Falco's Blog

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EIOPA's first stress test for Occupational Pensions in Europe

Recently the European Insurance and Occupational Pension Authority (EIOPA) published the results of the first stress test for pensions in Europe.

I think it is good to have these stress tests. Pensions are an activity over a very long period of time and many assumptions are made in order to produce an expected outcome. Actuaries promote and support to present the effects of adverse scenarios in addition to the expected numbers. And that is one of the main achievements of this first European stress test.

As pensions usually have a very strong base in the working relationship between employer and employees, I support the view that both employers and employees should have good information to base their decisions on. Results of a stress test are part of such information and could be used by employers and employees to analyse and discuss the characteristics of the pension deal.

Adverse situations can happen and there is benefit in analysing such potential events in order to make all stakeholders aware of what can happen and what actions could be taken.

It all starts with getting clarity about the pension deal in order to establish who will take what part of a potential burden if an adverse scenario would become reality. Trying to eliminate all risks does not make sense, as risks will always be there and are implicitly part of the deal.

It is extremely important to assess the risks right from the beginning. This has not always been done. A stress test could contribute to address these issues and to create a dialogue amongst the relevant stakeholders.

Although the supervision is on pension funds (Institutions for Occupation Retirement Provision, IORP) the remit of a stress test is wider than the pension fund and shows how the other stakeholders are affected: the sponsor, the employee, the pensioner.

EIOPA introduced a common methodology in order to facilitate comparability between Member States. I accept that the common methodology is "work in progress" but I do support EIOPA's intention to build a common framework that would objectively describe and evaluate all the building blocks of the pension deal and it's financing.

One of the important topics for further work is what discount rate to apply. EIOPA is applying a risk-free rate in all circumstances.

All conditions of a pension scheme should be included in the expected cash-flows. In order to achieve this, stochastic modelling is almost a necessity. I know from experience that most European IORPs are not (yet) using a stochastic approach. Those IORPs will likely model the expected cash-flows without including the effects of conditional terms. Only using the risk-free curve will then result in a value that is too high and as a consequence will show too high deficits. In such cases it will be necessary to add a risk premium to the risk-free curve in order to properly reflect the risks/conditions of the deal.

As a consequence the results in the EIOPA stress test report, based on the common methodology, could overstate the impact of the stress scenario.

EIOPA formulates the conclusions in terms of resilience or vulnerability of IORPs to the stressed scenarios. This might be right in some cases, but in most other situations the vulnerability rests with the beneficiaries and/or with the sponsor. I think it is very important to make that clear.

I agree with EIOPA's conclusions of the DC satellite module. EIOPA is stressing the impact for the beneficiaries and even for different groups of beneficiaries (younger and older ones). Of course this can be expected in a DC environment where all risks are born by the plan members.

I also agree with EIOPA's way forward, especially to continue to work on a common market-sensitive methodology. I would be happy to contribute to this process and have already made some suggestions in the AAE paper "Clarity before Solvency".

Finally I believe that the valuation itself could be improved. There is merit in developing more forward looking projection methods, compared to merely putting everything into one single value at the valuation date.