

**EIOPA Financial Stability Report
December 2016**

**Feedback Statement by the EIOPA
Occupational Pensions Stakeholder
Group**

Executive Summary

This feedback statement to the EIOPA Financial Stability Report of December 2016 discusses both 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. This macro stability could gain more attendance in a next issue of the EIOPA Financial Stability Report.

Introduction

1. The EIOPA Financial Stability Report (link [here](#)) devotes much attention to the insurance sector. Only chapter 4 discusses the pension fund sector, although chapter 1, on key developments, and chapter 5, on risk assessments, provide some comments which are of relevance as well. Most of this OPSG feedback statement concentrates on chapter 4.
2. While preparing this feedback statement, it became clear that the term financial stability as such is prone to multiple interpretations. Reference to the financial stability of institutions, such as pension funds and IORPs, can be called micro financial stability. Reference to the financial stability of the economy as a whole, can be called macro stability. A definition of macro financial stability could be: "The ability of the financial system to help the economic system allocate resources, manage risks and absorb shocks." This feedback report discusses both types of stability. For micro financial stability, the impact of economic developments on institutions is central, whereas for macro financial stability, the impact of the pension sector on the economy is under scrutiny. Given the scope of the EIOPA Financial Stability Report on pension funds, this OPSG response will focus on pension funds, too.
3. The Report states that the impact of the low interest rate environment to IORP liabilities is extremely challenging to insurance companies, pension funds, and other pension providers, which all have long durations of liabilities. On p.11 the Report notes that there is no consensus among economists as to whether interest rates will return to their previous levels. The OPSG wants to underscore that academic research is still inconclusive in this respect, while market data have proven to be poor predictors of future interest rates. On the same note, however, the OPSG notes that pension funds manage substantially sized assets, which makes their investment behaviour relevant as such.
4. The Report then provides ample data on the investment allocations and returns of European pension funds. The market value of bond portfolios has increased due to low interest rates, but overall the coverage rates of DB and hybrid plans have suffered because the liabilities of the plans increased faster. Depending on their institutional setting, some IORPs executing such schemes can take remedial actions, such as increasing sponsor contributions or reducing benefits. To the extent that pension plans are related to sponsor firms, as in company pension plans, the financial health of the sponsors may limit or prevent increasing sponsor contributions. Put differently, the sponsors' obligations towards their pension funds may lower their budgets for operations and investments, which may have impact on the real economy. Of course, other types of pension plans, including IDC and savings plans, suffered from low investment returns as well. However, since these plans don't have liabilities, the low interest does not feed into any coverage metric.

5. EIOPA captures the risk of low interest as twofold: (1) it endangers the probability of meeting future obligations, and (2) it induces risk seeking investment behaviour ('search for yield'). EIOPA announces that it will be cautious with respect to any 'search for yield' trend that may emerge. Whether or not a search for yield is a merit or a risk, the report does not provide indications as to whether such behaviour is observed already. Depending on the mandates IORP boards and managers were given by their plan members and/or their sponsors; they have to strike the proper balance between risk and return. By implication, they may indeed search for yield, within their risk constraints. As such, this does not threaten their micro financial stability. It may even support it, as in situations where low risk strategies are adopted by many pension funds, thus driving up prices of particular assets or instruments. In such situations, the balance between risk and return shifts, and may induce taking some more risk.
6. Macro financial stability may however be endangered, especially if large portions of pension money are reallocated. Such movements may be driven either by symmetric independent investment decisions, such as taking hedging measures, or by regulatory requirements, such as derisking, or implementing a different UFR. Since 83% of the pension assets is managed by UK and Netherlands based pension funds, EIOPA mentions that these countries are watched with extra scrutiny¹. Such reallocations do not cause a systemic risk per se, as long as the sectors invested in can handle the changes. Others note that systemic risk² increases the more risk based solvency measures are harmonized across financial sectors, as such solvency requirements induce similar and simultaneous responses to shocks (Beetsma and Vos, 2016).
7. The report notes that the average rate of return decreased in 2015, but remained positive in most of the countries. OPSG notes that annual rates of return are less relevant for pension funds, as they (should) have a long term horizon. That being said, the average ROA (Figure 4.6) in 2015 (un-weighted 2.8 per cent, weighted 4.1 per cent) was lower compared to 2014 (un-weighted 7.6 per cent, weighted 10.3 per cent), but still substantially above risk free rates. From this fact, some OPSG members derive the conclusion that using risk free rates to discount liabilities may be a conservative approach which, if applied to the long-term liabilities many IORPS have, could lead to a significant exaggeration of the impact of low interest rates. Other OPSG members are of the conviction that pension benefits should be secured, and by implication the liabilities should be discounted at a (proxy of the) risk free rate. The large difference between valuations using risk free rates and market asset returns, shows the importance of discussions about and analysis of appropriate valuation methods that can be used by IORPS which operate DB or hybrid (e.g. CDC) plans (As mentioned earlier, this discussion is less relevant for IDC plans.).

