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Position paper systemic importance of pension funds

Background

On 4 March 2015 the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) published the second consultation document Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (NBNI G-SIFIs).

In the consultation document, FSB and IOSCO propose a set of methodologies to identify systemically important financial institutions (SIFIs), whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. In the first consultative document it is stressed that the proposed methodologies are targeted at measuring the impact of the failure of a financial entity on the global financial system and wider economy, rather than the risk that a failure of an institution could occur.

On the basis of responses to the first consultative document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (2014), FSB and IOSCO propose to exclude pension funds from the scope of Global Systemically Important Financial Institutions. In the second consultation paper it is stressed that pension funds, because of their long-term investment perspective, pose low risk to global financial stability and the wider economy. Moreover, they are covered indirectly by making use of (regulated) asset managers and investment funds.

Summary

In this paper we argue that pension funds have a broad range of policy measures at their disposal to prevent insolvency and should **not** be regarded as Global Systemically Important Financial Institutions or treated as such.

Pension funds cannot go into disorderly failure, are not globally interconnected, are legally restricted from borrowing and have a long-term investment horizon. For these reasons, they pose low risk to global financial stability and the wider economy.

The focus (of IOSCO/FSB) should be on those institutions whose distress or disorderly failure would cause a significant disruption to the global financial system in order to address potential systemic risks within the financial system and reduce moral hazard.

Criteria to assess the systemic importance of institutions

FSB defines global systemically important financial institutions as 'institutions of such size, market importance, and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries'¹. In the first consultation regarding the Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, FSB and IOSCO provide a basic set of factors to identify systemically important financial Institutions. These criteria include:

1. The size of an institution and the scale of financial activity that the entity undertakes (size)
2. The extent to which the failure of distress of one institution triggers distortions on the financial system (interconnectedness)
3. The extent to which other parts of the financial system can substitute the financial services in case of failure of one institution (substitutability)
4. The complexity of financial structures and business models, relating to the complexity of resolving the failing institution (operational complexity)
5. The extent to which the institution with cross-border assets and liabilities can impact the global level (cross-jurisdictional activities).

Assessing the systemic importance of pension funds

In order to assess the systemic importance of pension funds, we identify how the situation of pension funds relates to the key criteria that can be used to identify the systemic importance of markets and institutions. First, we demonstrate that a disorderly failure is not possible for a pension fund. In addition, we argue that even if a pension fund would somehow fail, this has no significant impact on financial markets as a whole, as financial risks of pension funds are born by scheme participants and are not transferred to other players on the financial markets, which positively influences financial stability.

Financial stability is defined by the European Central Bank (ECB) as a 'condition in which the financial system – comprising of financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unraveling of imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities'.

Because of their long term liabilities, pension funds are traditionally long-term investors that invest in financial assets that support the growth of the real economy. According to the Bank of England 'long-term investment is crucial not only to long-term economic growth, but also has the potential to improve the resilience of the financial system and provide support to financial stability'². As pension funds traditionally have limited short term liquidity needs, they can invest in less liquid asset categories with higher returns for pensioners. Furthermore, pensioners cannot withdraw their assets from (DB) pension schemes at once, which makes pension funds more inclined to buy and hold assets across the economic cycle. 'As such, they might have the potential to play a stabilizing, or even countercyclical role in the financial system' according to Bank of England.

¹ FSB report 'Reducing the moral hazard posed by systemically important financial institutions FSB Recommendations and Time Lines, 2010, p.2

² Bank of England and Procyclicality Working Group Discussion Paper 'Procyclicality and structural trends in investment allocation of insurance companies and pension funds', 2014, p.47

1. Size and volume: can pension funds (be too big to) fail?

For financial entities (other than banks, insurers, investment funds, finance companies, brokers) the proposed threshold in the consultation document of IOSCO/FSB is USD 100 billion (75 billion euros) in balance sheet total assets in order to determine which institutions will be assessed in more detail to determine whether they are systemically important or not. In our view, the size of an institution and the scale of its financial activities should be viewed in relation to other critical factors such as interconnectedness and the potential impact of failure of an institution on the wider financial system. When a financial entity with a large balance sheet poses no external threat to financial stability, as there is no significant degree of financial interdependence or exposure to other market players, it should not be considered a systemically important institution. Moreover, the assets of smaller pension funds are often pooled together in an investment vehicle to profit from economies of scale. Thus, size and scale alone provide no good starting point in assessing the systemic relevance of institutions.

