

POSITION PAPER

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SUBJECT: Stress Test Report EIOPA

Pension funds mitigate financial shocks and work as a stabilising factor for the financial sector, according to EIOPA

EIOPA has published its stress test report on January 26th, 2016. In the following position paper, the Federation of the Dutch Pension Funds (the Federation) provides its analysis and views on EIOPA's Stress Test Report.

Introduction

From May to August 2015, EIOPA asked supervisors of 17 Member States to participate in a European stress test for IORPs. EIOPA is mandated to conduct stress tests based on EIOPA regulation (EU) No.1094/2010. EIOPA aimed (...) *to examine the sensitivity of the occupational pensions sector to adverse market developments and to reach robust conclusions for the stability of the financial system as a whole and to enhance consumer protection.*¹

Separate stress tests were conducted for IORPs operating DB and DC schemes. The DB stress test assessed the immediate impact of shocks based on the so-called Common Methodology (i.e. the Holistic Balance Sheet, HBS) and on IORPs balance sheet based on national methodologies, by using three different scenarios. The DC stress test assessed the long-term impact on the pensionable income of the IORPs' beneficiaries for each of these three scenarios.

¹ See: <https://eiopa.europa.eu/financial-stability-crisis-prevention/financial-stability/occupational-pensions-stress-test>

- **Key Remarks**

1. The Federation stresses the **importance of monitoring the resilience and systemic risks of financial institutions**, considering the interests of participants. In practice, Dutch IORPs do this on a regular basis, by means of their Asset & Liability Management studies (ALM). Given the Dutch supervisory framework, **which already includes amongst others ALM studies as well as sustainability and resilience testing (haalbaarheidstoets)**, the Federation questions the added value for a European stress test among Dutch pension funds.
2. The Federation is **not surprised by the outcome of the stress tests**. It indicates that Dutch IORPs **do not pose a threat to the financial system** due to the way they are organised. Given the long recovery periods, **Dutch IORPs effectively mitigate financial shocks and do not transmit these to other financial institutions**. EIOPA's stress test results indicate that during the financial crisis IORPs have indeed worked as a **stabilising factor for the financial industry**.
3. The Federation welcomes EIOPA's acknowledgement of the **heterogeneity of European IORPs and their respective financial assessment frameworks**. As a consequence, funding requirements and funding ratios differ from one country to the other.
4. The baseline scenario already shows that Dutch IORPs have **low funding ratios, due to the declining interest rate used in the national framework over the last 10 years, the development on financial markets** and due to recent further increases in future longevity projections. As a consequence, it is not surprising that the stress test demonstrates that the **balance sheet of IORPs come under more pressure in case of further severe shocks**.
5. Given the fact that Dutch IORPs are **large institutional investors which invest on a large scale in the European economy**, it is only logical that a severe shock will have a severe negative effect on Dutch IORPs. In this respect, the Federation **highlights the important role of institutional investors such as IORPs for the Capital Market Union**.
6. The Federation encourages EIOPA to use **a more open and principle-based common framework instead of the Common Methodology as used in the DB stress test**. The Federation is **furthermore not in favour of using the HBS approach** as a basis for such a common

- framework. **An ALM study analysis that shows future projections would be preferable.**
7. According to the Federation, **assessing the impact of stress and longevity scenarios on the contributions and the pensionable income of beneficiaries would be more useful.** The stress test for DC IORPs is better suited in this respect. In addition, the **differences in outcomes of the stress tests between DC plans using projections and DB plans** based on balance sheets (both the national balance sheet and the HBS) are difficult to explain.
 8. The **DC satellite module provides insight into the risks for members and beneficiaries.** At the same time, we think that the DC satellite module could be further improved by also **taking into account the more modern DC plans,**² such as those that have been implemented in The Netherlands.
 9. The exercise of these stress tests was **cost-intensive** and included a **high work load** for the IORPs involved. The Federation also questions the use of such stress test for IORPs' beneficiaries.
 10. Based on our previous comments, we recommend that for a future stress test **further work should be done by EIOPA** in order to create an adequate stress test methodology and a **common principle-based framework.**

² More modern DC plans for instance include a mandatory conversion to a guaranteed lifelong annuity and actively match the interest rate conversion risk. This can be DC schemes which apply a variable lifelong annuity through a combination of managed drawdown and deferred fixed lifelong annuity and/or DC plans which apply an investments strategy which encompasses the usage of specific derivatives in view of optimal duration matching.

