In general, we support a climate stress test with a focus on transition risks. Climate change is perceived as the most material environmental risk and for transition risks more data is available than for physical (climate change) risks. Next to that, the transition risk seems more urgent.
- It was positive that the scenario was not a double-hit scenario, which would have made it more unrealistic.
 - Maintaining the original NGFS scenario and using a cash flow analysis approach as stress test methodology would, according to us, have made the stress test exercise more meaningful.
 - The scenario did not capture the decarbonisation progress made by IORPs in their investment portfolio to date.
- We believe that a cash flow analysis would have been a better equipped methodology to fully capture the economic (climate change) scenario in a more meaningful way, since it takes into consideration the time factor.
 - The DC schemes used the Common Balance Sheet (CBS) methodology for the first time, and they found it time consuming and more time consuming than what the application of cash flow analysis would have been. In particular for pure DC IORPs, the application of the CBS was not meaningful.
 - We hope that in the future EIOPA would also conduct IORP stress tests only with a cash flow analysis as common methodology, instead of the CBS.
- IORPs were obliged to classify all their sponsoring companies based on the NACE codes, which caused a lot of work. We do not see the relevance or benefits of this classification for the purpose of EIOPA IORP stress test.
- While we see more relevance with the obligation for participating IORPs to provide data on their investments based on NACE codes, the obligation to use a look-through approach with NACE codes for UCITs also caused a big burden especially to small IORPs which invest significantly in UCITs.
 - For the future IORP stress tests, we would find it important that the (NACE) requirements will be aligned with IORPs' ordinary reporting requirements as far as it is possible, and data is available.
 - If EIOPA wants to go more granular in the future, EIOPA should provide the required data. The obligation for IORPs to provide more granular NACE data is not the way forward.
- To assess members' and beneficiaries' benefits, the long term expected return should be used as the basis, instead of the risk-free return.
- In future stress tests, the impact on assets should be related to the impact on the pension outcome, which is also impacted by (the interest rates of) the stress scenario.

- We note that around 70% of all the assets of participating IORPs were from the Dutch IORPs, as also last time. We would like to propose that next time EIOPA would provide the aggregated results both with the Dutch IORPs, and also without them.
- We note that usually EIOPA has an objective to analyse issues from members/beneficiaries' point of view. For the DB schemes, EIOPA could have added a scenario in which it would have excluded benefit adjustments but included everything else. EIOPA could have done that easily by itself.
- In general, we appreciated that EIOPA asked qualitative questions on how IORPs consider ESG risks and investments, which made the exercise more interactive between EIOPA and participating IORPs than in the past.
- There are many best practices and approaches of how pension funds consider sustainability factors, and therefore, it is important to note that having a high share of ESG assets under the taxonomy does not become synonymous with responsible investment.

1. Introduction

We would like to thank EIOPA for good communication and constructive dialogue with us during the preparations and exercise of EIOPA 2022 IORP stress test. We appreciated it, and we look forward to continuing the dialogue with EIOPA to further define its stress testing methodology and to improve future stress tests.

We found it positive that EIOPA press communication was more balanced than in the past, and that this time EIOPA also highlighted in its press communication that the stress test exercise is not a pass or fail exercise. In some areas, EIOPA had also improved the stress test report by itself; for instance, by not comparing apples with pears as last time (such as average carbon footprint of IORPs' investments compared with the average greenhouse gas intensity of all economic activities in the EU). We would like to thank EIOPA for having considered some of our comments and concerns also in that respect, and that this time the timeline of the stress test exercise was more realistic and doable. Nevertheless, these exercises remain a challenge for small and medium-sized IORPs.

2. Scenario

In general, we support a climate stress test with a focus on transition risks. Climate change is perceived as the most material environmental risk and for transition risks more data is available than for physical (climate change) risks. Next to that, the transition risk seems more urgent.

It was positive that the scenario was not a double-hit scenario, which would have made it more unrealistic. While we appreciate the work by the Network for Greening the Financial System (NGFS), we found it interesting that the chosen scenario assumed 'no policy change' and that there will not be any new climate policies introduced by 2030, and it neither included any subsequent economic recovery nor the benefits stemming from the green transition.

We question why the ESRB/EIOPA decided to make the NGFS scenario more unrealistic, as for all the variables, the calibrations consisted of frontloading the effect of the first three years of the delayed transition scenario by ten years. So, instead of the transition risk taking place during three years

between 2031 and 2033, EIOPA assumed that the transition risk took place instantaneously on 31 December 2021. **Maintaining the original NGFS scenario and using a cash flow analysis approach as stress test methodology would, according to us, have made the stress test exercise more meaningful.**

The scenario did not capture the decarbonisation progress made by IORPs in their investment portfolio to date. Most Dutch IORPs participated in the additional voluntary stress test by calculating the shock in the energy sector more granular. The underlying assumptions of the scenario in the field of energy sector (D35) was not very clear and transparent, and even EIOPA and ECB were not able to help giving full understanding of the scenario. More transparency would have been helpful. Due to this the Dutch supervisor DNB and the Dutch IORPs had to make assumptions. A better understanding of the scenario will also increase the usefulness for IORP's own boards of trustees and risk management.

