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OCCUPATIONAL PENSIONS STAKEHOLDER GROUP

Opinion on the Results of the 2022 IORP Climate Stress Test

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1. INTRODUCTION

On December 13th EIOPA published the results of this year´s pan-European stress test exercise, which has been designed as a climate stress test. Additionally, the behaviour of IORPs towards the integration of ESG aspects in their investment policy and the role of inflation in scheme design and investment strategy has been assessed in a more qualitative manner. The OPSG has issued a paper commenting EIOPA´s "Discussion Paper on a Methodological Framework for Stress-Testing IORPs" in autumn 2021 and a template commenting the "draft technical specifications for the 2022 IORP stress test" in early 2022. Since in these two papers the OPSG analysed and commented the methodology of the stress test in detail, no further comments in this regard shall be given in this paper. Instead, it will solely focus on the results of the exercise and on the conclusions, which can or cannot be drawn on that basis. Regarding comments and criticisms on methodology, we take explicitly reference to the OPSG papers mentioned above.

2. DETAILED COMMENTS ON SINGLE RESULTS

1. The OPSG shares EIOPA´s view, that the last stress test exercise, which has been carried out in 2019 showed that in general the long-term nature of IORP´s businesses allows them to sustain short term volatilities in a very effective way, even for longer time periods.

2. Furthermore, the OPSG appreciates, that EIOPA is pointing out, that this stress test should in no way be seen as a "pass or fail exercise", but as an instrument to understand potential risk sources and their impact on the occupational pension landscape.

3. The OPSG appreciates, that overall the envisaged coverage target (at least 60% of AuM) could be reached. However, there is still a certain degree of dispersion between single countries: you find countries with coverage ratios around 90% as well as countries showing values of less than 50%. EIOPA should strive in discussion with the respective national authorities and national lawmakers to increase the coverage ratio for the latter ones also to at least 60%.

4. As was also to be seen in the 2019 stress test exercise, the whole DB occupational pension landscape in Europe is somewhat “unbalanced”, since roughly 70 % of DB assets are stemming from Dutch IORPs. So, it could be interesting and give additional insight, if some of the results of this stress test were shown in two versions: one including the Netherlands (NL) and one without them. This could make it more transparent, which risks and potential problems are more or less common to the majority of countries and which are more NL-specific.

5. In the OPSG´s view it is good, that EIOPA clarifies in the introduction, that the Common Balance Sheet (CBS) is more a tool to allow some degree of comparability between the results from different member states and that IORPs usually do not use this tool outside the stress test and that also legal funding requirements are NOT based on the CBS. This may be, of course, the main reason, why IORPs generally do not use the CBS as a steering tool.

6. Unfortunately Figures 2.1 and 2.2 cannot give a full economic insight into the asset allocation – and therefore into risk exposures – of IORPs and into the effects of the stress scenario on the allocation. The problem here is, that for some countries the percentage share of the category “Mixed & alternative CIUs” is relatively large (e.g. for CY and LU) and that this category itself can contain exposures to other asset classes otherwise shown in the analysis (e.g. equities, bonds, …). Maybe EIOPA can try to find out, why for such cases a look-through is not possible. Usually, the OPSG would expect, that the percentage of “non-transparent” assets not allowing any look-through should be “relatively small” (although it is clear to the OPSG, that it cannot be expected, that this percentage is zero).

7. Since roughly 70% of the DB assets are stemming from Dutch IORPs and Dutch IORPs show the most sensitive reaction to the Adverse Scenario (-14.2 %), the total average of the fall in the value of the assets for all countries excluding the Netherlands is around – 10 %, which is less than the same figure including the Netherlands, which is around -13 %. This comparison gives a feeling for the dominance of the Dutch IORPs in this analysis.

8. The climate stress scenario is in the opinion of the OPSG in general relatively plausible and in itself consistent and the results, especially the impacts on investments in Corporate Bonds and Equity (please refer to figure 2.4), are not very much surprising given the shock parameters for the different industries. However, the OPSG believes, that we should look beyond the pure numerical results and ask ourselves, what consequences could or should result out of these numbers. When doing this, the OPSG wants to give the hint, that just drawing the conclusion, that IORPs should immediately “ban” those industries experiencing the largest shocks in the scenario from their asset allocation, would be far too simple. This would lead for companies being active in these industries to increased difficulties to get financing (equity capital and debt capital). But many of these companies in fact will need

financing for transforming their businesses, processes (especially production processes) and products, so that they become more sustainable in the future (under all three aspects of ESG). Hence, any prohibitive measures against investing into these segments per se could be counter-productive under ESG-aspects. However, investing into such companies gives IORPs the possibility and responsibility to follow their transition processes and potentially to engage with them and discuss ESG matters. In this context it also should be taken into account, in how far the European society desperately needs some certain industries, services and products – at least for a transitional period.