Methodology of the DB stress test could be improved

The Federation is pleased to see the confirmation of previously made statements that the systemic risk of IORPs is non-existent. Indeed, with the stress test, EIOPA aims to evaluate the systemic risk of IORPs. Given the nature of Dutch IORPs and the way they deal with financial shocks, we actually question the added value of testing only pension funds' balance sheets, be it national or based on a Common Methodology (HBS) as introduced by EIOPA. In this respect, the Federation has observed that EIOPA introduced the Common Methodology as a new term (apparently replacing the HBS). The Federation would appreciate an explanation for this replacement. It does not consider this as an improvement because the term 'Common Methodology' could wrongly suggest that this is a generally accepted methodology within the EU.

Dutch IORPs are institutions that do not have shareholders, are not allowed to take out loans and – most importantly – cannot go into default. Therefore, they do not pose a systemic risk to other financial institutions in the context of this stress test. On the contrary, DB IORPs absorb shocks without amplifying or transmitting these to other institutions, and have proven to be a stabilising factor in financial markets, especially in times of financial market stress. The stress test results add objective proof that this is the case. A DB stress test for Dutch IORPs would be more valuable if it measured the impact of shocks on the future contributions of sponsors and the future pensionable income of members and beneficiaries, i.e. similar to the DC stress test methodology.

In our view, an Asset Liability Management (ALM) analysis would be better suited as a DB stress test methodology. An ALM analysis includes future projections and as such provides for information about the impact on the (future) pensionable income and contributions of members and beneficiaries. It allows for analysis of what happens after a shock in both high return and low return scenarios. Moreover, it provides metrics (such as expected impact and impact in a 'bad weather' scenario over multiple time horizons) that give insight into the consequences of a shock.

DB stress test outcomes are difficult to interpret

The DB stress test was performed on balance sheets based on both national legislation and on the 'Common Methodology' (HBS). The Dutch results from the stress test based on the national balance sheet show that – due to the financial shocks and increased longevity projections from the last 10 years – Dutch IORPs currently are in a stressed financial position.

- Applying further stress scenarios obviously worsens their financial position.³

EIOPA used its Common Methodology in order to be able to compare the different IORPs of the participating countries. The results based on the Common Methodology (HBS) are difficult and complex to communicate and to be understood.

An adverse market scenario could lead to a substantial decrease of the IORP's coverage ratio, when looking at its national balance sheet. At the same time, it is possible that this IORP will show a increasing surplus based on the Common Methodology (HBS), resulting from an increase in the option values of its policy instruments. Such results carry a severe communication risk, because these option values are (incorrectly) interpreted as expected values by many stakeholders.

| Box 1: Expected value versus option value | | | |
|--|-------|-----------------------|--|
| Assets | 1 000 | | |
| Technical Provisions | 907,6 | | |
| | | | |
| <i>Policy instrument</i> | | <i>Expected value</i> | |
| | | | |
| <i>Option value</i> | | | |
| Indexation | 193,3 | 84,0 | |
| Benefit reductions | -4,2 | -155,5 | |

In box 1 we have shown the difference between the expected values and the option (market) values of two policy instruments (discretionary indexation and benefit reductions) at the end of 2014. We present figures for an IORP roughly equal to the size of the Dutch IORP sector, with total assets of approximately €1.000 billion, technical provisions of € 907,6 billion, and a funding ratio equal to 110%. The expected value of *discretionary indexation* awarded to IORP members and beneficiaries is €193,3 billion.⁴ The option (market) value of indexation is only €84 billion. As a result, there is a large difference between the expected value and the option (market) value.

Looking at *benefit reductions* the difference is even larger. The expected value of benefit reductions is €-4,2 billion, but the option (market) value is €-155,5 billion. These significant differences show that the Common Methodology (HBS) valuation of policy instruments should not be

³ This is especially the case since the stress test is designed such that the only safe haven is an investment portfolio of 100% cash, plus a full interest rate risk hedge by using interest rate derivatives. Actual investment portfolios look very different.

⁴ Next to communicating the expected value, IORPs should also communicate a bad/good weather scenario, showing the outcome under more adverse/positive scenarios.