Contrary to large banks and insurers, which can become *too big to fail* considering the economic and social impact in case of a failure, pension funds do **not** run the risk of failure and becoming a burden on society when they end up in a situation where they can no longer live up to their liabilities. Pension funds technically cannot become insolvent as they have a broad range of policy options at their disposal to prevent insolvency and continue operating. For example by limiting indexation, increasing contributions and - in extreme cases - reducing pension entitlements. This is very different from the policy options available to for example insurance companies: the price of the insurance contract is fixed, and once the price is agreed upon there are no possibilities to raise the contributions like a pension fund can do.

Furthermore, pension funds are legally restricted in borrowing. In the IORP directive, member states are required to 'prohibit the institution from borrowing' and may authorize borrowing only for liquidity purposes and on a temporary basis³. Pension funds finance their investments with premium contributions and are not leveraged. In fact, pension funds are major providers of liquidity and collateral to the financial system, even in times of market stress.

When a large number of participants is dependent on a (future) pension income from a pension fund, a situation of underfunding could have serious repercussions for a large number of (future) pensioners. Pension entitlements can be reduced and (future) pensioners could receive a lower pension benefit than expected. It should be noted however that additional (capital-funded) pension funds merely provide supplementary pension savings in addition to existing state pension arrangements, which usually provide the basic pension income. Policymakers and supervisory authorities can support pension funds in a situation of underfunding through policy measures, for example by extending recovery periods or by influencing pension accrual through tax policy.

In the aftermath of the financial crisis, national supervisors and regulators in the European Union applied the regulatory policy framework for pension funds in a more flexible manner, in order to alleviate the burden of the global financial market crisis on the pension fund sector. During the 2008 financial crisis, even in extreme market conditions, pension funds proved to be stable to withstand large negative shocks on the global financial markets and smooth these developments over time. The first cuts in pension entitlements (in The Netherlands) were applied five years after the initial market crash. In addition, the reduction in pension entitlements was several times lower than the decline in asset prices at the time.

³ Directive 2003/41/EC (IORP directive), article 18

Pension funds, as players on the financial markets, are thus able to absorb large financial shocks and thereby contribute to the relief of stressed markets.

2. Interconnectedness with other parts of the financial system

Pension funds in Europe, as opposed to systemically important banks, are not interconnected with other pension institutions in terms of financial dependency. Banks are highly interconnected through a system of interbank loans and debt of credit institutions. When a bank can no longer live up to its liabilities, there is a risk that other banks are also not able to meet their obligations in the interbank market. Furthermore, undertakings which hold assets in the affected institution may lose their funds and consequently experience both liquidity and solvency problems which could trigger a bigger systemic crisis. Insurers – via the reinsurance market – are also directly interconnected, which could lead to contamination risks in case of a failure of an insurance company⁴.

In addition to the interconnection with other financial institutions, modern financial products such as repurchase agreements (repo's) and derivative contracts increase the interdependence between institutions on the financial markets. In the event of a crisis, counterparty risk (i.e. the risk that a counterparty cannot fulfill its obligations under the contract when they become due) may involve substantial losses that could trigger the failure of other institutions on the financial markets.

In the 2008 financial crisis, the derivative market for credit default swaps (CDS) contributed significantly to the spreading of the financial crisis through a complex web of interconnections. Factors such as inadequate collateralization, the limited use of central counterparties and the inherent ambiguity of derivatives markets, eventually led to a much higher counterparty credit risk associated with OTC derivatives than both market participants and regulators previously thought⁵.

Pension funds make use of OTC derivatives to hedge their investments risks such as interest rate risk and currency risk (exchange rate fluctuations). As players on the derivatives markets, pension funds are exposed to counterparty risk. In the event of counterparty failure, it is uncertain if a pension fund would be able to actually realize any positive value from derivatives contracts. In addition, there is concentration risk as pension funds may find themselves in a situation where they cannot replace existing counterparties because of the small number of counterparties available for certain types of derivatives.

For pensions funds, the safety of derivatives markets is thus of utmost importance when it comes to hedging investment risks.

In order to increase transparency in the derivatives market and reduce counterparty credit risk and operational risk, the European Market and Infrastructure Regulation (EMIR) was introduced in 2012. EMIR requires that all standard derivative contracts must be cleared through Central Counterparties (CCPs) and that initial and variation margins have to be posted on a bilateral basis. In addition, the capital adequacy framework for banks (CRD IV), introduces higher capital requirements for bilaterally traded OTC derivative contracts. Furthermore, reporting on derivatives transactions to centralized trade repositories is mandatory and should allow supervisory authorities to monitor the risks and exposures of major market players more effectively and intervene when necessary to avoid systemic failures⁶.

