Selected issue 1: Background on collection of cash-flow data and questions to stakeholders

The IORPs Stress Test Report 2015 concluded that further analysis would be needed on how security and benefit adjustment mechanisms of IORPs tend to absorb adverse scenarios over time.[1] The timing of these mechanisms will largely be determined by the pension arrangements and national prudential mechanisms. As such, the analysis can be conducted by providing a qualitative overview of pension schemes and prudential regulation at the national level. In addition, it could be considered to examine the smoothing of shocks in a quantitative way by collecting data on cash-flows.

The analysis of cash-flow data will make explicit that balance sheet values for sponsor support and benefit reductions will often not have to be implemented right away as many countries dispose of mechanisms to distribute cash-flows over time, like allowing for substantial recovery periods for IORPs or making use of sponsor support where the sponsor is required to provide support directly to members and beneficiaries over the whole lifetime of the obligation. This will contribute to financial stability since sponsoring companies and household income, and hence the real economy, will not be affected immediately during stress situations. The potential downside is that necessary adjustments are postponed to an extent that they may, depending i.e. on the rules of the pension scheme, impose a disproportionate burden on younger plan members.

Although a cash-flow analysis constitutes a promising extension of the first pensions stress test exercise, a (potential) drawback is that IORPs will have to calculate/report additional data. It is important to minimise to the largest extent possible the additional burden imposed on participating IORPs.

Question to stakeholders

1) In the view of stakeholders, should the 2017 IORP stress test exercise include an analysis of cash-flows, also taking into consideration the feasibility of keeping the additional burden for IORPs at an acceptable level?

Cash-flows to be reported

The technical specifications for the common framework's balance sheet may provide a natural starting point for the collection of cash-flows in a comparable way. The specifications define the different types of benefits, security and benefit reduction mechanisms.[2] In principle, the values for all balance sheet items have to be derived as (the probability-weighted average of) discounted future cash-flows.

Questions to stakeholders:

2) For which balance sheet items should cash-flows be requested in order to allow for a meaningful analysis? Which cash-flows could be ignored or possibly combined to reduce the reporting burden on participants? Please explain.

[1] Page 8, paragraph 32.

[2] The reporting template in the 2015 stress test distinguished sponsor support (legally and not-legally enforceable), pension protection scheme, unconditional benefits (excl. DC), pure conditional benefits (excl. DC), mixed benefits, pure discretionary benefits, benefit reductions (ex ante, ex post, in case of sponsor default) and pure DC liabilities. EIOPA intends not to distinguish mixed benefits as a separate category of benefits in the 2017 stress test.

3) Should cash-flows relating to technical provisions be reported? If yes, should they be reported gross of (re-)insurance expenses? Please explain.

4) Should the cash in-flows (contributions/premiums) and cash out-flows (benefits) relating to the best estimate of technical provisions be reported separately? Please explain.

5) Should cash-flows arising from expenses be reported separately? Please explain.

Number of scenarios

IORPs that value the elements of the common framework's balance sheet using a deterministic approach will have one (central) scenario of future cash-flows. Participating IORPs could be requested to provide the deterministic scenario for the baseline balance sheet as well as the stressed balance sheet. This would allow for an analysis on how the effects of the adverse scenario are absorbed over time. IORPs performing a stochastic valuation may potentially dispose of thousands of scenarios. In EIOPA's 2016 insurance stress test as well as the regular Solvency II reporting insurers only have to provide data for the central scenario, recognising that this will not allow for a perfect reconciliation between cash-flows and the balance sheet values.

Question to stakeholders:

6) Do stakeholders agree only to request one central scenario with cash-flows in both the baseline and the adverse scenario (i.e. two in total)? If not, please explain the alternative approach.

Projection/reporting horizon

The technical specifications prescribe that the projection horizon should cover the full lifetime of all the cash in- and outflows required to settle the obligations relating to existing pension schemes/contracts on the date of the valuation, unless an accurate valuation can be achieved otherwise.[3] Under the regular Solvency II reporting, insurers have to provide cash-flow information for each year from year 1 to year 30 and aggregated for the intervals of years 31 to 40 and 41 to 50 and aggregated for all the years after year 50. In the 2016 insurance stress test, undertakings had to provide cash-flows for each year from year 1 to year 60 and aggregated for all the years after year 60.