We were surprised that transportation in general had a lower stress than railway transportation. In addition, surprisingly every bond had the same stress in emerging markets, and if investing all the assets there, the solvency situation would be better post-shock.

3. Methodology

A cash flow analysis would have been a better equipped methodology

We appreciate that in line with the EIOPA methodological framework for stress testing IORPs, in principle the choice of analytical approaches and tools in the 2022 IORP stress test followed the narrative and perspective of the 2022 exercise. However, **we believe that a cash flow analysis would have been a better equipped methodology to fully capture the economic (climate change) scenario in a more meaningful way, since it takes into consideration the time factor.**

The DB schemes, which had participated in EIOPA IORP stress tests also in the past, found the application of the Common Balance Sheet (CBS) slightly easier than last time. **The DC schemes used the Common Balance Sheet (CBS) methodology for the first time, and they found it time consuming and more time consuming than what the application of cash flow analysis would have been. In particular for pure DC IORPs, the application of the CBS was not meaningful,** as it does not fit with such schemes for which liabilities fits the assets in place. The various shortcomings and inherent limitations of the CBS have been elaborated in detail in the joint stakeholder [input](#) (September 2021) by PensionsEurope and AEIP to EIOPA on methodological framework for stress testing IORPs. **We hope that in the future EIOPA would also conduct IORP stress tests only with a cash flow analysis as common methodology, instead of the CBS.**

Shortcomings of NACE

In general, the stress test was doable to participating IORPs, but it also contained some unnecessary complexity and burden. For instance, **IORPs were obliged to classify all their sponsoring companies based on the NACE codes, which caused a lot of work.** Furthermore, while NACE codes are linked to an industry (or a sector or subsector), companies often do have different activities linked to different NACE industry codes, and therefore, in many cases individual companies could have been classified in different NACE categories. **We do not see the relevance or benefits of this classification for the purpose of EIOPA IORP stress test.**

While we see more relevance with the obligation for participating IORPs to provide data on their investments based on NACE codes, the obligation to use a look-through approach with NACE codes for UCITs also caused a big burden especially to small IORPs which invest significantly in UCITs. Today neither IORPs nor their asset managers have access to all the detailed underlying information to determine the NACE codes of the investments based on a look-through approach. Often the percentage linked to the different NACE codes are not readily available to the IORP and their providers and as such it was often difficult to determine to which of the 22 NACE codes the investment line belonged to. **For the future IORP stress tests, we would find it important that the (NACE) requirements will be aligned with IORPs' ordinary reporting requirements as far as it is possible, and data is available.**

In the voluntary part, some large Dutch IORPs looked at all the individual companies (in the energy sector (NACE sector D35)) to have a thorough understanding of their exposures. They found the work on NACE sector D35 burdensome, and therefore, in the future so detailed approach could only be acceptable if it was fully accommodated by EIOPA in the form of templates and data; it should be 'click and play'. This approach would take more time to develop for private markets, as we recognize that in general private companies can be less advanced in how they disclose ESG data, which can cause (much) more work for participating IORPs and the supervisors (when auditing the numbers) also in the future.

IORPs get a risk premium

To assess members' and beneficiaries' benefits, the long term expected return should be used as the basis, instead of the risk-free return. IORPs do not invest in a risk-free world, but as long-term investors they receive a risk premium (as well as an illiquidity premium) for the risk (and illiquidity) they accept. First applying stress on investments in combination with the use of a risk-free rate is a contradiction in terminis. If acted upon, such assumptions might prevent IORPs from long-term investments into sustainable real assets, which are in contradiction with the aims of the CMU.

4. Results of the quantitative stress test

From the perspective of being able to pay out pensions, we are glad to see that the impact of the stress test scenario on the funding ratios of DB schemes was limited and reasonable with declines of 2.5% on the European aggregated National Balance Sheet (NBS) and 2.9% on the CBS. The aggregated post-shock funding ratios in DB schemes staid high: 117% in CBS and 120% in NBS.

As the scenario had such a limited impact on IORPs' balance sheet, it was not a big surprise that this time EIOPA decided to focus more on the impact on IORPs' assets, with the overall drop of 12.9%. At the end of 2021, IORPs had on average around 6% of their equity and 10% of their corporate bond investments in carbon intensive industries such as electricity and other energy production sectors, for which the scenario prescribed steep write-downs of between 20% and 38%. But an asset only measurement does not include the final impact on the pension outcome. A rising yield will make purchasing an annuity cheaper and the impact of a 12.9% on pensions could be limited. One can read this from the small decline in funding ratios for DB IORPs. **In future stress tests, the impact on assets should be related to the impact on the pension outcome**, which is also impacted by (the interest rates of) the stress scenario.