¹ Obviously, Brexit will have a far reaching impact on the relative size and compositions of pension fund assets. This is not discussed in the June 2017 Financial Stability Report, but may be analyzed by EIOPA at a later stage.

² A description of systemic risk is: "The risk of collapse of an entire financial system or entire market, as opposed to risk associated with any one individual entity, group or component of a system, that can be contained therein without harming the entire system. It refers to the risks imposed by interlinkages and interdependencies in a system or market, where the failure of a single entity or cluster of entities can cause a cascading failure, which could potentially bankrupt or bring down the entire system or market. It is also sometimes erroneously referred to as "systematic risk"."

Pension funds and financial stability

8. The report addresses the vulnerability that pension plans may have to financial shocks. The impact may be on their asset side, their liabilities side, or both sides of their balance sheet. However, the opposite impact can be of importance as well. One of the concerns raised during the discussion on the holistic balance sheet was that if the measures do not correctly capture the real economic and long-term nature of IORPs, unnecessary and possibly destabilizing changes may be triggered.
9. In general, once social partners or sponsors of pension funds decide to change the pension plans, or pension funds change their investment allocations, this has external effects to other sectors and markets. An example is the origination of mortgages by pension funds or their assets managers. Once pension funds allocate more assets to mortgages, this may influence aggregate spending on housing, and maybe prices for residential real estate. Thus, pension funds cause externalities, which have to be taken into account from a macroeconomic perspective. In fact, EIOPA aims to do so by assessing the second round effects in its stress testing 2017.
10. An obvious example of externalities is the labour market, which is impacted by pensions as a component of labour compensation. Due to IFRS reporting requirements, several listed firms decided to migrate from a DB plan to a DC plan. This influenced the labour market, and it will influence pension spending when the capital payouts are due. Figure 4.2 of the report shows the penetration rates, which indicates just how large pension capital can be as compared to the GDP of countries. If these pension plans have to cut benefits, this has an impact on consumption (and saving) levels of these countries, and thereby GDP growth. Some member states have seen an example of this effect after the dotcom crisis. Logically, a change in the pension allocation, e.g. investing with or without a home bias, can have substantial influence on the availability of funding for such economy. This fact in turn may induce political pressure on pension funds, which in the end may not serve the purposes of the pension plans. In other words, while pension fund managers should be aware of the possible distorting effects of their actions, they should also remain independent so as so optimally realize their mission.
11. Another connection of pensions with the labour market has to do with the wage rates and social security taxation. For public pensions to remain sustainable, income taxation should remain sufficiently high. Occupational pensions are not only financial products, but also part of labour compensation. In order to secure pension benefits in the long run, labour remuneration should remain at a sufficient level. A related point is the wage (in)equality, which determines whether pension plans are able to provide sufficient benefits to lower paid workers. If a decent level of pensions in the decumulation phase is expected for everyone, the gaps inside the wages scale between the lowest and the highest paid employees should remain at a mastered proportion. More in general, the classic split between cost of labour, investment, and shareholders remuneration, should be in balance so as to preserve the remuneration to active pension plan members. In the taxonomy of this paper (#2), these points refer to the micro stability of pensions.
12. Other examples of externalities can be found on markets for various financial instruments, which reflect the actions pension funds take. For example, interest hedging policies determine the demand for interest derivatives. Depending on the size of the total pension

assets in relation to a country's GDP, the larger pension funds may be considered systemically relevant. The financial health of the very largest funds influence that of other parties in financial markets, via the pricing of instruments or asset classes. If large pension funds buy a particular type of instrument or asset class, its price rises, thus making it less affordable to smaller pension funds. However, usually those larger funds trade piecemeal, since they have an interest in preventing this from occurring. Moreover, the use of derivatives by pension funds is small as compared to their use by banks, because pension funds only use derivatives for hedging purposes.

