



## **Frequently Asked Questions & Answers**

### **EIOPA Occupational Pensions Stress Test 2017**

#### **1. What is a stress test?**

Stress test is an important risk assessment tool. It is used by financial institutions as well as micro- and macro-prudential supervisors to explore vulnerabilities and assess the resilience of financial institutions (e.g. Institutions for Occupational Retirement Provision - IORPs) and the implications for the wider financial system and economy to severe but plausible shocks. Stress tests assess the impact of adverse scenarios, exploring a variety of risks. They provide an indication of the capacity to absorb losses on materialisation of these risks, and help to indicate areas where further supervisory actions are needed.

#### **2. What conclusions EIOPA took from the first stress test conducted in 2015 for the preparation of its second stress test? What were macro-financial developments since then?**

The first IORPs stress test conducted in 2015 showed the main vulnerabilities of the occupational pensions sector, in aggregate substantial pre- and post-stress shortfalls when comparing assets and liabilities of the DB/hybrid IORP sector. Those shortfalls would have to be covered by future sponsor support and/or benefit reductions or by future investment returns in excess of the risk-free interest rates used for valuing both the national balance sheet, where applicable, and the common balance sheet. The results of the DC satellite module demonstrated that older plan members that are close to retirement are relatively more vulnerable to an instantaneous fall in asset prices, while younger DC members are more sensitive to the low return scenarios.

The 2015 stress test report concluded that further work is needed, especially to deepen the understanding of the second round effects on the real economy and financial stability.

Since the last stress test, the external economic and financial environment for IORPs has remained challenging. Risk-free interest rates have decreased further

between end-2014 and mid-2016 with a rebound towards end-2016 albeit interest rates for the euro have not reached end-2014 levels. The situation is more profound for the British pound as yields decreased further in mid-2016 in response to the results of the European Union referendum in the United Kingdom in June 2016. The decline in nominal interest rates has been accompanied by a rise in break-even inflation rates to levels comparable to the second adverse market scenario in the 2015 stress test, implying an even more pronounced decline in real interest rates.

The lower risk-free interest rates in combination with narrowing credit spreads have resulted in higher bond prices. Also global equity prices have risen by almost 20% measured in euro and nearly 30% measured in GBP, reflecting the 10% depreciation of the pound vis-à-vis the euro since the last stress test.

### **3. What are the objectives of the second EIOPA stress test for occupational pensions?**

The main objectives of the 2017 exercise are to assess the resilience of IORPs to an adverse market scenario ('double-hit scenario'), developed in cooperation with the European Systemic Risk Board (ESRB), and to assess the transmission mechanisms of IORPs towards the real economy and financial markets ('second round' effects). The exercise will analyse how IORPs transfer shocks, resulting from the impact of the adverse market scenario, to the real economy and financial markets. Moreover, the exercise will address the expected investment behaviour of IORPs following the adverse market scenario.

### **4. Which countries will participate in the exercise and what is its market coverage?**

EIOPA's aim is to cover all the European Economic Area (EEA) countries with a material IORP sector, which is over EUR 500 million in assets and to reach a coverage rate of IORPs of at least 50% of assets of the total IORP sector per country in the EEA.

20 countries from the European Economic Area will participate in the stress test: Austria, Belgium, Cyprus, Germany, Denmark, Finland, Greece, Iceland, Ireland, Italy, Liechtenstein, Luxembourg, the Netherlands, Norway, Portugal, Slovakia, Slovenia, Spain, Sweden and the United Kingdom.

## 5. What does the stress test for occupational pensions 2017 consist of?

The stress test includes all types of IORPs, i.e. IORPs that provide defined benefit (DB) schemes, hybrid schemes and defined contribution (DC) schemes. The IORP stress test framework consists of a part for:

- IORPs providing DB and hybrid schemes, and
- IORPs providing DC schemes

The resilience of both, DB/hybrid and DC schemes and the subsequent second round effects on the real economy and financial markets will be assessed using an adverse market scenario developed in cooperation with the ESRB.

