View of the Pensions Committee of the AAE on a Cash Flow analysis to assess the financial risks of IORPs

Short intro to Cash Flow Analysis

A cash flow analysis is an analysis of an array of numbers over a period of time (the cash-flows, such as pension payments). The analysis of such an array of numbers could provide important information on the conditions under which pension payments can always be done now and in the future. Such analysis could provide a wealth of information on possible future developments under different (stress) scenarios. A cash-flow analysis is especially useful for long-term pension promises and could include an analysis of the effects of conditional characteristics of both the pension payments as well as the assets, and also an analysis to verify that contingency arrangements are adequate in the event of employer insolvency.

Our Core Motivation to support looking into a Cash Flow Analysis is that it might support the quantitative part of the Own Risk Assessment of IORPs in assessing whether the obligations of IORPs can always be met (long-term horizon) as well as the European IORP Stress Test which focuses on both vulnerability of plan members and macro-economic impact and financial stability.

Goal of Cash Flow Analysis: to give information on the likelihood of whether a pension (insurance) promise can be met.

The goals of Solvency II and IORP II for reference and comparison:

Goal of Solvency II: to establish a single regulatory framework within the EU to protect insurers' policyholders via adequate capital and consistent risk management standards, thus ensuring that policyholder obligations are met with a very high likelihood.

Goal of IORP II Directive: to ensure a high level of protection and security for members and beneficiaries of occupational pension schemes (Recital 2); to ensure good governance, the provision of information to scheme members and the transparency and safety of occupational retirement provision (Recital 4).

Whereas

1) There is large support to develop a cash flow analysis for the assessments of risks of IORPs[1]
2) Stakeholders in the European pension industry are generally unhappy with the Common European Framework for the Assessment of Risks of IORPs as developed and used by EIOPA
3) There is no agreement on what discount rate to use (the AAE has presented its views earlier[2])

[1] EIOPA stakeholder group: OPSG Position Paper on Risk Assessment and Transparency for IORPs, Frankfurt, 16-1-2017

[2] AAE Discussion Paper 'Clarity before Solvency', May 2015 (https://actuary.eu/discussion_papers/clarity-before-solvency/)

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4) The national valuation and funding approaches are very different and there are no “pillar 1” requirements in IORP II

We summarise our current view on the development of a cash flow approach:

1. the AAE supports further exploration of cash flow analysis.
2. the AAE believes that the results of a cash flow analysis provides additional information to the results of a valuation.
3. the AAE aims to respect social character of pension arrangement
4. the AAE absolutely respects national social and labour law requirements
5. the AAE aims to produce realistic measures that may use a period to recover
6. the AAE would position such a cash flow analysis first as supporting the quantitative aspects of the Own Risk Assessment (ORA) under IORP II and second as a tool that could be used for Stress Tests on a national as well as on a European level.
    a. The ORA assesses the long-term capability of an IORP to meet its liabilities
    b. The stress test assesses the macro-economic impact and financial stability
7. the AAE sees different ways to summarise the results of a cash flow analysis:
    a. The outcome could be expressed by showing the return on investment needed in order to always meet the pension payments. The return on investment could be viewed in terms as “realistically possible” or “not feasible”
    b. The outcome could be expressed in terms of ruin theory:
        i. The length of the period that all due pensions can be paid (or how long does it take before all the assets are used for pension payments) (Time to default)
        ii. The size of the remaining due pension payments after all assets are used (Default deficit)
        iii. The number of times that not all due pension payments can be paid (Probability of default)
8. the AAE makes a concrete suggestion for a step-wise approach:
    a. Assessment without additional sponsor support or benefit reductions
    b. Identify what is needed to prevent a technical default (return on investments, additional contributions, reductions of benefits or a combination)
    c. Feed information back to sponsor and representatives of members/beneficiaries (social partners)
    d. For social partners to decide what to do (e.g. additional contributions, benefit reductions, change in investment strategy)
    e. Check solution complies with national social and labour law
    f. National supervisor to challenge the decisions made by social partners
    g. EIOPA to look at the aggregate results.
9. the AAE suggests having a committee of independent (from the pensions industry including supervisors, EU and national governments) experts to set the assumptions for the economic and demographic parameters. There are assumptions needed for at least a base scenario and an adverse scenario. Such parameters could be given as maxima or minima and don’t have necessarily to be one number or one curve. In addition to the suggested scenario sets, assumptions to incorporate ESG risks must be given.

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10. Finally, we note that a cash flow approach would also fit very well to generate relevant information on the risks that members of DC arrangements face.

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