OPSG

OCCUPATIONAL PENSIONS STAKEHOLDER GROUP

Advice on EIOPA's Financial Stability Report June 2019

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EXECUTIVE SUMMARY

This feedback statement endorses the remarks in the June 2019 Financial Stability Report (hereafter: FSR), and indicates some points of attention going forward. These refer mainly to asset liability management of pension funds and macroeconomic stability. Discontinuity risk for pension plans is a macro stability risk of itself.List bullet

INTRODUCTION

1. In its feedback statement of 15 September 2017 (link here) on the December 2016 FSR, the OPSG reflected on the difference between micro stability and macro stability. Micro stability has to do with the financial health of individual pension funds and IORPs. Their investment decisions, whether market or regulation driven, may impact the stability of the economy as a whole, especially if the pension assets in total are large as compared to a country's GDP. Macro financial stability could be defined as: "The ability of the financial system to help the economic system allocate resources, manage risks and absorb shocks." The OPSG suggested that macro stability could gain more attendance in a next issue of the EIOPA FSR.

2. Two and a half years later, the current FSR still focuses on micro stability issues. This may have to do with data limitations. The EIOPA Chairman recently indicated that as from 2020 onwards, EIOPA has more data available for analyses.

3. Chapter 4 of the June 2019 FSR draws attention to the volatility in the equity markets, and the impact of the sustained low interest rate. These effects raise concerns on micro stability, most notably for pension funds (IORPs) in the UK and NL.

4. These pressures point to the trade-off between adequacy and sustainability of pension plans. If the balance between the two is not considered a fair one by all stakeholders, then the support for pension plans may be at stake. This discontinuity risk does affect the macroeconomic stability.

IMPACT OF FINANCIAL MARKETS VOLATILITY

5. Chapter 4 of the FSR starts with a reference to the fall in stock prices by the end of 2018, and the low long-term interest rates. Obviously, both developments impact pension funds' balance sheets. This holds even more for the member states which have a high penetration rate (pension assets to GDP ratio), as indicated in figure 4.2[1]. Pension funds in the Netherlands have a high allocation to equity (figure 4.3). Their sensitivity to negative returns impacted the EEA and EA average returns (p.37).

6. Although volatility is not helpful in general, its detrimental effects stem from the combination with more or less fixed liabilities. In other words, pension plans with some sort of a defined benefit suffer most from asset market's volatility. Therefore, a further analysis should not only take assets into account, but liabilities as well.

7. The OPSG encourages EIOPA to complement its assessment of investment allocations with an assessment of liability allocations. Which fractions of the pension promises are in defined benefit terms, and which are in defined contribution terms, or other terms? How large is the sensitivity of the liabilities to the asset volatility? An asset-liability assessment on the macro level of member states would provide such insight.

8. Such asset-liability assessment is logically connected to the stress testing exercise, which is gaining sophistication. It could provide insights into the differences between asset allocations across member states, and their rationales (or lack of rationales).

[1] The caption of figure 4.2 seems to contain an error, as the y-axis unit is not percentages but perunages.

9. A further reason to digress on the macro economic balances relates to interest rate sensitivity. As the recent annual report by Mercer and Melbourne University[2] indicates, the two countries which rank highest on their list, also have the highest private debts. In economic terms: individuals hold long balances. Although the report interprets this as a sign of trust and comfort of citizens, it also enhances their interest rate sensitivity. As the sensitivities are in opposite direction, the impact of interest rate changes might cancel out to some extent, but this is likely to differ grossly among individuals, while the impact also affects people in different stages of their lives.

ADEQUACY VERSUS SUSTAINABILITY

10. In the current low interest rate environment, pension plans suffer. Their coverage ratio's decline rapidly, especially if their supervisors request liability discounting against any curve derived from market rates. This brings the essential trade-off back to the table: how to commensurate pension adequacy with the sustainability of pension plans?

11. The debate on the proper balance between the two may to some extent diverge along cohort lines. With some degree of exaggeration, one could say that for elderly people, the adequacy of their pensions is of acute importance, while for younger people the sustainability of the pension system should be secured. Whether or not this holds true, if too many young people lack trust in their pension funds, the funds face a discontinuity risk. Discontinuity of pension funds could lead to a deterioration of the second pillar of pension systems. The impact of such risk was elaborated upon in the abovementioned 2017 OPSG feedback statement (recitals 8-16).

12. The possibility of a deteriorating second pillar is not only – indirectly – caused by the discontinuity risk, but also – directly – by the low interest rate and the discount rates for the liability of pension plans. The more capital based plans are at risk, the more PAYG plans are called for. However, demographic elements add additional strain (FSR, p. 34) and PAYG plans are inherently sensitive to demographic risk. There is no quick fix here.

CONCLUSIONS

13. The OPSG recommends EIOPA to consider the combination of assets and liabilities of pension plans at a macro level, for each of the member states. This would allow for a more

[2] The two highest ranking countries are The Netherlands and Denmark (Melbourne Mercer Global Pension Index 2019, https://info.mercer.com/rs/521-DEV-513/images/MMGPI%202019%20Full%20Report.pdf)

sophisticated assessment of the investment risks, within the context of the liabilities.

14. The OPSG recommends EIOPA to consider the issue of pension adequacy in relation to pension plans sustainability, in the context of changing population structures. The discontinuity risk of pension plans may incur macro stability risks. Depending on the penetration rate, these may impact the economies of member states to a different degree.