European solvency regulation for pension funds

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Pensjonskassekonferansen 2016, Sandefjord
14 April 2016
Outline

• Revision IORP (Institutions for Occupational Retirement Provision) Directive
  o Background
  o IORP II
    o EIOPA Opinion to EU institutions
• First pensions stress test
Background

• April 2011 - Commission’s Call for Advice
  - Harmonised solvency regime for IORPs

• February 2012 - EIOPA’s advice
  I. Valuation and solvency requirements
  II. Governance and supervisory review
  III. Transparency requirements

• July 2013 – Report on quantitative impact study (QIS) for pensions
  - EIOPA concluded that further work is needed on solvency of IORPs
<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
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<tbody>
<tr>
<td>May 2013</td>
<td>Commission announcement:</td>
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<tr>
<td></td>
<td>I. Solvency rules not in IORP II</td>
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<td>March 2014</td>
<td>Commission’s IORP II proposal:</td>
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<tr>
<td></td>
<td>II. Governance requirements</td>
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<td>III. Information requirements</td>
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<td>December 2014</td>
<td>Council’s general approach</td>
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<td>January 2016</td>
<td>European Parliament ECON Committee’s Report</td>
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<td>Now</td>
<td>Trilogue negotiations</td>
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Three years of further work on solvency of pension funds

- 2013 – Quantitative impact study (QIS)
- 2014 – Consultation paper
  - Valuation of technical provisions and sponsor support
  - Six examples of supervisory regimes
- 2015 – Quantitative assessment (QA)
  - BE, DE, IE, NL, PT and UK
- Today – Opinion to the EU institutions
  - Issued on EIOPA’s own initiative
  - Not intended to interfere with IORP II proposal
Opinion to EU institutions

Common framework for risk assessment and transparency

- Maintain current funding requirements in pillar 1
- Common framework in pillar 2/3 of IORP Directive
  - Market-consistent balance sheet, incl. all security and benefit adjustment mechanisms
  - Standardised risk assessment based on common, pre-defined stress scenarios (0.5% probability of occurrence)
  - Public disclosure of main outcomes accompanied by appropriate explanations
  - Sufficient powers for NSAs to take supervisory action based on conclusions risk assessment
  - Proportionate application, allowing for simplifications
Objective view of pension obligations

• Heterogeneous discount rates range from risk-free market rates to expected returns on assets
• Market-consistent technical provisions 27% higher than under national regime
Risks and vulnerabilities

- Reliance sponsor support (€1,037bn) and benefit reductions (€363bn)
- Exposure to mostly equity, interest rate and longevity risk
- Sponsor support doubles to €1,737bn and benefit reductions to €727bn under 0.5% probability shock scenarios
Benefits of common framework

• Protection of members and beneficiaries
  o Better understanding of vulnerabilities and risks
  o Transparency and scope for supervisory action encourage dialogue and timely adjustments

• Functioning of internal market
  o Supervisory coordination
  o Identification and prevention of regulatory arbitrage
  o Cross-border activity
  o Cross-sectoral consistency with insurance framework
Objectives of the first pensions stress test at EU level

- To **produce a comprehensive picture** of the heterogeneous European occupational pensions landscape
- To **test resilience** of defined benefits (DB) and hybrid pension schemes against adverse market scenarios and increased life expectancy
- To **identify potential vulnerabilities** of defined contribution (DC) schemes
- To reveal areas that require **further supervisory focus**
Participation

- 17 European Economic Area countries with material IORP sectors took part in the exercise
- Threshold for participation: EUR 500 million in assets

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<tr>
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<th>Countries</th>
<th>IORPs</th>
<th>Notes</th>
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<tr>
<td>DB/hybrid core module</td>
<td>BE, CY, DE, DK, ES, IE, IT, LU, NL, NO, PT, SE, SI, UK</td>
<td>140</td>
<td>Over 50% of total assets in almost each country</td>
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<td>DC satellite module</td>
<td>AT, CY, ES, IS, IT, NL, PT, SK, UK</td>
<td>64</td>
<td>Over 50% of total assets or number of members in almost each country</td>
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Overview of adverse scenarios for DB/hybrid module

Main stress impacts in adverse market and longevity scenarios

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<thead>
<tr>
<th>Scenario</th>
<th>Adverse market 1</th>
<th>Adverse market 2</th>
<th>Longevity</th>
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<tbody>
<tr>
<td>EU property (price downward shock)</td>
<td>-55%</td>
<td>-36%</td>
<td>-</td>
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<tr>
<td>EU stock prices (price downward shock)</td>
<td>-45%</td>
<td>-33%</td>
<td>-</td>
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<tr>
<td>EU government bonds (spread widening)</td>
<td>120 bps</td>
<td>67 bps</td>
<td>-</td>
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<tr>
<td>Corporate bonds (spread widening)</td>
<td>120 bps</td>
<td>204 bps</td>
<td>-</td>
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<tr>
<td>Euro-dollar exchange rate</td>
<td>+20%</td>
<td>-2%</td>
<td>-</td>
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<tr>
<td>Mortality rates (permanent decrease)</td>
<td>-</td>
<td>-2%</td>
<td>-20%</td>
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**Interest rate**

**Inflation rate**
• IORPs more vulnerable to a severe drop in assets prices (adverse scenario 1)
• IORPs relatively more resilient to the permanent decrease of 20% in mortality rates than to market adverse scenarios
Impact stress scenarios under Common Methodology

- IORPs more sensitive to an abrupt drop in interest rates and increase in inflation rates (adverse scenario 2)
- Shortfalls are covered by future sponsor contributions and/or benefit reductions

Excess of assets over liabilities

Sponsor support & benefit reductions

Note: Excess of assets over liabilities excludes sponsor support and benefit reductions
Way forward

• To develop a deeper understanding of the **impact** of the pressures in the pensions sector on **financial markets** and the **real economy**

• To continue working on a **common market-sensitive methodology** for the purposes of stress testing

• To continue providing an up-to-date picture of the European Union pensions landscape, including the **different prudential mechanisms** used to deal with the identified risks and vulnerabilities
Thank you

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