9. Technically the climate stress scenario has been modeled as a one-time instantaneous shock event. The OPSG believes, that a scenario, in which consequences out of a materialization of climate risks develop over a multi-year-period, is much more realistic. In such a scenario IORPs also would have the possibility to take action and to react to these developments.

10. All in all, EIOPA´s analysis shows, that the percentage share of equity investments in the five most ESG sensitive industries (according to the scenario) is in total about 6 %. This figure on a stand-alone basis does not tell too much. The OPSG thinks, that it makes sense to put this figure in relation to the investment market. For example: the average weight of shares of energy companies and utilities (according to the definition of Stoxx-industries) in the EuroStoxx50 is about 10%. Before that background, the percentage share of equity investments in the five most ESG sensitive industries is not inadequately high. In light of this comparison, they in fact seem to be "underweighted". For corporate bonds, a comparison with the weight of energy and utilities in the iboxx Euro Corporates could make sense. When doing this, one finds that the percentage share of corporate bond investments in the five most ESG sensitive industries, which is slightly above 10 % (according to the EIOPA report) is just at the level of the index. For the avoidance of doubt: these facts and comparisons should not hinder any IORP from considering carefully if and to what extent amounts invested into companies belonging to these ESG sensitive industries are adequate and acceptable under responsibility aspects, risk management aspects and fiduciary duties.

11. Regarding the valuation of liabilities, the OPSG is still convinced that it is not completely methodologically correct to use a risk-free interest rate curve – not even in the case of a climate stress test. Climate-related risks are an additional source of risk, that increases risk amounts within the traditional risk categories (market risk, credit risk, operational risk). Hence, a market-consistent valuation of liabilities, as obtained using a risk-premium-augmented interest rate, seems to the OPSG more appropriate. The reason is that we assume shocks to assets refer to their market-consistent value. Additionally, from general capital market theory, an IORP earning only risk-free interest rates can be assumed to be completely hedged against such usual investment risks. Hence, theoretically such an IORP would not suffer any loss in such a risk scenario. In fact, using a risk-free rate for the

valuation of liabilities can be also one adverse scenario. Also, if the liabilities have a more conditional nature the interest rate to be used should reflect this by adding an appropriate risk premium to the risk-free rate (this would e.g. be the case for the Netherlands)

12. The OPSG appreciates, that EIOPA used a scenario, where an increase of all interest rates, which are used for the purpose of valuation of assets (incl. risk-free interest rates such as e.g. AAA-rated government bond yields or swap yields), is accompanied by a corresponding increase of the risk-free rates flowing into the valuation of liabilities (instead of using a “double dip scenario” as in the past, which is much less plausible from an economic point of view).

13. Regarding the current funding ratios in the CBS before and after stress the report differentiates only between an analysis taking all security and benefit adjustment mechanisms into account and an analysis where security as well as benefit adjustment mechanisms are not taken into account. From a beneficiary´s point of view, it would be more than interesting to see an analysis like in figures 2.11 and 2.12 taking security mechanisms (like sponsor support and pension protection schemes) into account but excluding benefit adjustment mechanisms. This would in the opinion of the OPSG be of special interest because the beneficiary would suffer in case of benefit reduction but his risk resulting out of lower funding degrees in fact is mitigated by sponsor support and/or pension protection schemes.

14. It is remarkable, that voluntary submission of additional information has only been provided by Dutch IORPs. Without speculating, one reason might have to be seen in the very special shape of the Dutch IORP landscape, which is dominated by relatively few very big IORPs. The IORP landscape in other member states is partially much more dominated by many smaller IORPs, which may not have the staff or the instruments available to provide more granular information or to do some extra analysis work additionally. In this context it should be stressed, that the level of granularity and complexity of this stress test exercise is already relatively high and has been already quite demanding for most IORPs. The OPSG would not recommend, to increase this level of granularity and complexity further. This should also be taken into account when thinking about the additional consideration of physical risks or the introduction of multiple scenarios.

