Quantitative Easing: first views for OPSG opinion

OPSG, Frankfurt, July 8, 2015

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Agenda

* Higher liabilities due to Quantitative Easing (QE)
* Impact on IORPs/pensions
  * Increased risk in financial policy
* Only give leeway for low rates to the extent caused by QE
* Possible solutions
  * Via pensions and/or via supervision
* Feedback and suggestions OPSG
* Process

Higher liabilities due to QE

- Higher value liabilities due to extra low rates caused by QE
  - Especially when discounted marked-to-market (m-t-m)
  - Also when (indirect) link between market rate and discount rate
    - Even in UK indirect impact via buy in/buy out
- Higher impact in Europe than in US
  - Stronger link between discount rates and market rates
  - HBS/m-t-m in solvency regime for IORPs would worsen impact of QE
  - Puts EU in poorly competitive global position
  - Negative impact on Plan Juncker/CMU
    - Esp. when "forced" buying of bonds and interest rate hedging

Impacts on IORPs/pensions (1/3)

- Impact on 1st pillar: possible desire for better 1st pillar
- Impact on funding IORPs: lower funding ratio (DB)
- Impacts on IORPs asset allocation: higher risk, lower return (DB and DC)
- Impacts on sponsors and contributors: higher contributions, lower pension accrual (DB and DC)
- Impact on member/beneficiaries: lower pensions/adequacy, more risk (DB and DC)

Impacts on IORPs/pensions (2/3)

Impact on 1st pillar: possible desire for better 1st pillar

* Lower accrual in 2nd pillar and more risk borne by members could increase desire for higher and more secure 1st pillar

Impact on funding IORPs: lower funding ratio (DB)

* Negative impact (due to m-t-m liabilities and long liability duration)
  * Impact more severe for previous underfunded IORPs (due to larger duration mismatch)
* Increased risk of benefit cuts
* Lower trust in IORPs/capital funding

Impacts on IORPs asset allocation: higher risk, lower return (DB and DC)

* Increased risks in financial policy
  * See next sheet

Increased risk in financial policy

* Search for yield could lead to more equities and other riskier assets (credit and growth)
* Risk models distorted by current market prices
* Interest rate hedging of liabilities less useful/sensible
* Both could lead to selling government bonds (resulting in higher yields) mitigating intended impact of QE
* At same time: possibly extra derisking (e.g. liability hedging) leading to (even) lower yields
* Thus: tension between economics (sell govies when expensive) and risk management (buy protection/govies)
  * IORPs could become forced buyer (or have to have additional reserves to meet solvency requirement)
* Insensible to invest in bonds with negative yields
  * Extrapolation of trend and self-fulfilling prophecy (due to m-t-m liabilities)

Impacts on IORPs/pensions (3/3)

Impacts on sponsors and contributors: higher contributions, lower pension accrual (DB and DC)

* Increase in cost price of new accrual (esp. DB)
* Need for higher contributions to cover low/underfunding (DB)
* Need for higher contributions to obtain same expected benefits at same risk profile
* Effects on sponsor’s creditworthiness (DB)
* Effects on global competiveness of EU business
* Further move to DC

Impact on member/beneficiaries: lower pensions/adequacy, more risk (DB and DC)

* Lower expected benefits
* Lower hedging of longevity risk (annuity more expensive and less capacity/supply in market)

Only give leeway for low rates to the extent caused by Quantitative Easing

* Should IORPs get leeway for low interest rates?
* If current and future interest rates are persistently low due to economic reasons, IORPs should have to cope with these
* But if rates are (extra) low due to Quantitative Easing (QE), IORPs should get leeway to handle (extra) impact of QE
  * Especially if QE has impact on stability of DB IORPs and sponsors and on member/beneficiary behaviour

Possible solutions 1/3

* On pension side: change discounting, accrual and/or benefits
* On member/beneficiaries side: address impact, consider tax incentives, make annuities more flexible
* On supervisory side: temporary relaxation of (capital) requirements
* …

Possibile solutions (pensions) 2/3

- On pension side: change discounting, accrual and/or benefits
  - Neutralise effects on liabilities (e.g. by using UFR and QE adjustment to discount rates* or using corporate bond yields (similar to accounting))
  - Less/lower/no guarantee, shift towards DC
  - Lowering pension accrual (temporarily)
  - No/lower indexation or, last resort, benefit cuts (not permitted everywhere)
- On member/beneficiaries side
  - Address negative impact of QE on expected benefits and beneficiaries longevity risk (annuity)
    - What would be possible way?
  - Tax incentives at national level
  - Introduction medium term annuity (3/5/10 year) with option for subsequent life annuity (if market conditions change)
- …

* Also see volatility adjustment in running Quantitative Assessment of HBS

Possible solutions (supervision) 3/3

- Temporary relaxation of (capital) requirements
  - Longer horizon for recovery plans
  - Extend period for filing/implementing recovery plan
  - Accept more risk (temporarily)
    - E.g. more risky assets and lower level of liability hedging
    - Switch from government bonds and swaps into illiquid assets (also helpful for CMU and EU investment plan)
- …

Feedback and suggestions OPSG

* Do you have feedback on the content of our presentation?
* Do you miss (important) elements?

* What is your view on QE and the impact on IORPs and on pensions?
* What should be the OPSG's position on QE?

Process

* Solvency subgroup will write draft position paper (in summer)
* Draft position paper distributed for feedback to OPSG (late summer)
* Written feedback on draft position paper before October meeting
* Final position paper on QE in October meeting

Thank you

OPSG's subgroup on solvency issues