- interpreted as expected values. However, the latter is unfortunately the interpretation almost universally used. For this reason, showing a significant value for possible future benefit reductions which substantially overstates the likelihood and extent of such possible reductions could lead to a significant decline in the trust in EU Member States' pension systems.

In addition, we foresee that it is difficult – if not impossible – for EIOPA to adequately explain the huge differences between the results based on the Common Methodology (HBS) and the ALM future projection results as done based on the Dutch Financial Assessment Framework (FTK). This is also an issue when comparing the results of the stress tests for DB IORPs and DC IORPs.

These different results arise due to the fact that the DB stress test does not show the effects of the different smoothing mechanisms that have recently been introduced in the FTK. More specifically, in The Netherlands IORPs make policies based on a 12-month average of the funding ratio, not just on the current funding ratio. For the purpose of measuring shocks, the full impact of policy decisions occurs one year after the initial shock took place, if this shock is not temporary. In addition, IORPs are allowed to smooth shocks over a maximum of 10 years in their recovery plans, which is not shown in the stress test results.

In addition to the difficulties in explaining the differences between the results based on the Common Methodology (HBS) and the different national supervisory frameworks, the very nature of the European IORPs is also diverse. EIOPA is right in stating that it is difficult to compare the different countries' IORPs. National financial supervisory frameworks stipulate different discount rates. In the Netherlands, assets and liabilities are marked to market (fair value). Another difference between IORPs in various Member States is found in the investment portfolios. In general, Dutch IORPs invest more in equities and real estate than IORPs in various other EU Member States. At the same time, the Federation underlines that such risk capital is needed in order to achieve the Capital Market Union's goals, one of the major projects of the European Union.

Stress Test DC

Contrary to the DB stress test, the stress test approach for DC IORPs focuses on the scheme members' expected pension benefit at retirement age and not on the IORPs' solvency position. As mentioned above, we fully support and welcome this EIOPA approach. In case of Dutch DC IORPs, their solvency position is hardly useful or even irrelevant information. Until the moment of retirement, all financial and biometric risks are borne by the IORPs' stakeholders (i.e. members, beneficiaries, (re-)insurers and to some extent the sponsors) and not by the IORP itself.

- Key in that respect is enhancing the protection of members and beneficiaries, one of the stress test's objectives measuring the resilience of the members' pension benefit.

The Federation would like to note and welcome the EIOPA approach that the calculated replacement ratios should not be judged in terms of absolute levels, but only on the relative changes caused by the stress shocks, as this is the main aim of the DC satellite module. Moreover, the replacement rate outcomes in absolute terms heavily depend on local pension scheme design, i.e. salary level, career path, paid contributions, transferred-in pension wealth for older scheme members, and on the model parameters being used as shown by the EIOPA report.

The Federation would welcome the opportunity to help EIOPA to further develop the DC satellite module calculation tool, with a view to making it more suitable to (Dutch) DC schemes and their sophisticated nature. For instance at this moment, this goes for the interest rate hedge in view of guaranteed annuity pay-outs, the use of derivatives, the impact of adverse market development on the asset allocation, and the application of the return-matching portfolio concept in the life cycle approach. In the near future, more advanced DC-plans will be allowed in The Netherlands. In these plans more sophisticated investment strategies are used after retirement, allowing the retirees to still take some investment risk without a substantial year-to-year volatility in pension income.

Differences in methodologies between DB and DC stress tests make DB and DC results incomparable.

Finally, a difficult communication issue arises from the differences in the methodologies used for the DB and the DC stress tests. The stress test approach for the DC IORPs provides better and more adequate insights than the results for DB IORPs. Making future projections, including policy (like recovery plans), risk premiums in the expected returns and looking at the impact on the pensionable income, makes the DC stress test much more relevant than the DB stress test. The latter uses discounted values (discounting based on yields excluding risk premiums) and looks at the impact on the IORP itself and not on its stakeholders. In addition, including risk premiums in the expected returns makes the DC stress test much more relevant.

The Federation is ready to provide further advice on the above mentioned issues and to enter into dialogue with all the relevant stakeholders with regard to the Dutch experience with modern DC IORPs.

- *On behalf of about 260 pension funds, the Federation promotes the pension interests of 5.6 million participants, 2.9 million pensioners and 8.3 million early leavers.*

About 80% of the total number of Dutch employees is participant of a pension fund which is associated with the Federation. The members of the Federation have around 1.0 trillion euros of assets under management.

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