Question to stakeholders:

7) What should the horizon be for projecting and reporting the cash-flows? Please explain your answer.

Technical specifications for cash-flow projections

The technical specifications define which benefits and contributions should be included in the cash-flows underlying the best estimate of technical provisions[4] (contract boundaries) and the payments that should be included in the cash-flows underlying the value of sponsor support.[5] Moreover, they provide guidance on the (risk-neutral) financial market

[3] HBS.5.5-HBS.5.7.
[4] HBS.5.8-HBS.5.10.
[5] HBS.7.13.

assumptions/scenarios[6] as well as pension technical risk[7] to be used in making cash-flow projections. Finally, the technical specifications contain guidance on taking into account behaviour of members/beneficiaries and/or sponsors[8], IORP management actions[9] and expert judgement.[10]

Question to stakeholders:

8) Do the technical specifications for the first stress test (and the quantitative assessment) contain adequate guidance for participating IORPs to make the cash-flow projections? If not, what additional guidance in which areas should be included?

Cash-flows unconditional benefits

The cash-flows should be consistent with the IORPs' pension schemes and national prudential regulation. IORPs will (implicitly or explicitly) dispose of cash-flow data for unconditional benefits to value technical provisions on the national balance sheet. However, these may deviate from cash-flows under the common methodology because, for example, no mortality trend is included or because of differing contract boundary definitions. Moreover, IORPs in some Member States only update cash-flow projections once every three years.

Question to stakeholders:

9) Do stakeholders have suggestions for simplifications for IORPs to project the cash-flows for unconditional benefits?

Non-unconditional benefits, security mechanisms and benefit reduction mechanisms

Non-unconditional benefits (discretionary and conditional), security mechanisms (sponsor support and pension protection schemes) and benefit reduction mechanisms (ex ante, ex post and in the event of sponsor default) are usually not explicitly valued in national balance sheets. Under EIOPA's common methodology, the valuation of many of these items does not necessarily have to be based on cash-flow projections. Benefit reductions, pension protection schemes and – under certain conditions – sponsor support may be valued using the balancing item approach. Moreover, the available simplifications for sponsor support derive its value as a function of the gap between technical provisions and financial assets.

Question to stakeholders:

10) Do stakeholders have (concrete) proposals for simplified methods and, possibly, spreadsheet tools to assists IORPs in deriving cash-flows for security and benefit reduction mechanisms?

Other suggestions

Question to stakeholders:

[6] HBS.4.10-HBS.4.16.
[7] HBS.4.17-HBS.4.21.
[8] HBS.4.22-HBS.4.25.
[9] HBS.4.26-HBS.4.31.
[10] HBS.4.32.

11) Do stakeholders have any other (concrete) suggestions on the approach to the cash-flow analysis in general or on specific issues not addressed above? Please explain.

References:

EIOPA, IORPs Stress Test Report 2015, 26 January 2016, available under https://eiopa.europa.eu/Publications/Surveys/EIOPA%20IORPs%20Stress%20Test%20Report%202015%20bookmarks.pdf

EIOPA, Technical Specifications – Quantitative Assessment of Further Work on Solvency of IORPs, EIOPA-BoS-15/070v2, available under https://eiopa.europa.eu/Publications/QIS/EIOPA-BoS-15-070v2-Technical_specifications_QA_IORPs.pdf

EIOPA, Insurance reporting template on Projection of future gross cash flows (Annex I: S.13.01.01) and additional instructions (Annex II: S.13.01), available under https://eiopa.europa.eu/Publications/Reports/Annexes%20%28clean%20printable%20A4%29%20to%20Final%20Report%20on%20CP-14-052%20ITS%20on%20regular%20supervisory%20reporting.zip

EIOPA, 2016 Insurance stress test reporting template sheets on projections of future gross cash flows in Baseline (Sheet [0.Liabilities.CF]) and Low yield scenario (Sheet [LY.Liabilities.CF]), available under https://eiopa.europa.eu/Publications/Surveys/EIOPA-16-339-ST2016_Templates_(20160629).xlsx