⁴ CPB Memorandum 'Systeemrisico's van Nederlandse pensioenfondsen' 2003

⁵ Commission staff working document: Economic review of the financial regulation agenda, 2014

⁶ Commission staff working document: Economic review of the financial regulation agenda, 2014

Contrary to insurance groups and conglomerates that engage in non-insurance or non-traditional activities, such as using credit default swaps (CDS) transactions for non-hedging purposes or leveraging assets, pension funds only use derivatives for hedging purposes as stipulated by the 2003 IORP directive. As stated above, pension funds are also legally restricted from borrowing. For this reason, pension funds are less likely to contribute to systemic risk than for example systemically important insurance conglomerates that engage in these activities.

3. Substitutability of key functions and services of pension funds

As discussed in the first chapter, pension funds technically cannot become insolvent as they have a broad range of policy options at their disposal to prevent a situation of failure / insolvency. For this reason, the substitutability indicator provides a bad parameter in assessing the systemic importance of pension funds. However, the services of pension funds, which broadly include asset management, pension administration, collecting contributions and paying out pensions, can largely be substituted by other pension funds or insurance companies in case of a hypothetical failure of such an institution.

In several European pension systems, participation in second pillar pension schemes is mandatory and pension contributions are locked in until the pensionable age is reached. Contrary to the banking sector, which was particularly hit during the financial crisis when the money market dried up, large withdrawals of deposits are absent in the pension sector. Even in a situation of underfunding, a pension fund can continue operating and carry out its key functions. Banks perform vital and public functions (operation of the payment system, credit creation, etc) on the financial markets which, in case of a failure, potentially cease to exist in a market economy. It is therefore of utmost importance that these services are easily substitutable in a situation of failure of a major provider of such services. Pension funds do not provide vital functions such as the infrastructure for financial payments or settlement systems.

4. Complexity in relation to the resolution of institutions

The systemic impact of a financial entity's distress or failure is expected to be positively related to its overall complexity, i.e. its business, structural and operational complexity. According to the FSB, the more complex a financial entity, the more difficult, costly and time-consuming it will be to resolve the failing institution. As we discussed in previous chapters, failure of a pension funds is very unlikely. As pension funds technically cannot become insolvent, the current (European and national) supervisory regime for pension funds is focused at preventing a situation of underfunding. When pension funds find themselves in a situation of underfunding, pension benefits can be cut as a solution of last resort in order to restore the financial position of a pension fund. Further contamination of the financial system is prevented as scheme participants can - in extreme situations - share the financial (investment) risks.

5. Cross-jurisdictional activities of pension funds

The impact of a financial institution's distress or failure is expected to vary in line with its share of cross-border assets and liabilities. According to the FSB, 'The greater the global reach of a financial entity, the more widespread the spill-over effects from its failure'⁷. For pension funds, a large share of their assets is invested cross-border from a portfolio diversification point of view. For the investment portfolio of an average Dutch pension fund, more than 75% of the assets are invested cross-border.

⁷ FSB and IOSCO, '2nd Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions', March 2015

As stated by FSB, the bigger the share of cross-border activities, the more widespread the spill-over effects from the failure of a financial institution will be. However, pension funds as end users in the global investment chain, merely bear the risks that are transferred to them by other market players, and do not add additional risks to the financial system. In fact, because of their long-term investment horizon, pension funds have the potential to improve the resilience of the financial system and financial stability. As highly creditworthy institutions pension funds have limited short term liquidity needs, which makes them more inclined to buy and hold (cross-border) assets across the economic cycle. This in turn contributes to financial stability and the resilience of financial markets as a whole.

Concluding remarks

In the first consultative document regarding the Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (NBNI G-SIFIs), it was stressed that the proposed methodologies were targeted at measuring the impact of the failure of a financial entity on the global financial system and wider economy, rather than the risk that a failure of an institution could occur. The special characteristics of a pension fund explain why pension fund supervision is merely targeted at the financial solidity of individual pension institutions and consumer protection rather than the prevention of financial instability and the minimization of systemic risk. As the risk of contamination between pension funds is totally absent, prudential requirements are targeted at enhancing the stability of individual pension funds, rather than safeguarding the financial system as a whole.

For end users such as pension funds, the safe and proper functioning of financial markets is of great importance. Systemic risk stemming from other market players should be monitored closely and managed adequately, so that pension scheme participants do not suffer potential losses due to the failure of other institutions on financial markets. Pension funds themselves, as highly creditworthy and liquid counterparties with practically no leverage, do not add to risk to the financial system as a whole, but may actually contribute to financial stability through their role as long term investors.