15. The fact that the inclusion of ESG factors in the IORP´s investment policies has significantly grown compared to the 2019 stress test exercise resulting in 95 % of IORPs taking such factors into account is really encouraging and good news from the OPSG´s point of view!

16. EIOPA states, that IORPs using environmental stress test in their risk management seem to be more resilient to the climate change scenario. However, strictly scientifically this is only

an observed coincidence and does not constitute a scientific proof of causality between these two characteristics. Of course, it is generally not unplausible to assume, that IORPs taking ESG risks into account in their risk management could be generally more aware to a broader spectrum of risks than in "traditional" risk management and hence are – hopefully – more resilient towards such scenarios. However, this cannot be drawn from the figures in the stress test results, at least not on a strictly scientifical basis.

17. The OPSG wants to stress, that the extra administrative burden resulting out of SFDR and taxonomy disclosures for IORPs (especially for smaller and medium size ones) should not be underestimated. In some European countries many IORPs yet do not know how to manage these additional reporting requirements coming into force.

18. The grouping of sponsoring undertakings into the different NACE business activities has been an extremely difficult and time-consuming exercise for many IORPs. Additionally, often several different possibilities existed to group a certain company into a business activity. This makes comparison and interpretation of the results more difficult. However, this is not a problem, which is specially related to this stress test exercise. We know the same problem from the big equity index providers: here, it can often be observed that one (i.e., the same) company is grouped into different industries from different index providers. Moreover, for the OPSG it does not become totally clear, what the benefit of this – extremely burdensome – exercise is, and which conclusions EIOPA wants to draw out of this.

19. In assessing the IORPs' frameworks aimed at potentially mitigating the loss in purchasing powers of future retirement income resulting from higher inflation, EIOPA recalls two caveats to consider when reading the results: a) participating IORPs' might not be representative of a Member State's entire second pillar sector, which may not only include IORPs and b) some IORPs carry out cross border activities in other countries. Additionally, it would be worthwhile also to consider the weight of retirement income coming from IORPs on the overall retirement income, compared to that originated from the first pillar pensions. In many Member States, public pensions represent the bulk of retirement income. Moreover, public pensions are usually indexed to inflation.

20. EIOPA states, that on average "55 % of […] IORPs providing DB schemes offer DB benefits linked to inflation". In this context it should be mentioned that in some countries (in many cases) the legal duty for inflation adjustment is with the employer and that for that reason the IORP itself does not offer inflation adjustment (although the beneficiary gets an inflation adjustment). So, just from the fact, that an IORP does not finance any inflation adjustment, you cannot draw the conclusion, that there is none for the beneficiary. And of course, in such cases there is no need for the respective IORP to gear the investment strategy towards inflation protection.

21. EIOPA states that "only for 15% of participating IORPs offering DC schemes the benefits provided in those DC schemes are directly linked to inflation". The finding, unsurprising and largely predictable, is due to the characteristics of DC schemes, in particular pure DC schemes. However, the linkage of benefits to inflation for DC schemes seems to be a feature affecting a very few Member States (4, one of which has been classified differently compared to past stress tests) more than an EU wide feature; and only a few DC IORPs (non-pure DC) more that the entire landscape of DC schemes. For that reason, a general DB/DC comparison on that topic does not seems insightful, a comparison DB/non pure DC would be more appropriate. Of course, it does not mean that DC schemes without a link between benefits and inflation does not consider inflation risk. EIOPA states that "almost 67% of participants declared that their investment strategy is geared towards inflation protection" in some way, without distinguishing between DB and DC schemes. However, based on that percentage, it is plausible to assume that also a substantial share of DC IORPs without a link between benefits and inflation adopt an investment strategy geared towards inflation protection. An in-depth analysis on the different behaviors of DC and DB IORPs would be deemed more useful than a general one on that topic.

3. SUMMARY

22. The 2022 stress test exercise has offered interesting and additional insights into the resilience of the European occupational pensions landscape as a whole against a pre-defined climate risk scenario. In the points raised above, the OPSG has tried to give EIOPA additional hints, ideas and further "food for thought", which should be used when interpreting the results of the stress test and for the design of future stress test exercises.