13. The materiality of the above arguments differs across EU/EEA member states. For instance, in The Netherlands, Iceland, Switzerland, and the UK, occupational pensions range from 180% down to 95% of GDP, respectively. For other member states, these pensions to GDP ratios come down from about 45% to less than 10% (Investment & Pensions Europe, 2016). By implication, the question as to whether pension funds are of a systemically relevant character, may be answered differently for each country. In fact, this was one of the main comments in the OPSG discussion on this feedback statement.
14. The influence of (large) pension funds on prices is not necessarily negative. If large funds decide to invest in a more sustainable way (e.g. compliant with the United Nations Principles for Responsible Investing, the Sustainable Development Goals, or other ESG types of criteria) then it may be more profitable for the demand side of capital to come up with well formatted sustainability investment propositions, such as impact investing. Mid-size and smaller pension funds can profit from those propositions too, as they may be easier to analyse. The growing volume may in turn induce the development of rating instruments, and the creation of investment funds, which fuel sustainable investing by pension funds. As sustainable investing is generally considered to be more stable, e.g. because of less risk of stranded assets and more support by the public at large, this may in the end contribute to financial stability.
15. Another way in which pension funds can contribute to financial stability is by their investment in mortgages and real estate. Since pension funds have a rather long time horizon, they can invest in illiquid assets. Examples are mortgage portfolios (direct or securitized) and real estate projects, such as residential housing, or offices and retail. Long term investors can mitigate the volatility in these markets. Especially for mortgages, this may reduce the impact of business cycles on spending by households. It should however be noted, that demographic changes also impact the duration and liquidity requirements of pension funds. For example, the pension assets for babyboomers have to be liquidated in the next decades.
16. Regulators nowadays realize that risk based capital requirements can have procyclical effects. The OPSG expected the Report to have mentioned this, as this point was raised by a range of stakeholders and observers as a significant concern in relation to Solvency II. If risk based capital requirements were to become more stringent in adverse market situations, then pension funds could be obliged to take measures which were unnecessary from an economic point of view, such as rising contribution rates or lowering benefits. Both are likely to reduce consumption by households, thereby aggravating the downward movement of GDP. Changes in asset allocation as induced by new regulations, will impact all pension funds in the same direction, thereby inducing substantial financial effects. This holds even more

when such regulations apply to other types of financial institutions as well (#6 above). By implication, micro economic prudential regulation of pension funds should be right in timing and proportion. Whenever necessary, macro prudential measures may add to stabilizing the economies of the member states.

Final remarks

17. In a next report, attention could be paid to the structure of the pension sector in the member states. If there are many small ('atomistic') pension funds, then systemic risk ('too large to fail') is less likely than in a heavily concentrated pension funds sector. Looking at the HHI of pension funds, or just the more common CR-X measures, gives a good indication of such risk.³
18. It is important to investigate whether market value, historical value accounting, or another approach (such as a cashflow approach based on market asset returns) produces better outcome for micro prudential regulation and has the most stabilizing impact on the macro economy. Although marked-to-market pricing is as volatile as the markets themselves are, there are less drastic revaluations as in historic valuation, at the moment of transactions. Thus, EIOPA should devote attention to the impact of valuation methods on macro financial stability.
19. Pension funds are less of a challenge in terms of financial stability than are other financial organisations, such as banks. They don't exploit leverage, they only use derivatives for hedging purposes, and they have a long duration. In those member states where pension funds are very large and so they could possibly represent a systemic financial risk, a cut of benefits may be allowed so that they can prevent insolvency, and consequently said systemic financial risks. Still, their masses of assets make it relevant to monitor them, and study their impact on macro stability.

References

- Beetsma, R., and S. Vos (2016) 'Stabilisers or amplifiers: Pension funds as a source of systemic risk', Voxeu.org, 23 February 2016.
- Investment & Pensions Europe (2016) 'IPE Top 1000 Pension Funds 2016', IPE International Publishers, ipe.com.

³ HHI: Hirschman Herfindahl index (the sum of squares of all market shares).

CR-X: the accumulated market share of the X largest entities.