The stress scenario combines a drop in risk-free interest rates with a fall in the price of assets held by IORPs ('double-hit' scenario). It has been designed for the harmonised valuation of DB and hybrid IORPs using a common balance sheet approach and the market valuation of assets of DC IORPs.

First of all, the stress test assesses the **resilience of IORPs to the adverse market scenario**. DB/hybrid IORPs have to apply the scenario to the national balance sheet and the common, market-consistent balance sheet including all security and benefit adjustment mechanisms. **New in the 2017 exercise** is that DC IORPs have **to assess the impact of the adverse market scenario on the market value of assets**.

Secondly, the **stress test will assess the 'second round' effects on the real economy and financial markets**. The DB/hybrid-part of the exercise will analyse how the adverse market scenario impacts on sponsor support and pension benefits over time and affects sponsoring companies. The DC-part will assess the impact of the adverse market scenario on the assets of the IORP and on the retirement income of three representative plan members, which will subsequently be extrapolated to all plan members. Both the DB/hybrid and DC part of the exercise will address the expected investment behaviour of participating IORPs following the adverse market scenario.

## 6. Why do IORPs providing DB/hybrid schemes have to apply the adverse scenario to the common balance sheet?

DB/hybrid IORPs have to apply the adverse market scenario to the national balance sheet and the common balance sheet, corresponding to the common framework's balance sheet which EIOPA advised in its Opinion on a Common Framework for Risk Assessment and Transparency of IORPs.

The national balance sheet is relevant for assessing IORPs' compliance with funding requirements, but is characterised by a high degree of heterogeneity among countries. Valuation methods for the national balance sheet are country specific, being based for assets either on market or book values and for liabilities on discount rates varying between risk-free rates and expected returns on assets. Also different national funding requirements coexist as well as different prudential mechanisms are in place to deal with the funding deficits.

In order to ensure comparability of the stress test results, the adverse market scenario should also be applied to the common balance sheet based on market-consistent valuations. This is particularly relevant for liabilities as the common balance sheet uses realistic assumptions and market risk-free rate for discounting.

The common balance sheet captures future developments by including different security and benefit adjustment mechanisms. Therefore, the common balance sheet will make transparent to what extent shortfalls revealed under the baseline and adverse market scenario need to be covered by sponsor support, pension protection schemes and/or benefit reductions.

## **7. Which institutions will support EIOPA in conducting the exercise?**

The stress test is coordinated by EIOPA. It is a cooperative effort involving IORPs, National Competent Authorities (NCAs) and the ESRB.

The adverse market scenario for the stress test has been developed in close cooperation with the ESRB.

The NCAs will identify and contact participants in the test. IORPs will perform the calculations. The results will be validated by the NCAs and submitted to EIOPA for a central validation.

## **8. What is the reference time for the stress test for occupational pensions 2017?**

The reference date for the valuation of the balance sheets is end December 2016.

## **9. What are the benefits of the exercise?**

The exercise will provide up-to-date information on the risks and vulnerabilities of the European occupational pensions' sector and the propagation of the adverse scenario to the real economy and financial markets. The outcomes will allow for informed conclusions on the need for supervisory actions and/or further work within the European System of Financial Supervision, considering the stability of the financial system and the European economy.

Supervisors and IORPs will deepen their understanding of the risks to which the institution(s), sponsors and plan members are exposed as a consequence of the common, transparent, risk-sensitive methodologies used in the exercise. Moreover, supervisors and IORPs will acquire experience and insight into the operation of a market-sensitive stress test framework.

## **10. Will the results for the individual pension schemes be published?**

The stress test report will not contain data that can be linked to individual IORPs and the names of IORPs participating in the exercise will not be disclosed. While conducting its stress tests, EIOPA is looking at the pensions sector from the European and not from individual perspective.