While any vulnerabilities of IORPs should be taken seriously, there are also numerous other aspects which should not be ignored when investing for instance in electricity and other energy producers. Major investments are needed in electricity and other energy production sectors to implement the long-lasting and long-term objective of the EU to increase the energy independence. The same applies to speed up the shift to low-carbon power and heat production where many companies producing energy are currently making significant investments in low-carbon production. The demand for electricity in Europe also continues increasing with electrification, which brings numerous benefits that go beyond decarbonization, and where investments are urgently needed. In addition, the impact of the ongoing geopolitical tensions and sanctions should not be ignored when discussing the investments in electricity and other energy producers in Europe. Furthermore, a significant need for fossil energies still remains in Europe.

We note that around 70% of the all the assets of participating IORPs were from the Dutch IORPs, as also last time. **We would like to propose that next time EIOPA would provide the aggregated results both with the Dutch IORPs, and also without them.**

We also note that usually EIOPA has an objective to analyse issues from members/beneficiaries' point of view. **For the DB schemes, EIOPA could have added a scenario in which it would have excluded benefit adjustments but included everything else. EIOPA could have done that easily by itself.**

5. ESG exposures – qualitative survey

In general, we appreciated that EIOPA asked qualitative questions on how IORPs consider ESG risks and investments, which made the exercise more interactive between EIOPA and participating IORPs than in the past.

According to the EIOPA report, over 90% of IORPs incorporate ESG factors in the policy, which is significantly up from 55% in 2019, and the number is expected to continue growing. The report also notes that IORPs use different classification systems (taxonomy), standards and other guidance in order to consider ESG factors in the investment policies and determine if an investment can be classified as 'sustainable'. Besides using external ESG ratings or indices and considering publicly disclosed information by investees, IORPs also use classification systems, developed internally or by a third party, against which investments are checked to determine their 'sustainability'.

The EU Taxonomy offers an assessment of whether activities are environmentally sustainable, which does not capture all responsible investment approaches. **There are many best practices and approaches of how pension funds consider sustainability factors, and therefore, it is important to note that having a high share of ESG assets under the taxonomy does not become synonymous with responsible investment.**

According to EIOPA report, IORPs which are using environmental stress testing in their own risk management performed better overall in the stress test exercise. It is important to note that this is a coincident, but it is not per se a causality.

6. Inflation in scheme design and investment strategy – qualitative survey

If the purpose of EIOPA is to explore the impact of a high inflation on overall retirement income, it would be important also to consider the role of public pension, as in many EU Members States it represents the bulk of pension income. Furthermore, first pillar benefits are subjected to inflation hedging. In the report EIOPA only acknowledged that participating IORPs might not be representative of Member States' entire second pillar sector, which may not only include IORPs, and some IORPs carry out cross border activities in other countries.

EIOPA explored which IORPs provide benefits linked with inflation. If IORPs do not provide those benefits, it cannot be concluded that they would not be given, as they can be given by an employer as well.

The use of the horizontal approach was questioned during the preparation of the stress test, and the EIOPA report showed the worth of those comments, especially regarding the DB/DC comparison on the direct linkage between benefits and inflation. According to the EIOPA report, only 15% of participating IORPs offering DC schemes provided benefits directly linked to inflation. In that respect it is important to note that pure DC schemes do not have a linkage of benefits to inflation, and it exists only in DC IORPs of 4 participating Member States (of which one was classified differently than in the past stress tests) and it is not (and couldn't be, by definition) a common feature of the DC landscape. At least a comparison with the exclusion of pure DC schemes would have been more insightful.

Also, DC IORPs without a direct link between benefits and inflation may consider inflation risk. EIOPA states that 67% of participating IORPs declared that their investment strategy is geared towards inflation protection, without distinguishing between DB and DC schemes. The percentage is very high, so it is reasonable to assume that also many DC IORPs without a link between benefits and inflation hedge inflation through investments and would like to invite EIOPA to provide more information and/or clarification based on the information that it has. In general, an in-depth analysis on the different behaviors of DC and DB IORPs would have been more useful.

For further information please contact:

PensionsEurope

Montoyerstraat 23 rue Montoyer – 1000

Brussels Belgium

Tel: +32 (0)2 289 14 14

info@pensionseurope.eu

AEIP - The European Association of Paritarian Institutions

Panayiotis Elia, AEIP Policy Advisor, Pension & Financial Affairs

Panayiotis.elia@aeip.net

Rue Montoyer 24

B- 1000 Brussels, Belgium

Tel: +32 2 233 54 23